

City and County of Honolulu

Sewer Fund

Financial Statements

June 30, 2002 and 2001

**City and County of Honolulu
Sewer Fund**

Index of Financial Statements

	Page
Report of Independent Accountants	1
Management's Discussion and Analysis	3
Financial Statements:	
Statements of Net Assets	7
Statements of Revenues, Expenses and Changes in Fund Net Assets	8
Statements of Cash Flows	9
Notes to Financial Statements	11

Report of Independent Accountants

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, 2002 and 2001, and the related statements of revenues, expenses and changes in fund 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 report dated December 26, 2001, we expressed an opinion that, except for the effects on the financial statements for certain adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the carrying value of the inventories of materials and supplies and related expense, the fiscal 2001 financial statements fairly presented the financial position, results of operations and cash flows in conformity with accounting principles generally accepted in the United States of America. As described in Note 3, the Sewer Fund has restated its 2001 financial statements to correct the carrying value of the inventories of materials and supplies and related expense. Accordingly, our present opinion on the fiscal 2001 financial statements, as presented herein, is different from that expressed in our previous report.

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, 2002 and 2001, and the changes in financial position and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As also described in Note 3, the Sewer Fund restated its 2001 financial statements to properly include certain previously excluded capital assets owned by the Sewer Fund, together with the related depreciation expense.

As described in Note 1 to the financial statements, the Sewer Fund has implemented a new financial reporting model as required by the provisions of Governmental Accounting Standards Board Statement No. 34, "*Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*," effective July 1, 2001.

The management's discussion and analysis on pages 3 through 6 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 required supplementary information. However, we did not audit the information and express no opinion on it.

PricewaterhouseCoopers LLP

Honolulu, Hawaii
March 14, 2003

Sewer Fund City and County of Honolulu

Management's Discussion and Analysis June 30, 2002

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 ("Sewer Fund") for the fiscal year ended June 30, 2002. 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.

(All financial amounts are expressed in thousands of dollars.)

Financial Highlights

- 114.7 million gallons of wastewater were collected and treated, an increase of 3.7% over fiscal year 2001. The Wastewater Enterprise as of June 30, 2002 had approximately 136,000 customer accounts and served approximately 600,000 residents.
- Total assets were \$1,433,035 and exceeded total liabilities by \$779,380 as of June 30, 2002. Net assets (difference between assets and liabilities) decreased by \$39,039 or 4.8% over the prior fiscal year (as restated). The decrease in net assets is primarily due to operating transfers to the City and County of Honolulu's (the "City") general fund.
- Total assets increased by \$114,289 or 8.7% over the prior fiscal year (as restated). The increase is primarily due to adding capital assets in accordance with the infrastructure and facilities twenty-year capital plan.
- During fiscal 2002, certain capital assets (primarily infrastructure) were identified which should have been recorded in prior years. Accordingly, additional capital assets, net of accumulated depreciation, amounting to \$213,673 have been recorded by restating the 2001 financial statements.
- The issues relating to the 2001 inventory of material and supplies and the related expense have been resolved. The 2001 material and supplies inventory and related expense balances have been restated and were decreased by \$7,702 and \$6,263 respectively.

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

Net assets 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 \$779,380 at the end of fiscal year 2002. This represented a decrease of \$39,039 or 4.8% over the fiscal year 2001 net assets, which was attributable to increases in operating 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.

Additionally,

- Operating revenues (primarily sewer service charges) increased less than 1% to \$113,810 for the fiscal year 2002. Sewer service charge rates have not been increased since 1994.
- Operating expenses increased \$6,610 or 7.7% to \$92,738 for fiscal year 2002. The majority of the increase was due to additional depreciation expense for fixed assets recently placed in service.
- Contributed capital decreased by \$7,262 from \$9,328 in 2001 to \$2,066 in 2002. Contributed capital represents assets (primarily capital assets) transferred from other city governmental funds.
- Operating transfers of \$41,000 were made to the City's general fund for reimbursement of expenditures made in prior years by the general fund on behalf of the sewer fund.

The Wastewater Enterprise's condensed financial information (in thousands of dollars):

Net Assets

	2002	2001 (as restated)
Current and other assets	\$ 197,915	\$ 125,816
Capital assets, net	1,235,120	1,192,931
Total assets	<u>1,433,035</u>	<u>1,318,747</u>
Current liabilities	41,666	34,208
Noncurrent liabilities	611,989	466,120
Total liabilities	<u>653,655</u>	<u>500,328</u>
Invested in capital assets, net of related debt	650,381	726,116
Restricted for debt service	54,489	39,562
Unrestricted	74,510	52,471
Total net assets	<u>\$ 779,380</u>	<u>\$ 818,419</u>

Changes in Net Assets

	2002	2001 (as restated)
Operating revenues	\$ 113,810	\$ 113,041
Operating expenses	(92,738)	(86,128)
Income from operations	21,072	26,913
Nonoperating revenues (expenses):		
Interest income	4,779	7,322
Interest expense	(18,208)	(17,677)
Other	(1,753)	(207)
Income before operating transfers and contributed capital	5,890	16,351
Operating transfers out	(46,995)	(6,120)
Contributed capital	2,066	9,328
Change in net assets	<u>(39,039)</u>	<u>19,559</u>
Net assets, Beginning of Year, as previously reported	818,419	600,357
Prior period adjustment	-	198,503
Net assets, Beginning of Year, as restated	<u>818,419</u>	<u>798,860</u>
Net assets, End of Year	<u>\$ 779,380</u>	<u>\$ 818,419</u>

Capital Asset and Debt Administration

Capital assets. The Wastewater Enterprise's investment in capital assets amounted to \$1,235,120, net of accumulated depreciation, as of June 30, 2002, an increase of \$42,189 or 3.5%. Capital assets include land, buildings, infrastructure, land improvements, equipment and machinery for the eight treatment plants, sixty-eight 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. Wastewater revenue bonds outstanding as of June 30, 2002 totaled \$454,463. State revolving fund notes payable outstanding at June 30, 2002 totaled \$90,411. Wastewater revenue bonds of \$136,020 and State revolving fund notes payable of \$26,022 were issued during fiscal year 2002. Also during fiscal year 2002, tax-exempt commercial paper of \$10,183 was issued and outstanding at year-end.

Debt service coverage was 187% at June 30, 2002 and exceeded the requirements of bond covenants and policies of the City Council.

The City and County of Honolulu has ratings of Aa3 from Moody's Investor Services Inc. and AA- from Fitch Inc. for the wastewater revenue bonds.

The Wastewater Enterprise has plans to issue approximately \$200,000 in wastewater revenue bonds during fiscal year 2003. The proceeds will be used to fund the acquisition and construction of capital assets.

Additional information on the City'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.

**City and County of Honolulu
Sewer Fund**

**Statements of Net Assets
June 30, 2002 and 2001**

	2002	2001 (as restated)
Assets		
Current Assets:		
Cash and cash equivalents	\$ 25,642,906	\$ 33,973,174
Investments	142,946,421	65,276,329
Receivables –		
Accounts (net of allowance for uncollectible accounts of \$308,226 and \$302,396 in 2002 and 2001, respectively)	16,771,958	16,405,562
Interest	984,947	682,101
Due from other City funds	6,858,896	5,198,192
Inventories of materials and supplies	4,710,434	4,281,125
Total current assets	197,915,562	125,816,483
Capital Assets, Net	1,235,120,372	1,192,930,462
	\$ 1,433,035,934	\$ 1,318,746,945
Liabilities and Net Assets		
Current Liabilities:		
Accounts payable	\$ 6,554,334	\$ 10,504,560
Bonds payable	10,905,590	10,944,921
Notes payable	5,408,026	4,171,384
Tax-exempt commercial paper	10,183,484	3,199
Interest payable	8,126,580	8,226,645
Other current liabilities	487,902	357,391
Total current liabilities	41,665,916	34,208,100
Notes Payable	85,002,960	64,658,592
General Obligation Bonds Payable	67,644,502	77,418,211
Revenue Bonds Payable	453,412,890	318,442,890
Other Liabilities	5,929,076	5,599,790
Total liabilities	653,655,344	500,327,583
Commitments and Contingencies		
Net Assets:		
Invested in capital assets, net of related debt	650,381,346	726,116,190
Restricted for debt service	54,489,107	39,561,845
Unrestricted	74,510,137	52,741,327
Total net assets	779,380,590	818,419,362
	\$ 1,433,035,934	\$ 1,318,746,945

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 Fund Net Assets
For the Years Ended June 30, 2002 and 2001**

	2002	2001 (as restated)
Operating Revenues:		
Sewer service charges	\$ 112,147,942	\$ 111,554,998
Other revenue	1,662,009	1,485,629
Total operating revenues	<u>113,809,951</u>	<u>113,040,627</u>
Operating Expenses:		
Administrative and general	32,942,854	30,514,420
Depreciation	29,983,222	25,417,546
Fringe benefits	10,676,502	7,613,426
Utilities	6,753,502	7,086,589
Contractual services	6,665,001	6,806,210
Materials and supplies	3,849,583	6,393,284
Fuel and lubricants	1,641,179	1,892,963
Maintenance	226,071	403,583
Total operating expenses	<u>92,737,914</u>	<u>86,128,021</u>
Operating income	21,072,037	26,912,606
Nonoperating Revenues (Expenses):		
Interest income	4,779,138	7,321,680
Interest expense	(18,208,184)	(17,677,304)
Other	(1,752,860)	(206,520)
Total nonoperating expenses	<u>(15,181,906)</u>	<u>(10,562,144)</u>
Income before operating transfers and contributed capital	5,890,131	16,350,462
Operating Transfers Out	(46,995,060)	(6,120,000)
Contributed Capital	<u>2,066,157</u>	<u>9,328,412</u>
Change in net assets	(39,038,772)	19,558,874
Net Assets at Beginning of Year , as previously reported	818,419,362	600,357,168
Prior period adjustment	-	198,503,320
Net Assets at Beginning of Year , as restated	<u>818,419,362</u>	<u>798,860,488</u>
Net Assets at End of Year	<u>\$ 779,380,590</u>	<u>\$ 818,419,362</u>

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

**City and County of Honolulu
Sewer Fund**

**Statements of Cash Flows
For the Years Ended June 30, 2002 and 2001**

	2002	2001 (as restated)
Cash Flows from Operating Activities:		
Cash received from customers	\$ 113,200,021	\$ 112,643,177
Cash payments to suppliers for goods and services	(59,054,879)	(58,091,210)
Payments to other funds for internal activity	(1,660,703)	(3,939,008)
Other expenses	(75,436)	(109,522)
Net cash provided by operating activities	<u>52,409,003</u>	<u>50,503,437</u>
Cash Flows from Noncapital Financing Activities:		
Operating transfers out	<u>(46,995,060)</u>	<u>(6,120,000)</u>
Net cash used in noncapital financing activities	<u>(46,995,060)</u>	<u>(6,120,000)</u>
Cash Flows from Investing Activities:		
Purchase of investments	(465,309,193)	(394,295,252)
Proceeds from maturity of investments	387,639,100	413,034,669
Interest on investments	4,476,283	8,062,779
Net cash provided by (used in) investing activities	<u>(73,193,810)</u>	<u>26,802,196</u>
Cash Flows from Capital and Related Financing Activities:		
Acquisition and construction of capital assets	(71,380,176)	(64,815,349)
Proceeds from issuance of notes	26,022,039	4,904,143
Repayments on notes	(4,441,029)	(4,073,582)
Interest paid on notes	(2,572,969)	(2,346,768)
Proceeds from issuance of tax-exempt commercial paper, net	10,180,285	3,199
Proceeds from issuance of bonds, net of discount	134,067,084	-
Repayments on bonds	(10,863,040)	(9,334,524)
Interest paid on bonds	(21,562,595)	(19,011,647)
Net cash provided by (used in) capital and related financing activities	<u>59,449,599</u>	<u>(94,674,528)</u>
Net Decrease in Cash and Cash Equivalents	(8,330,268)	(23,488,895)
Cash and Cash Equivalents, beginning of year	<u>33,973,174</u>	<u>57,462,069</u>
Cash and Cash Equivalents, end of year	<u><u>\$ 25,642,906</u></u>	<u><u>\$ 33,973,174</u></u>

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

**City and County of Honolulu
Sewer Fund**

**Statements of Cash Flows (continued)
For the Years Ended June 30, 2002 and 2001**

	2002	2001 (as restated)
Cash Flows from Operating Activities:		
Operating income	\$ 21,072,037	\$ 26,912,606
Adjustments to reconcile operating income to net cash provided by operating activities –		
Depreciation expense	29,983,222	25,417,546
Write-off of capital assets	4,463,741	-
Increase in accounts receivable	(366,396)	(178,434)
Increase in due from other City funds	(1,660,704)	(3,939,008)
Increase in materials and supplies inventory	(429,309)	(555,593)
Increase (decrease) in accounts payables	(1,113,385)	2,659,391
Increase in other liabilities	459,797	186,929
	<u>52,409,003</u>	<u>50,503,437</u>
Net cash provided by operating activities	<u>\$ 52,409,003</u>	<u>\$ 50,503,437</u>

Supplemental Disclosure of Noncash Capital and Related Financing Activities:

The Sewer Fund received \$2,066,157 and \$9,328,412 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, 2002 and 2001, respectively.

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

City and County of Honolulu Sewer Fund

Notes to Financial Statements
June 30, 2002 and 2001

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. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting.* Under GASB No. 20, all applicable Financial Accounting Standards Board (“FASB”) pronouncements and Accounting Principles Board Opinions issued on or before November 30, 1989 are applied, unless those pronouncements conflict or contradict GASB pronouncements.

Effective July 1, 2001, the City adopted 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.* These Statements establish new financial reporting requirements for state and local governments. The implementation of these Statements resulted in a presentation of net assets and a management discussion and analysis section for the Fund.

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.

City and County of Honolulu

Sewer Fund

Notes to Financial Statements June 30, 2002 and 2001

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.

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	3-20

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.

City and County of Honolulu

Sewer Fund

Notes to Financial Statements June 30, 2002 and 2001

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.

Effective July 1, 2001, the City raised its equipment capitalization threshold to \$5,000 and its buildings, improvements and infrastructure threshold to \$100,000. Management believes the new capitalization threshold is more consistent with the industry standard and will lessen the administrative burden on its staff.

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 \$10.7 million and \$10.8 million at June 30, 2002 and 2001, respectively.

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 9) 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 27 years from July 1, 2002. The City is required by State statute to fund the actuarially determined pension contribution requirement annually.

City and County of Honolulu

Sewer Fund

Notes to Financial Statements June 30, 2002 and 2001

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.

It is the opinion of the City's legal counsel that the Fund has no liability for losses under the plan, but does have the duty of due care that would be required of an ordinary prudent investor.

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, 2002 and 2001, accrued vacation amounted to approximately \$5.7 million and \$5.4 million, respectively.

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, 2002 and 2001, accumulated sick leave, including vested and nonvested accumulated rights to receive sick leave benefits, amounted to \$17.1 million and \$15.5 million, respectively.

Operating Transfers

Operating 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.

3. Restatements

During 2002, a study was performed by a third party, which allowed the City to determine that inventories at June 30, 2001 and July 1, 2000 were overstated and that the amount reported as materials and supplies expense was also overstated for 2001. As a result, materials and supplies expense and the year-end inventory balances for 2001 were restated, resulting in an increase of \$6,262,665 in the changes in net assets previously reported for 2001 and a prior period adjustment of (\$13,964,720) to the 2001 beginning net assets.

City and County of Honolulu

Sewer Fund

Notes to Financial Statements June 30, 2002 and 2001

The City also identified capital assets belonging to the Sewer Fund that were erroneously recorded in the City's general fixed assets, certain assets that were required to be capitalized and certain assets acquired by contribution, which had never been recorded. Therefore, the 2001 financial statements have been restated to reflect these additional assets, related depreciation expense and contributed capital, resulting in an increase of \$1,204,467 in the changes in net assets previously reported for 2001 and a prior period adjustment of \$212,468,040 to the 2001 beginning net assets.

The total impact of these changes was an increase of \$7,467,132 in the changes in net assets previously reported for 2001 and an increase of \$198,503,320 in the July 1, 2000 net asset balances previously reported. The following balances were restated:

	As Previously Reported	Adjustments	As Restated
At June 30, 2001:			
Inventories of material and supplies	\$ 11,983,180	\$ (7,702,055)	\$ 4,281,125
Capital assets, net	979,257,955	213,672,507	1,192,930,462
Net assets, June 30, 2001	(612,448,910)	(205,970,452)	(818,419,362)
For the Year Ended June 30, 2001:			
Depreciation expense	\$ 22,024,582	\$ 3,392,964	\$ 25,417,546
Materials and supplies expense	12,655,949	(6,262,665)	6,393,284
Contributed capital	(4,730,981)	(4,597,431)	(9,328,412)
Operating income	24,092,904	2,819,702	26,912,606
Change in net assets	12,091,742	7,467,132	19,558,874
At July 1, 2000:			
Net assets, July 1, 2000	\$ (600,357,168)	\$ (198,503,320)	\$ (798,860,488)

4. 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.

5. 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 \$6.6 million and \$4.8 million at June 30, 2002 and 2001, respectively.

City and County of Honolulu Sewer Fund

Notes to Financial Statements June 30, 2002 and 2001

6. Capital Assets

The historical cost of capital assets and capital assets activity for the years ended June 30, 2002 and 2001 were as follows:

	Balance at July 1, 2001 (as restated)	Additions	Retirements/ Transfers	Balance at June 30, 2002
Depreciable Assets:				
Buildings and improvements	\$ 394,973,195	\$ 338,763	\$ (888,540)	\$ 394,423,418
Transmission and distribution system	754,020,617	33,498,414	-	787,519,031
Equipment and machinery	22,418,010	2,039,717	(4,494,856)	19,962,871
Land improvements	2,387,431	164,239	-	2,551,670
Total depreciable assets	<u>1,173,799,253</u>	<u>36,041,133</u>	<u>(5,383,396)</u>	<u>1,204,456,990</u>
Less Accumulated Depreciation:				
Buildings and improvements	(17,674,529)	(9,415,496)	104,199	(26,985,826)
Transmission and distribution system	(33,040,858)	(17,507,884)	-	(50,548,742)
Equipment and machinery	(5,877,439)	(2,975,816)	1,948,647	(6,904,608)
Land improvements	(133,977)	(83,205)	-	(217,182)
Total accumulated depreciation	<u>(56,726,803)</u>	<u>(29,982,401)</u>	<u>2,052,846</u>	<u>(84,656,358)</u>
	1,117,072,450	6,058,732	(3,330,550)	1,119,800,632
Land	5,367,575	273,387	(11,460)	5,629,502
Construction Work in Progress	70,490,437	72,243,177	(33,043,376)	109,690,238
	<u>\$ 1,192,930,462</u>	<u>\$ 78,575,296</u>	<u>\$ (36,385,386)</u>	<u>\$ 1,235,120,372</u>
	Balance at July 1, 2000 (as restated)	Additions	Retirements/ Transfers	Balance at June 30, 2001 (as restated)
Depreciable Assets:				
Buildings and improvements	\$ 385,781,264	\$ 9,191,931	\$ -	\$ 394,973,195
Transmission and distribution system	697,273,002	56,747,615	-	754,020,617
Equipment and machinery	19,673,876	2,777,820	(33,686)	22,418,010
Land improvements	2,387,431	-	-	2,387,431
Total depreciable assets	<u>1,105,115,573</u>	<u>68,717,366</u>	<u>(33,686)</u>	<u>1,173,799,253</u>
Less Accumulated Depreciation:				
Buildings and improvements	(8,330,952)	(9,343,577)	-	(17,674,529)
Transmission and distribution system	(18,071,938)	(14,968,920)	-	(33,040,858)
Equipment and machinery	(2,859,911)	(3,022,445)	4,917	(5,877,439)
Land improvements	(133,977)	-	-	(133,977)
Total accumulated depreciation	<u>(29,396,778)</u>	<u>(27,334,942)</u>	<u>4,917</u>	<u>(56,726,803)</u>
	1,075,718,795	41,382,424	(28,769)	1,117,072,450
Land	5,419,598	-	(52,023)	5,367,575
Construction Work in Progress	54,223,243	73,592,582	(57,325,388)	70,490,437
	<u>\$ 1,135,361,636</u>	<u>\$ 114,975,006</u>	<u>\$ (57,406,180)</u>	<u>\$ 1,192,930,462</u>

City and County of Honolulu

Sewer Fund

Notes to Financial Statements June 30, 2002 and 2001

7. 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 1998 in the original amount totaling \$373.7 million and maturing serially through fiscal year 2018. The general obligation bonds bear interest at rates ranging from 5.0% to 8.75% at June 30, 2002.

Wastewater system revenue bonds were issued in fiscal year 1999 in the original aggregate amount of \$319.5 million (Series 1998) and in fiscal year 2002 (Series 2001) for \$136.0 million. The 2001 and 1998 series are subject to redemption, at the option of the City, on or after July 1, 2011 and July 1, 2009, respectively. The bonds bear interest at 4.0% to 5.0% at June 30, 2002 and mature at various dates through fiscal year 2032. 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 \$90.4 million and \$68.8 million at June 30, 2002 and 2001, respectively, bearing interest ranging from 2.1% to 3.0%, and require annual principal and interest payments through fiscal year 2022.

During fiscal 2002, the City issued tax-exempt commercial paper of approximately \$10 million to refinance long-term debt. The debt bears interest ranging from 1.35% to 1.5% with maturity dates of 90 days or less.

City and County of Honolulu Sewer Fund

Notes to Financial Statements June 30, 2002 and 2001

Long-term debt activity for the years ended June 30, 2002 and 2001 were as follows:

	Balance at July 1, 2001	Additions	Reductions	Balance at June 30, 2002	Amount Due Within One Year
General obligation bonds	\$ 87,353,132	\$ -	\$ (9,853,040)	\$ 77,500,092	\$ 9,855,590
Revenue bonds	319,452,890	136,020,000	(1,010,000)	454,462,890	1,050,000
Notes payable	68,829,976	26,022,039	(4,441,029)	90,410,986	5,408,026
Tax-exempt commercial paper	3,199	10,183,484	(3,199)	10,183,484	10,183,484
Total long-term debt	\$ 475,639,197	\$ 172,225,523	\$ (15,307,268)	\$ 632,557,452	\$ 26,497,100

	Balance at July 1, 2000	Additions	Reductions	Balance at June 30, 2001	Amount Due Within One Year
General obligation bonds	\$ 96,687,656	\$ -	\$ (9,334,524)	\$ 87,353,132	\$ 9,934,921
Revenue bonds	319,452,890	-	-	319,452,890	1,010,000
Notes payable	67,999,415	4,904,143	(4,073,582)	68,829,976	4,171,384
Tax-exempt commercial paper	-	3,199	-	3,199	3,199
Total long-term debt	\$ 484,139,961	\$ 4,907,342	\$ (13,408,106)	\$ 475,639,197	\$ 15,119,504

Scheduled maturities of long-term debt is as follows:

Year ending June 30,	General Obligation Bonds	Revenue Bonds	Notes Payable	Tax-Exempt Commercial Paper	Total
2003	\$ 9,855,590	\$ 1,050,000	\$ 5,408,026	\$ 10,183,484	\$ 26,497,100
2004	9,776,284	1,095,000	5,567,160	-	16,438,444
2005	9,692,027	1,140,000	5,703,167	-	16,535,194
2006	9,612,770	3,550,000	5,839,084	-	19,001,854
2007	9,061,268	3,710,000	5,979,680	-	18,750,948
2008-2012	29,450,639	38,367,980	32,130,407	-	99,949,026
2013-2017	47,546	74,913,585	22,713,960	-	97,675,091
2018-2022	3,968	98,511,325	7,069,502	-	105,584,795
2023-2027	-	140,075,000	-	-	140,075,000
2028-2032	-	92,050,000	-	-	92,050,000
	77,500,092	454,462,890	90,410,986	10,183,484	632,557,452
Less current portion	9,855,590	1,050,000	5,408,026	10,183,484	26,497,100
	\$ 67,644,502	\$ 453,412,890	\$ 85,002,960	\$ -	\$ 606,060,352

**City and County of Honolulu
Sewer Fund**

**Notes to Financial Statements
June 30, 2002 and 2001**

8. Net Assets

At June 30, 2002 and 2001, net assets consisted of the following:

	2002	2001 (as restated)
Invested in Capital Assets, Net of Related Debt:		
Net property, plant and equipment	\$ 1,235,120,372	\$ 1,192,930,462
Less:		
Wastewater general obligation bonds payable	(77,500,092)	(87,353,132)
Wastewater system revenue bonds payable	(454,462,890)	(319,452,890)
Notes payable	(90,410,986)	(68,829,976)
Tax-exempt commercial paper	(10,183,484)	(3,199)
Amount of debt related to unspent debt proceeds	<u>47,818,426</u>	<u>8,824,925</u>
	650,381,346	726,116,190
Restricted for Debt Service	54,489,107	39,561,845
Unrestricted	<u>74,510,137</u>	<u>52,741,327</u>
 Total net assets	 <u>\$ 779,380,590</u>	 <u>\$ 818,419,362</u>

9. Employee Benefit Plans

Defined Benefit Pension Plans

Plan Description – All full-time employees of the City are eligible to participate in the Employees’ Retirement System of the State of Hawaii (“ERS”), a cost-sharing multiple-employer defined benefit pension plan. The ERS was established by Chapter 88 of the Hawaii Revised Statutes (“HRS”) and is governed by a Board of Trustees. All contributions, benefits and eligibility requirements are established by Chapter 88, HRS, 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. Both plans provide death and disability benefits and cost-of-living increases. In the contributory plan, employees may elect normal retirement at age

City and County of Honolulu

Sewer Fund

Notes to Financial Statements June 30, 2002 and 2001

55 with 5 or 10 years of credited service or elect early retirement at any age with 25 years of credited service. Such employees are entitled to retirement benefits, payable monthly for life, of 2% or 2.5% of their average final salary, as defined for each year of credited service with certain limitations. Benefits fully vest on reaching 5 years of service; retirement benefits are reduced for early retirement. In the noncontributory plan, employees may elect normal retirement at age 62 with 10 years of credited service or at age 55 with 30 years of credited service, or elect early retirement at age 55 with 20 years of credited service. Such employees are entitled to retirement benefits, payable monthly for life, of 1.25% of their average final salary, as defined, for each year of credited service. Benefits fully vest on reaching 10 years of service; retirement benefits are reduced for early retirement.

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.

Funding Policy – All funding requirements are established by Chapter 88, HRS, and can be amended by the State legislature. Covered contributory plan employees are required to contribute 7.8% or 12.2% of their salary to the plan; the City is required to contribute the remaining amounts necessary to pay contributory plan benefits when due. The City is also required to contribute all amounts necessary to pay noncontributory benefits when due. The City's contribution requirements are actuarially determined based on actuarial assumptions established by Chapter 88, HRS. The Fund's contribution to the ERS for the fiscal years ended June 30, 2002 and 2001 was \$2,900,000 and \$196,000, respectively, which was equal to the required contributions for the respective years.

Post-Retirement Health Care and Life Insurance Benefits

In addition to providing pension benefits, the State of Hawaii Public Employees Health Fund provides certain health care (medical, prescription, vision and dental) 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 expenses 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 9,124 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 \$32.1 million and \$29.0 million for the fiscal years ended June 30, 2002 and 2001, 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

City and County of Honolulu

Sewer Fund

Notes to Financial Statements June 30, 2002 and 2001

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 216 of the 2000 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 from 5 years to 19 years effective for the year ended 1999. The City's annual payments amount to \$1,070,400 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, 2002 and 2001, the remaining balance was \$9.3 million and \$9.9 million, respectively. Separate information for the Fund is not available.

10. Management Agreement

The City and County of Honolulu has 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 approximately \$100,000 per year through fiscal 2003. The fees for 2004 are subject to negotiation.

11. Commitments and Contingencies

The City has contractual commitments for the Fund of approximately \$201.1 million at June 30, 2002, primarily for construction contracts.

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 ("NPDES") 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 has also 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 7.2 dry tons

City and County of Honolulu Sewer Fund

Notes to Financial Statements June 30, 2002 and 2001

(20.1 wet tons) a 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 \$4.3 million has been paid as of June 30, 2002, 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 has not been assessed any penalties, as the specified obligations and deadlines continue to be met. The Kaneohe treatment facility has been converted into a temporary 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 cites stipulated 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 and County of Honolulu Sewer Fund

Notes to Financial Statements June 30, 2002 and 2001

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 December 31, 2003. 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. The EPA has reviewed the plan and is currently discussing it with the City. 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.

Kahuku – The State issued a notice of apparent violation resulting from discharge of chlorinated secondary filtered effluent from an effluent pipe break at the Kahuku Wastewater Treatment Plant onto private property. The City has not been assessed any penalties, however, \$750,000 in costs were incurred to construct a new line.

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.