

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

Fiscal Years Ended June 30, 2005 and 2004

**CITY AND COUNTY OF HONOLULU
SEWER FUND**

TABLE OF CONTENTS

	<u>Page</u>
INDEPENDENT AUDITORS' REPORT	3 - 4
MANAGEMENT'S DISCUSSION AND ANALYSIS	5 - 10
FINANCIAL STATEMENTS	
Statements of Net Assets	11
Statements of Revenues, Expenses and Changes in Net Assets	12
Statements of Cash Flows	13 - 14
Notes to Financial Statements	15 - 27



NISHIHAMA & KISHIDA, CPA'S, INC.
CERTIFIED PUBLIC ACCOUNTANTS

AMERICAN SAVINGS BANK TOWER
1001 BISHOP STREET, SUITE 1700
HONOLULU, HAWAII 96813-3696
TELEPHONE (808) 524-2255
FAX (808) 523-2090

INDEPENDENT AUDITORS' REPORT

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

We have audited the accompanying statement of net assets of the Sewer Fund, City and County of Honolulu (Sewer Fund) as of June 30, 2005, and the related statements of revenues, expenses and changes in net assets, and cash flows for the fiscal year then ended. These financial statements are the responsibility of the management of the Sewer Fund. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of the Sewer Fund as of June 30, 2004, were audited by other auditors whose report dated December 22, 2004, expressed an unqualified opinion on those statements.

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

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Sewer Fund as of June 30, 2005, and the changes

NISHIHAMA & KISHIDA, CPA'S, INC.
CERTIFIED PUBLIC ACCOUNTANTS

in financial position and cash flows for the fiscal year then ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis is not a required part of the basic financial statements but is supplementary information required by the Governmental Auditing Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Nishihama & Kishida, CPAs, Inc.

Honolulu, Hawaii
November 10, 2005

**City and County of Honolulu Sewer Fund
MANAGEMENT'S DISCUSSION AND ANALYSIS
Fiscal Years Ended June 30, 2005 and 2004**

The following summary discussion and analysis of the financial statements, for fiscal years ended June 30, 2005 and 2004, are provided by the City and County of Honolulu's Wastewater Enterprise. It provides an introduction to the financial statements and the financial condition of the Wastewater Enterprise. We also encourage readers to review the financial statements as a whole.

Financial Highlights

- 112.3 million gallons per day of wastewater were collected and treated in fiscal year 2005, a decrease of 8.2% from fiscal year 2004, reflecting a more normal weather pattern. There were 122.3 million gallons per day of wastewater collected and treated in fiscal year 2004, an increase of 10.4% from fiscal year 2003, reflecting significant wet weather. As of June 30, 2005, the Wastewater Enterprise had approximately 160,000 customer accounts and served approximately 640,000 residents.
- Total assets were \$1,498.8 million and exceeded total liabilities by \$655.6 million as of June 30, 2005. As of June 30, 2004, total assets were \$1,533.5 million and exceeded total liabilities by \$671.7 million. As of June 30, 2005, net assets (difference between assets and liabilities) decreased by \$16.1 million, or 2.4% from June 30, 2004, while net assets as of June 30, 2004, decreased by \$36.7 million, or 5.2%, from June 30, 2003. The decreases in net assets in 2005 and 2004 were primarily due to decreases in cash and increases in depreciation of capital assets.
- As of June 30, 2005, total assets decreased by \$34.7 million to \$1,498.8 million, representing a 2.3% decrease from the prior fiscal year, while total assets decreased by \$42.9 million to \$1,533.5 million by June 30, 2004, representing a 2.7% decrease from June 30, 2003. The decrease in fiscal year 2005 was primarily due to depreciation of capital assets. The decrease in fiscal year 2004 was primarily due to transfers to other City funds and depreciation of capital assets.
- Total current assets decreased by 67.7%, or \$101.0 million, to \$48.1 million by June 30, 2005, while current assets decreased by 42.9%, or \$111.9 million, to \$149.1 million by June 30, 2004. The decrease in 2005 was primarily due to expenditure of revenue bond proceeds 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 decreased by 3.2%, or \$1.8 million, to \$54.5 million primarily due to a reduction in accounts payable. As of June 30, 2005, total liabilities decreased 2.2%, or \$18.6 million, to \$843.2 million due to the

**City and County of Honolulu Sewer Fund
MANAGEMENT'S DISCUSSION AND ANALYSIS
Fiscal Years Ended June 30, 2005 and 2004**

repayment of long-term debt. As of June 30, 2004, total current liabilities increased by 19.3%, or \$9.1 million, to \$56.3 million primarily due to an increase in accounts payable. Total liabilities also decreased by 0.7%, or \$6.1 million, to \$861.8 million due to the repayment of long-term debt.

Overview of the Financial Statements

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

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

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

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

The statements of cash flows present 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.

**City and County of Honolulu Sewer Fund
MANAGEMENT'S DISCUSSION AND ANALYSIS
Fiscal Years Ended June 30, 2005 and 2004**

Financial Analysis

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

Net Assets

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Current and other assets	\$ 48,099	\$ 149,097	\$ 260,995
Capital assets, net	<u>1,450,690</u>	<u>1,384,386</u>	<u>1,315,361</u>
Total assets	\$ <u>1,498,789</u>	\$ <u>1,533,483</u>	\$ <u>1,576,356</u>
Current liabilities	\$ 54,492	\$ 56,276	\$ 47,178
Noncurrent liabilities	<u>788,715</u>	<u>805,550</u>	<u>820,806</u>
Total liabilities	\$ <u>843,207</u>	\$ <u>861,826</u>	\$ <u>867,984</u>
Invested in capital assets, net of related debt	\$ 648,889	\$ 638,114	\$ 625,114
Restricted for debt service	26,882	22,584	20,602
Unrestricted	<u>(20,189)</u>	<u>10,959</u>	<u>62,656</u>
Total net assets	\$ <u>655,582</u>	\$ <u>671,657</u>	\$ <u>708,372</u>

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 \$655.6 million and \$671.7 million at the end of fiscal years 2005 and 2004, respectively. Continued depreciation of capital assets and transfers to the City's general fund in fiscal year 2004 resulted in a 2.4% reduction in net assets from fiscal year 2004 to 2005 and a 5.2% reduction from fiscal year 2003 to 2004. 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 Oahu and, consequently, capital assets are not available to liquidate liabilities or other spending.

**City and County of Honolulu Sewer Fund
MANAGEMENT'S DISCUSSION AND ANALYSIS
Fiscal Years Ended June 30, 2005 and 2004**

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

Changes in Net Assets

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Operating revenues	\$ 118,893	\$ 115,032	\$ 115,747
Operating expenses	<u>(98,973)</u>	<u>(93,911)</u>	<u>(90,285)</u>
Operating income	<u>19,920</u>	<u>21,121</u>	<u>25,462</u>
Nonoperating revenues (expenses):			
Interest income	1,590	1,540	2,032
Interest expense	(27,677)	(26,573)	(35,354)
Other	<u>(4,801)</u>	<u>(3,168)</u>	<u>(4,521)</u>
	<u>(30,888)</u>	<u>(28,201)</u>	<u>(37,843)</u>
Loss before transfers and contributed capital	(10,968)	(7,080)	(12,381)
Transfers out	(6,255)	(31,078)	(59,633)
Contributed capital	<u>1,148</u>	<u>1,443</u>	<u>1,006</u>
Change in net assets	<u>(16,075)</u>	<u>(36,715)</u>	<u>(71,008)</u>
Net assets			
Beginning of Fiscal Year	<u>671,657</u>	<u>708,372</u>	<u>779,380</u>
End of Fiscal Year	\$ <u>655,582</u>	\$ <u>671,657</u>	\$ <u>708,372</u>

The changes in net assets were primarily due to:

- Operating revenues, comprised mainly of sewer service charges, increased 3.4% to \$118.9 million for fiscal year 2005 compared to the prior fiscal year and decreased 0.6% to \$115.0 million for fiscal year 2004 compared to fiscal year 2003. Sewer service charge rates have not been raised since 1994.
- Operating expenses increased \$5.1 million, or 5.4%, to \$99.0 million for fiscal year 2005 compared to the prior fiscal year and increased \$3.6 million, or 4.0%, to \$93.9 million for fiscal year 2004 compared to fiscal year 2003. The majority of the increase in 2005 was due to increases in fringe benefit costs, materials and supplies, and utilities, while the increase in 2004 was due to an increase in fringe benefit costs.
- Interest expense increased by \$1.1 million, or 4.2%, to \$27.7 million for fiscal 2005 compared to the prior fiscal year and decreased by \$8.8 million, or 24.8%, to \$26.6 million for fiscal 2004 compared to fiscal year 2003. The increase in

**City and County of Honolulu Sewer Fund
MANAGEMENT'S DISCUSSION AND ANALYSIS
Fiscal Years Ended June 30, 2005 and 2004**

2005 was due to higher interest on 2003 variable rate bonds. 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.

- Contributed capital remained generally constant at \$1 million in fiscal years 2005 and 2004. Contributed capital represents assets (primarily capital assets) transferred from other city governmental funds and other entities.
- Approximately \$6.0 million was transferred out during fiscal years 2005 and 2004 for the Wastewater Enterprise's share of central administrative expenses incurred by the City. During fiscal year 2004, an additional \$25.0 million was transferred out to reimburse expenditures made in prior fiscal 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 \$1.5 billion and \$1.4 billion, net of accumulated depreciation, as of June 30, 2005, and 2004, respectively, an increase of \$66.3 million, or 4.8%, in 2005 and \$69.0 million, or 5.2%, in 2004. Capital assets include land, buildings, infrastructure, land improvements, equipment, and machinery for the 8 treatment plants, 68 pumping stations, and over 2,100 miles of sewer line that make up the Wastewater Enterprise. Capital assets are added, rehabilitated, or replaced according to the infrastructure and facilities 20 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 \$218.4 million were issued on May 8, 2003. Revenue bonds outstanding as of June 30, 2005 and 2004 totaled \$679.4 million and \$678.8 million, respectively. State revolving fund notes payable outstanding as of June 30, 2005 and 2004 totaled \$74.1 million and \$79.9 million, respectively.

Debt service coverage was 440% on Senior Revenue Bonds, 212% on all revenue bonds, and 120% on all debt for fiscal year 2005, compared to 471% on Senior Revenue Bonds, 203% on all revenue bonds, and 147% on all debt for fiscal year 2004. Debt service coverage exceeded the requirements of bond covenants and policies of the City Council in 2005 and 2004.

The Wastewater Enterprise issued \$152.8 million in Senior Lien Wastewater Revenue Bonds in August 2005. The proceeds will be used to fund the acquisition and construction of capital assets and take out commercial paper. These insured bonds were rated Aaa by Moody's Investor Services, AAA by Fitch, Inc., and AAA by Standard & Poor's. Underlying ratings were Aa3 by Moody's Investor Services, AA- by Fitch, Inc., and AA- by Standard & Poor's.

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

**City and County of Honolulu Sewer Fund
MANAGEMENT'S DISCUSSION AND ANALYSIS
Fiscal Years Ended June 30, 2005 and 2004**

Requests for Information

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, 2005 and 2004**

	2005	2004
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$ 15,524,365	\$ 59,970,526
Investments	8,362,316	63,673,360
Receivables		
Accounts (net of allowance for uncollectible accounts of \$603,440 and \$646,073 in 2005 and 2004, respectively)	15,735,258	15,657,635
Interest	99,991	198,805
Due from other City funds	4,168,922	4,885,671
Inventories of materials and supplies	4,207,712	4,710,614
Total current assets	48,098,564	149,096,611
Capital assets, net	1,450,690,569	1,384,386,273
Total assets	\$ 1,498,789,133	\$ 1,533,482,884
LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES		
Accounts payable	\$ 12,917,615	\$ 17,391,224
Interest payable	11,830,210	11,438,310
Bonds payable	13,162,769	10,832,023
Tax-exempt commercial paper	10,021,810	10,021,810
Notes payable	5,893,627	5,756,217
Other current liabilities	666,441	836,473
Total current liabilities	54,492,472	56,276,057
LONG-TERM OBLIGATIONS		
Notes payable	68,229,803	74,123,433
General obligation bonds payable	38,811,946	48,344,034
Revenue bonds payable, net	675,817,146	677,652,164
Other liabilities	5,855,883	5,430,032
Total long-term obligations	788,714,778	805,549,663
Total liabilities	843,207,250	861,825,720
NET ASSETS		
Invested in capital assets, net of related debt	648,888,754	638,114,370
Restricted for debt service	26,882,150	22,584,211
Unrestricted	(20,189,021)	10,958,583
Total net assets	655,581,883	671,657,164
	\$ 1,498,789,133	\$ 1,533,482,884

See accompanying notes to financial statements.

City and County of Honolulu
Sewer Fund
STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS
Fiscal Years Ended June 30, 2005 and 2004

	2005	2004
OPERATING REVENUES		
Sewer service charges	\$ 112,746,081	\$ 111,886,155
Other revenue	<u>6,147,085</u>	<u>3,145,939</u>
Total operating revenues	<u>118,893,166</u>	<u>115,032,094</u>
OPERATING EXPENSES		
Depreciation	30,647,375	30,575,243
Administrative and general	30,361,702	29,989,890
Fringe benefits	11,344,034	10,347,830
Contractual services	8,836,785	8,230,622
Utilities	8,829,678	7,585,332
Materials and supplies	6,598,580	5,335,786
Fuel and lubricants	2,179,201	1,654,021
Maintenance	<u>175,808</u>	<u>192,646</u>
Total operating expenses	<u>98,973,163</u>	<u>93,911,370</u>
Operating income	<u>19,920,003</u>	<u>21,120,724</u>
NONOPERATING REVENUES (EXPENSES)		
Interest income	1,589,524	1,539,618
Interest expense	(27,676,643)	(26,572,828)
Other	<u>(4,801,592)</u>	<u>(3,168,345)</u>
Total nonoperating expenses	<u>(30,888,711)</u>	<u>(28,201,555)</u>
Loss before transfers and contributed capital	(10,968,708)	(7,080,831)
TRANSFERS OUT	(6,254,500)	(31,077,500)
CAPITAL CONTRIBUTIONS	<u>1,147,927</u>	<u>1,442,979</u>
CHANGE IN NET ASSETS	(16,075,281)	(36,715,352)
NET ASSETS AT BEGINNING OF FISCAL YEAR	<u>671,657,164</u>	<u>708,372,516</u>
NET ASSETS AT END OF FISCAL YEAR	<u>\$ 655,581,883</u>	<u>\$ 671,657,164</u>

See accompanying notes to financial statements.

**City and County of Honolulu
Sewer Fund
STATEMENTS OF CASH FLOWS
Fiscal Years Ended June 30, 2005 and 2004**

	2005	2004
Cash flows from operating activities		
Cash received from customers	\$ 118,819,491	\$ 115,481,638
Cash payments to suppliers	(32,649,942)	(30,897,787)
Cash payments to employees	(38,873,895)	(37,355,020)
Receipts (payments) to other funds for internal activity	(207,360)	20,140,069
Other revenues	65,011	30,646
Net cash provided by operating activities	47,153,305	67,399,546
Cash flows from noncapital financing activities		
Transfers out	(6,254,500)	(31,077,500)
Net cash used in noncapital financing activities	(6,254,500)	(31,077,500)
Cash flows from capital and related financing activities		
Acquisition and construction of capital assets	(93,677,053)	(92,275,668)
Proceeds from issuance of notes	--	3,013
Repayments on notes	(5,756,220)	(5,618,990)
Interest paid on notes	(2,698,616)	(2,770,920)
Proceeds from issuance of tax-exempt commercial paper, net	--	10,021,810
Proceeds from issuance of bonds, net of discount	17,431	56,311
Repayments on bonds	(10,768,773)	(10,844,070)
Interest paid on bonds	(29,298,851)	(27,070,049)
Net cash used in capital and related financing activities	(142,182,082)	(128,498,563)
Cash flows from investing activities		
Purchase of investments	(17,568,419)	(309,417,491)
Proceeds from maturity of investments	72,879,463	344,375,796
Interest on investments	1,526,072	1,642,291
Net cash provided by investing activities	56,837,116	36,600,596
Net decrease in cash and cash equivalents	(44,446,161)	(55,575,921)
Cash and cash equivalents at beginning of fiscal year	59,970,526	115,546,447
Cash and cash equivalents at end of fiscal year	\$ 15,524,365	\$ 59,970,526

**City and County of Honolulu
Sewer Fund
STATEMENTS OF CASH FLOWS (Continued)
Fiscal Years Ended June 30, 2005 and 2004**

	2005	2004
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES		
Operating income	\$ 19,920,003	\$ 21,120,724
Adjustments to reconcile operating income to net cash provided by operating activities		
Depreciation	30,647,375	30,575,243
Write-off of capital assets	375,921	218,313
(Increase) decrease in:		
Accounts receivable	(77,623)	678,600
Due from other City funds	(279,590)	20,300,212
Materials and supplies inventory	502,902	(287,434)
Increase (decrease) in:		
Accounts payable	(4,473,609)	(4,684,938)
Other liabilities	<u>537,926</u>	<u>(521,174)</u>
Net cash provided by operating activities	<u>\$ 47,153,305</u>	<u>\$ 67,399,546</u>

SUPPLEMENTAL DISCLOSURE OF NONCASH CAPITAL AND RELATED FINANCING ACTIVITIES

The Sewer Fund received \$1,147,927 and \$1,442,979 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, 2005 and 2004, respectively.

Amortization of bond discounts amounted to \$1,714,982 and \$1,633,417 in fiscal 2005 and 2004, respectively.

See accompanying notes to financial statements.

City and County of Honolulu
Sewer Fund
NOTES TO FINANCIAL STATEMENTS
June 30, 2005 and 2004

NOTE A - FINANCIAL REPORTING ENTITY

The Sewer 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 (HRS) and expended for the purposes authorized (operations of the City's wastewater system). The Sewer Fund was operated primarily through user charges. The City and County of Honolulu (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 (Sewer Fund).

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

- (1) **Basis of accounting** - The accompanying financial statements are presented using the economic resources measurement focus and the accrual basis of accounting, whereby revenues and expenses are recognized in the period earned or incurred.
- (2) **Use of estimates** - The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.
- (3) **Cash and cash equivalents** - Cash includes amounts in demand and time deposits primarily with various financial institutions in the State of Hawaii. 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.

City and County of Honolulu
Sewer Fund
NOTES TO FINANCIAL STATEMENTS
June 30, 2005 and 2004

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

- (4) **Investments** - Investments consist of U.S. government securities and are stated at cost, which approximates fair value.
- (5) **Inventories of materials and supplies** - Inventories of materials and supplies are stated at weighted average cost. The costs of inventories are recorded as expenditures when consumed rather than when purchased.
- (6) **Receivables** - Sewer service charge revenues are accrued by the City based on estimated billings for services provided through the end of the fiscal year. Estimated unbilled sewer charges amounted to approximately \$9.7 million and \$9.3 million at June 30, 2005 and 2004, respectively.
- (7) **Capital assets** - Capital assets include property, plant and equipment, including infrastructure (sewer system, network of pipes and sewer mains). Assets with an initial, individual cost of \$5,000 or more for equipment and \$100,000 for buildings, structures and infrastructure, and an estimated useful life of more that one year are capitalized. All infrastructure assets acquired prior to fiscal year ended June 30, 1980 are also capitalized. Such assets are recorded at cost or estimated cost. Interest cost is capitalized as part of the cost of acquiring certain assets.

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

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

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

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

- (8) **Bond issue costs 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.
- (9) **Refunding of debt** - The difference between the reacquisition price and the net carrying amount of the old debt is deferred and amortized as a component of interest expense in a systematic and rational manner over the remaining life of the old debt or the life of the new debt, whichever is shorter. The deferred amount is reported as a deduction from or an addition to the new debt liability.

City and County of Honolulu
Sewer Fund
NOTES TO FINANCIAL STATEMENTS
June 30, 2005 and 2004

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

- (10) **Accrued vacation** - Employees are credited with vacation at the rate of one and three-quarters working days per month. Accumulation of such vacation credits is limited to 90 days at calendar year-end and is convertible to pay upon termination of employment. Such accumulated vacation has been accrued and reflected in the statements of net assets.
- (11) **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 consists of all other net assets not included in the above categories.
- (12) **Operating revenues and expenses** - The City distinguishes operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services in connection with the Sewer Fund's principal wastewater operations. The principal operating revenues are from charges for wastewater system usage, while operating expenses include cost of services, administrative expenses and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.
- (13) **Capital contributions** - Capital contributions represent assets transferred from or constructed utilizing contributions from governmental agencies and developers and recorded at cost on the date placed in service.
- (14) **Transfers** - Transfers include authorized transfers of resources from the fund legally required to receive them to the fund through which such resources are to be expended. Transfers also include reimbursement of funds to the general fund for expenditures paid by the general fund on behalf of the Sewer Fund in prior years.
- (15) **Risk management** - The City is exposed to various risks for losses related to torts; theft of, damage to, or destruction of assets; errors or omissions; natural disasters; and injuries to employees. A liability for a claim for a risk of loss is established if the information indicates that it is probable that a liability has been incurred at the date of the financial statements and the amount of the loss is reasonably estimable.

City and County of Honolulu
Sewer Fund
NOTES TO FINANCIAL STATEMENTS
June 30, 2005 and 2004

NOTE C - CASH AND INVESTMENTS

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

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

NOTE D - CREDIT RISK

Financial instruments, which potentially expose the City to concentrations of credit risk, consist primarily of cash, investments in debt securities, and accounts receivable from customers. Cash and cash equivalents are maintained in various financial institutions in the State of 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, 2005, except as provided in the allowance for uncollectible accounts. The City manages its credit exposure through procedures designed to identify and monitor credit risk.

NOTE E - DUE FROM OTHER CITY FUNDS

Due from other City funds consists primarily of bond proceeds relating to bond issuances for the Sewer Fund held by the City's General Improvement Bond Fund of approximately \$4.1 million and \$4.9 million at June 30, 2005 and 2004, respectively.

City and County of Honolulu
Sewer Fund
NOTES TO FINANCIAL STATEMENTS
June 30, 2005 and 2004

NOTE F - CAPITAL ASSETS

The capital assets activity for the fiscal years ended June 30, 2005 and 2004, were as follows:

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

	Balance June 30, 2003	Additions	Deductions	Balance 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	<u>3,674,661</u>	<u>--</u>	<u>--</u>	<u>3,674,661</u>
Total depreciable assets	<u>1,255,382,356</u>	<u>9,650,082</u>	<u>(4,639,999)</u>	<u>1,260,392,439</u>
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	<u>(454,143)</u>	<u>(124,523)</u>	<u>--</u>	<u>(578,666)</u>
Total accumulated depreciation	<u>(114,858,381)</u>	<u>(30,575,243)</u>	<u>1,458,234</u>	<u>(143,975,390)</u>
	1,140,523,975	(20,925,161)	(3,181,765)	1,116,417,049
Land	5,840,840	14,808	--	5,855,648
Construction in progress	<u>168,996,488</u>	<u>98,582,130</u>	<u>(5,465,042)</u>	<u>262,113,576</u>
	<u>\$ 1,315,361,303</u>	<u>\$ 77,671,777</u>	<u>\$ (8,646,807)</u>	<u>\$ 1,384,386,273</u>

City and County of Honolulu
Sewer Fund
NOTES TO FINANCIAL STATEMENTS
June 30, 2005 and 2004

NOTE F - CAPITAL ASSETS (Continued)

Depreciation expense was \$30,647,375 and \$30,575,243 for the fiscal years ended June 30, 2005 and 2004, respectively.

NOTE G - LONG-TERM OBLIGATIONS

The City issues general obligation bonds for the construction of major capital facilities. The Sewer Fund's general obligation bonds are collateralized by or expected to be paid from sewer user charges. These instruments are a direct obligation of the City for which its full faith and credit is pledged. The general obligation bonds for the Sewer Fund were issued during 1992 through 2005 in the original amount totaling \$373.8 million, and maturing serially through fiscal year 2019. The general obligation bonds bear interest at rates ranging from 3.5% to 8.0% at June 30, 2005.

Wastewater system revenue bonds were issued during 1999 through 2003 in the original amount totaling \$706.1 million, less a discount (\$22.4 million at June 30, 2005, 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 2.5% to 5.5% at June 30, 2005, and mature at various dates through fiscal year 2033. The bonds are collateralized by the Sewer 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 \$74.1 million and \$79.9 million at June 30, 2005 and 2004, respectively, bearing interest ranging from 2.06% to 3.02%, and require annual principal and interest payments through fiscal year 2023.

Total interest costs incurred in 2005 and 2004 was \$34.2 million and \$31.4 million, respectively, of which \$6.5 million and \$4.8 million was capitalized in 2005 and 2004, respectively.

City and County of Honolulu
Sewer Fund
NOTES TO FINANCIAL STATEMENTS
June 30, 2005 and 2004

NOTE G - LONG-TERM OBLIGATIONS (Continued)

Long-term obligations activity for the fiscal years ended June 30, 2005 and 2004, were as follows:

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

	Balance			Amount Due	
	July 1, 2003	Additions	Reductions	Balance June 30, 2004	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 obligations	\$ 831,478,190	\$ 10,081,134	\$ (14,829,643)	\$ 826,729,681	\$ 26,610,050

Scheduled maturities of long-term debt are as follows:

	General Obligation Bonds	Revenue Bonds, Net	Notes Payable	Total Principal	Total Interest
Fiscal years ending June 30					
2006	\$ 9,612,769	\$ 3,550,000	\$ 5,893,627	\$ 19,056,396	\$ 37,370,257
2007	9,386,813	3,710,000	6,035,488	19,132,301	36,110,970
2008	8,084,586	8,775,000	6,179,904	23,039,490	35,240,340
2009	8,019,425	10,060,000	6,330,476	24,409,901	34,173,710
2010	6,955,678	12,345,000	6,482,112	25,782,790	33,045,010
2011 - 2015	6,336,576	128,171,730	29,605,734	164,114,040	127,602,171
2016 - 2020	28,868	119,298,270	13,106,332	132,433,470	137,355,906
2021 - 2025	--	171,470,000	489,759	171,959,759	81,716,996
2026 - 2030	--	188,460,000	--	188,460,000	35,459,009
2031 - 2034	--	55,945,000	--	55,945,000	3,890,609
	48,424,715	701,785,000	74,123,432	824,333,147	\$ 561,964,978
Less: Current portion	(9,612,769)	(3,550,000)	(5,893,627)	(19,056,396)	
	\$ 38,811,946	\$ 698,235,000	\$ 68,229,805	\$ 805,276,751	

City and County of Honolulu
Sewer Fund
NOTES TO FINANCIAL STATEMENTS
June 30, 2005 and 2004

NOTE H - NET ASSETS

At June 30, 2005 and 2004, net assets consisted of the following:

	2005	2004
Invested in capital assets, net of related debt		
Net property, plant and equipment	\$ 1,450,690,569	\$ 1,384,386,273
Less:		
Wastewater general obligation bonds payable	(48,424,715)	(58,036,057)
Wastewater system revenue bonds payable, net of unamortized discount	(679,367,146)	(678,792,164)
Notes payable	(74,123,430)	(79,879,650)
Tax-exempt commercial paper	(10,021,810)	(10,021,810)
Amount of debt related to unspent debt proceeds	<u>10,135,286</u>	<u>80,457,778</u>
	648,888,754	638,114,370
Restricted for debt service	26,882,150	22,584,211
Unrestricted	<u>(20,189,021)</u>	<u>10,958,583</u>
Total	\$ <u>655,581,883</u>	\$ <u>671,657,164</u>

NOTE I - EMPLOYEE BENEFIT PLANS

Defined benefit pension plan. Substantially all eligible employees of the City are members of the Employees' Retirement System of the State of Hawaii (ERS), a cost-sharing multiple-employer defined benefit pension plan. The ERS provides retirement benefits as well as death and disability benefits and is governed by a board of trustees. All contributions, benefits and eligibility requirements are established by 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 options provides for reduced benefits and covers most eligible employees hired after June 30, 1984. Employees hired before that date were allowed to continue under the contributory option or to elect the new noncontributory option and receive a refund of employee contributions. All benefits vest after five and ten years of credited service under the contributory and noncontributory options, respectively. Both options provide a monthly retirement allowance based on the employee's age, years of credited service, and average final compensation (AFC). The AFC is the average salary earned during the five highest paid years of service, including vacation payment, if the employee became a member prior to January 1, 1971. The AFC for members hired on or after that date and prior to January 1, 2003 is based on

City and County of Honolulu
Sewer Fund
NOTES TO FINANCIAL STATEMENTS
June 30, 2005 and 2004

NOTE I - EMPLOYEE BENEFIT PLANS (Continued)

the three highest paid years of service, excluding vacation payment. Effective January 1, 2003, the AFC is the highest three calendar years or highest five calendar years plus lump sum vacation payment or, highest three school contract years, or last 36 credited months or last 60 credited months plus lump sum vacation payment.

Most covered employees of the contributing option are required to contribute 7.8% or 12.2% of their salary. The City is required to contribute the remaining amounts necessary to pay contributory plan benefits and all amounts necessary to pay noncontributory benefits when due. The funding method used to calculate the total employer contribution requirement is the Entry Age Normal Actuarial Cost Method. Under this method, employer contributions to the ERS are comprised of normal cost plus level annual payments required to amortize the unfunded actuarial accrued liability over the remaining period of 29 years from July 1, 2000. The Sewer Fund's contribution to the ERS was \$4.7 million, \$4.0 million and \$2.9 million in 2005, 2004, and 2003 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 100% of these benefits for employees who have at least 10 years of service. According to Act 217, Session Laws of Hawaii 1995, employees hired after June 30, 1996 with 25 years or more of service receive 100% employer funding. The City's share of the cost of these benefits is prorated for employees with less than 25 years of service. The City also reimburses 100% of Medicare premium costs for retirees and qualified dependents (through the State) who are at least 65 years of age and have at least 10 years of service. Approximately 9,800 retirees and qualified dependents are currently receiving post retirement health care and benefits paid for by the City. The City's contributions for post retirement benefits, which are funded on a pay-as-you-go basis, amounted to approximately \$44.6 million and \$39.1 million for the fiscal years ended June 30, 2005 and 2004, respectively. Separate information for the Sewer Fund is not available.

NOTE J - MANAGEMENT AGREEMENT

The City had an agreement with the Board of Water Supply (Board) to provide certain services through June 30, 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 2005. The City and the Board are currently negotiating a new agreement for future years.

City and County of Honolulu
Sewer Fund
NOTES TO FINANCIAL STATEMENTS
June 30, 2005 and 2004

NOTE K - COMMITMENTS

Construction contracts. The City has contractual commitments for the Sewer Fund of approximately \$190 million at June 30, 2005, primarily for construction contracts.

Accumulated sick leave pay. Sick leave accumulates at the rate of one and three-quarters working days for each month, without limit. Sick leave is taken only in the event of illness and is not convertible to pay; accordingly, sick leave is not accrued. Employees who retire or leave government service in good standing with sixty or more unused sick leave days are entitled to an additional service credit in the retirement system. At June 30, 2005 and 2004, accumulated sick leave, including vested and nonvested accumulated rights to receive sick leave benefits, amounted to approximately \$17 million.

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

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.

NOTE L - LITIGATION

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

Clean water act. In 1991, the 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 has committed to spend at least \$10 million for sludge reuse. Sludge reuse is being accomplished through the U.S. Navy Biosolids Treatment Facility. The consent decree cites potential stipulated penalties of \$2,000 per day per violation for failure to comply.

City and County of Honolulu
Sewer Fund
NOTES TO FINANCIAL STATEMENTS
June 30, 2005 and 2004

NOTE L - LITIGATION (Continued)

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

Kailua and Kaneohe. As a result of a settlement reached between the parties, a consent decree has been filed for the Kailua and Kaneohe plants, which requires certain compliance actions such as developing a facilities plan, constructing a feasible ultraviolet disinfection facility and establishing and supporting an advisory council. The conceptual facilities plan and the environmental impact statement preparation notice were completed in September 1998. The design phase of the ultraviolet disinfection project was completed in October 1998. Responses to public comments were completed in June 1999. The City contracted a construction company to complete the construction phase for approximately \$2.3 million, which was completed in November 2000. Approximately \$5.5 million has been paid as of June 30, 2005, 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, and has dispersed all funds to the Kailua Bay Advisory Council.

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

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

City and County of Honolulu
Sewer Fund
NOTES TO FINANCIAL STATEMENTS
June 30, 2005 and 2004

NOTE L - LITIGATION (Continued)

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 2002. That facility is still under construction and is currently estimated to be completed in 2006. In October 2002, the EPA identified that the Sand Island plant violated certain discharge limits and ordered the City to stop discharge violations at the Sand Island plant and to submit a plan by December 1, 2002, to bring the facility into continuous compliance with its EPA permit. The City submitted the required plan and compliance schedule on November 29, 2002. Upon review by the EPA, the City submitted a revised plan on May 1, 2003, which is still subject to the EPA's final approval.

Honouliuli. The Honouliuli wastewater treatment plant operates under a 301(h) waiver permit issued by EPA. The current permit was issued June 1991. In September 2003, EPA identified that the Honouliuli plant violated certain permit conditions pertaining to the plant return streams, effluent flow meter and sampler, storm water pollution control plan, discharge monitoring reports, and improper discharge through the sewage outfall. The City has responded to the order and corrected items regarding plant return flow streams, effluent flow meter and sampler, and the storm water pollution control plan. Other items are still under discussion with EPA.

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

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

City and County of Honolulu
Sewer Fund
NOTES TO FINANCIAL STATEMENTS
June 30, 2005 and 2004

NOTE L - LITIGATION (Continued)

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

NOTE M - SUBSEQUENT EVENT

In August 2005 the City issued Series 2005A and Series 2005B wastewater system revenue bonds in the aggregate amount of \$152.8 million. The bonds bear interest rates of 3.2% to 5% and mature annually on July 1, 2010 through 2025, then on July 1, 2030 and July 1, 2035. The bonds maturing after July 1, 2015 are subject to redemption at the option of the City, in whole or in part at any time, from any maturity. Proceeds from the bonds will be used to fund the cost of certain additions and improvements to the wastewater system of the City, a common reserve account and current refunding of certain tax exempt commercial paper.