

**City and County of Honolulu
Sewer Fund
Financial Statements
June 30, 2011 and 2010**

**City and County of Honolulu
Sewer Fund
Index
June 30, 2011 and 2010**

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Report of Independent Auditors

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 City and County of Honolulu, Sewer Fund ("Sewer Fund"), as of June 30, 2011 and 2010, and the related statements of revenues, expenses and change in net assets and cash flows for the years then ended. These financial statements are the responsibility of the management of the Sewer Fund. Our responsibility is to express an opinion on these financial statements based on our audits.

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

As discussed in Note 1, 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, 2011 and 2010, and the changes in its financial position and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Sewer Fund as of June 30, 2011 and 2010, and the changes in its financial position and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The management discussion and analysis on pages 2 through 5 and schedule of funding progress on page 22 are not a required part of the basic financial statements but are 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 we express no opinion on it.

Acuity LLP

Honolulu, Hawaii
November 29, 2011

City and County of Honolulu

Sewer Fund

Management's Discussion and Analysis

June 30, 2011 and 2010

The following summary discussion and analysis of the financial statements for the fiscal years ended June 30, 2011 and 2010 are provided by the City and County of Honolulu's wastewater enterprise ("Wastewater Enterprise"). The summary is designed to provide an introduction to the financial statements and the financial condition of the Wastewater Enterprise. We encourage readers to also review the financial statements as a whole.

Financial Highlights

- 105 million gallons per day of wastewater were collected and treated in fiscal year 2011, approximately the same amount as in fiscal year 2010, when there were 105.6 million gallons per day of wastewater collected and treated, an increase of 2.5% from fiscal year 2009. As of June 30, 2011, the Wastewater Enterprise had approximately 144,100 customer accounts and served approximately 640,000 residents.
- Total assets were \$2,847.6 million and exceeded total liabilities by \$1,038.5 million as of June 30, 2011. As of June 30, 2010, total assets were \$2,515.0 million and exceeded total liabilities by \$908.8 million. As of June 30, 2011, net assets (difference between assets and liabilities) increased by \$129.8 million or 14.3% from June 30, 2010, while net assets at June 30, 2010, increased by \$108.2 million or 13.5% from June 30, 2009. The increases in net assets in 2011 and 2010 were primarily due to the operating income generated.
- As of June 30, 2011, total assets increased by \$332.6 million to \$2,847.6 million, representing a 13.2% increase from the prior fiscal year, while total assets increased by \$250.8 million to \$2,515.0 million at June 30, 2010, representing a 11.1% increase from June 30, 2009. The increases in fiscal years 2011 and 2010 were due to additional capital assets and increased cash.
- Total current assets increased by 41.1% or \$187.9 million to \$645.7 million at June 30, 2011, while current assets increased by 19.3% or \$74.1 million to \$457.8 million at June 30, 2010. The increase in 2011 was primarily due to the addition of revenue bond proceeds and increased sewer service charge revenues. The increase in 2010 was primarily due to the addition of revenue bond proceeds.
- Total current liabilities increased by 14.1% or \$14.1 million to \$113.8 million primarily due to an increase in interest payable and bonds payable. At June 30, 2011, total liabilities increased 12.6% or \$202.8 million to \$1,809.0 million due to an increase in notes payable and bonds payable. At June 30, 2010, total current liabilities increased by 11.5% or \$10.3 million to \$99.7 million primarily due to an increase in notes payable and bonds payable. At June 30, 2010, total liabilities increased 9.7% or \$142.6 million to \$1,606.2 million due to an increase in notes payable and bonds payable.

Overview of the Financial Statements

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

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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 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 change 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.

Financial Analysis

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

Statements of Net Assets

	2011	2010	2009
Current assets	\$ 645,710	\$ 457,777	\$ 383,718
Capital assets, net	2,191,602	2,048,617	1,873,157
Other noncurrent assets	10,264	8,591	7,339
Total assets	<u>\$ 2,847,576</u>	<u>\$ 2,514,985</u>	<u>\$ 2,264,214</u>
Current liabilities	\$ 113,773	\$ 99,684	\$ 89,378
Noncurrent liabilities	1,695,265	1,506,529	1,374,261
Total liabilities	<u>1,809,038</u>	<u>1,606,213</u>	<u>1,463,639</u>
Invested in capital assets, net of related debt	591,927	586,031	574,370
Restricted for debt service	158,662	144,307	131,469
Unrestricted	287,949	178,434	94,736
Total net assets	<u>1,038,538</u>	<u>908,772</u>	<u>800,575</u>
Total liabilities and net assets	<u>\$ 2,847,576</u>	<u>\$ 2,514,985</u>	<u>\$ 2,264,214</u>

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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 \$1,038.5 million and \$908.8 million at the end of fiscal year 2011 and 2010, respectively. Addition of capital assets resulted in a 14.3% increase in net assets from June 30, 2010 to June 30, 2011. The largest portion of the Wastewater Enterprise's net assets represented its investment in capital assets (e.g., land, buildings, transmission and distribution system, etc.). The Wastewater Enterprise uses these capital assets to provide wastewater services on the Island of Oahu and consequently, capital assets are not available to liquidate liabilities or other spending.

The following are the highlights of the condensed statements of revenues, expenses and change in net assets (in thousands of dollars):

Statements of Revenues, Expenses and Change in Net Assets

	2011	2010	2009
Operating revenues	\$ 347,038	\$ 308,407	\$ 251,953
Operating expenses	<u>(162,579)</u>	<u>(153,680)</u>	<u>(130,346)</u>
Operating income	184,459	154,727	121,607
Nonoperating revenues (expenses)			
Interest income	1,082	957	7,080
Interest expense	(50,832)	(43,555)	(45,269)
Other	<u>3,786</u>	<u>(409)</u>	<u>(3,329)</u>
Income before transfers and capital contributions	138,495	111,720	80,089
Transfers out	(9,552)	(9,485)	(12,931)
Capital contributions	<u>823</u>	<u>5,962</u>	<u>5,677</u>
Change in net assets	129,766	108,197	72,835
Net assets			
Beginning of year	<u>908,772</u>	<u>800,575</u>	<u>727,740</u>
End of year	<u>\$ 1,038,538</u>	<u>\$ 908,772</u>	<u>\$ 800,575</u>

The change in net assets was primarily due to:

- Operating revenues, comprised mainly of sewer service charges, increased 12.5% to \$347.0 million for fiscal year 2011 compared to the prior fiscal year and increased 22.4% to \$308.4 million for fiscal year 2010 compared to fiscal year 2009. Sewer service charge rates were raised 15% at July 1, 2010.
- Operating expenses increased \$8.9 million or 5.8% to \$162.6 million for fiscal year 2011 compared to the prior fiscal year and increased \$23.3 million or 17.9% to \$153.7 million for fiscal year 2010 compared to fiscal year 2009. The primary increase in 2011 was in depreciation, contractual services, and utilities. The primary increase in 2010 was in fringe benefits and administration and general.

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Management's Discussion and Analysis

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- Interest expense increased by \$7.3 million or 16.7% to \$50.8 million for fiscal 2011 compared to the prior fiscal year and decreased by \$1.7 million or 3.8% to \$43.6 million for fiscal 2010 compared to fiscal year 2009. The increase in 2011 was due to the issuance of additional revenue bonds and the decrease in 2010 was due to the refinancing of selected outstanding revenue bonds.
- Capital contributions decreased to \$0.8 million in fiscal year 2011 down from \$6.0 million in fiscal year 2010 and \$5.7 million in fiscal year 2009. Capital contributions represent assets (primarily capital assets) transferred from other City governmental funds and other entities. Approximately \$9.6 million and \$9.5 million was transferred out during fiscal years 2011 and 2010, respectively, for the Wastewater Enterprise's share of central administrative expenses incurred by the City.

Capital Asset and Debt Administration

Capital assets. The Wastewater Enterprise's capital assets amounted to \$2.2 billion and \$2.1 billion, net of accumulated depreciation, as of June 30, 2011 and 2010, respectively, an increase of \$143.0 million or 7.0% in 2011 and \$175.5 million or 9.4% in 2010. Capital assets include land, buildings, infrastructure, land improvements, equipment and machinery for the 9 treatment plants, 68 pumping stations, and over 2,100 miles of sewer line that makes up the Wastewater Enterprise. Capital assets are added, rehabilitated or replaced according to the infrastructure and facilities twenty-year capital plan.

Long-term debt. Wastewater revenue bonds and State revolving fund loans are the primary long-term financing instruments used to fund the acquisition and construction of capital assets. Revenue bonds outstanding as of June 30, 2011 and 2010 totaled \$1,508.6 million and \$1,320.9 million, respectively. State revolving fund notes payable outstanding at June 30, 2011 and 2010 totaled \$200.4 million and \$193.1 million, respectively.

Debt service coverage was 376% on Senior Revenue Bonds, 280% on all revenue bonds, and 218% on all debt at June 30, 2011, compared to 426% on Senior Revenue Bonds, 288% on all revenue bonds, and 218% on all debt at June 30, 2010. Debt service coverage exceeded the requirements of bond covenants and policies of the City Council in 2011 and 2010.

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

Requests for Information

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

**City and County of Honolulu
Sewer Fund
Statements of Net Assets
June 30, 2011 and 2010
(Amounts in thousands)**

	2011	2010
Assets		
Current assets		
Cash and cash equivalents	\$ 528,697	\$ 388,640
Investments	53,009	12,707
Receivables		
Accounts, net of allowance for uncollectible accounts of \$1,922 in 2011 and \$1,561 in 2010	48,596	41,088
Interest	73	45
Employee advances	1,205	1,269
Due from other City funds	1,015	1,027
Inventories of materials and supplies	11,040	11,021
Prepaid expenses	2,075	1,980
Total current assets	<u>645,710</u>	<u>457,777</u>
Capital assets, net	2,191,602	2,048,617
Deferred charges	10,264	8,591
Total assets	<u>\$ 2,847,576</u>	<u>\$ 2,514,985</u>
Liabilities and Net Assets		
Current liabilities		
Accounts payable	\$ 26,420	\$ 24,472
Due to other City funds	3,855	3,532
Interest payable	35,185	30,146
Bonds payable	29,653	24,262
Notes payable	16,900	15,365
Accrued payroll	1,423	1,552
Other current liabilities	337	355
Total current liabilities	<u>113,773</u>	<u>99,684</u>
Notes payable	183,492	177,738
General obligation bonds payable, net	63	1,276
Revenue bonds payable, net	1,480,176	1,301,853
Other liabilities	31,534	25,662
Total liabilities	<u>1,809,038</u>	<u>1,606,213</u>
Commitments and contingencies		
Net assets		
Invested in capital assets, net of related debt	591,927	586,031
Restricted for debt service	158,662	144,307
Unrestricted	287,949	178,434
Total net assets	<u>1,038,538</u>	<u>908,772</u>
Total liabilities and net assets	<u>\$ 2,847,576</u>	<u>\$ 2,514,985</u>

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

City and County of Honolulu
Sewer Fund
Statements of Revenues, Expenses and Change in Net Assets
Years Ended June 30, 2011 and 2010
(Amounts in thousands)

	2011	2010
Operating revenues		
Sewer service charges	\$ 343,660	\$ 299,502
Other revenue	3,378	8,905
Total operating revenues	<u>347,038</u>	<u>308,407</u>
Operating expenses		
Depreciation	47,321	42,281
Administrative and general	43,529	45,490
Contractual services	22,041	16,223
Utilities	20,213	16,719
Fringe benefits	16,652	21,196
Materials and supplies	11,028	9,625
Fuel and lubricants	1,341	1,769
Maintenance	454	377
Total operating expenses	<u>162,579</u>	<u>153,680</u>
Operating income	184,459	154,727
Nonoperating revenues (expenses)		
Interest income	1,082	957
Interest expense	(50,832)	(43,555)
Other	3,786	(409)
Total nonoperating expenses	<u>(45,964)</u>	<u>(43,007)</u>
Income before transfers and capital contributions	138,495	111,720
Transfers out	(9,552)	(9,485)
Capital contributions	<u>823</u>	<u>5,962</u>
Change in net assets	129,766	108,197
Net assets		
Beginning of year	<u>908,772</u>	<u>800,575</u>
End of year	<u>\$ 1,038,538</u>	<u>\$ 908,772</u>

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

City and County of Honolulu
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Statements of Cash Flows
Years Ended June 30, 2011 and 2010
(Amounts in thousands)

	2011	2010
Cash flows from operating activities		
Cash received from customers	\$ 339,139	\$ 302,107
Cash payments to suppliers	(61,846)	(61,705)
Cash payments to employees	(45,112)	(50,278)
Net cash provided by operating activities	<u>232,181</u>	<u>190,124</u>
Cash flows from noncapital financing activities		
Transfers out	<u>(9,552)</u>	<u>(9,485)</u>
Net cash used in noncapital financing activities	<u>(9,552)</u>	<u>(9,485)</u>
Cash flows from capital and related financing activities		
Acquisition and construction of capital assets	(174,305)	(200,273)
Proceeds from issuance of notes	22,991	49,147
Repayments on notes	(15,702)	(13,354)
Interest paid on notes	(2,747)	(2,048)
Proceeds from issuance of bonds, net of discount	310,972	288,034
Proceeds from grant funding	-	8,626
Repayments on bonds	(126,902)	(195,545)
Interest paid on bonds	(61,728)	(53,129)
Interest subsidies for wastewater system revenue bonds	4,098	1,309
Net cash used in capital and related financing activities	<u>(43,323)</u>	<u>(117,233)</u>
Cash flows from investing activities		
Purchase of investments	(524,371)	-
Proceeds from maturity of investments	484,069	-
Interest on investments	1,053	937
Net cash provided by (used in) investing activities	<u>(39,249)</u>	<u>937</u>
Net increase in cash and cash equivalents	140,057	64,343
Cash and cash equivalents		
Beginning of year	<u>388,640</u>	<u>324,297</u>
End of year	<u>\$ 528,697</u>	<u>\$ 388,640</u>

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

**City and County of Honolulu
Sewer Fund
Statements of Cash Flows
Years Ended June 30, 2011 and 2010
(Amounts in thousands)**

	2011	2010
Reconciliation of operating income to net cash provided by operating activities		
Operating income	\$ 184,459	\$ 154,727
Adjustments to reconcile operating income to net cash provided by operating activities		
Depreciation	47,321	42,281
Change in		
Accounts receivable	(7,493)	(7,806)
Due from other City funds	12	90
Prepaid expenses	(95)	(85)
Inventories of materials and supplies	(19)	(1,896)
Accounts payable	1,948	(6,243)
Due to other City funds	323	3,532
Other liabilities	5,725	5,524
Net cash provided by operating activities	<u>\$ 232,181</u>	<u>\$ 190,124</u>

Supplemental disclosure of noncash capital and related financing activities

The Sewer Fund received \$0.8 million and \$6.0 million in contributions of capital assets from government agencies and developers, which are recorded as capital contributions at their cost or estimated cost at June 30, 2011 and 2010, respectively.

Amortization of net bond premiums and discounts amounted to \$1.6 million and \$1.0 million in fiscal 2011 and 2010, respectively. Amortization of bond issue costs amounted to \$0.9 million and \$0.8 million in fiscal 2011 and 2010, 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, 2011 and 2010

1. Financial Reporting Entity

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

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

2. Summary of Significant Accounting Policies

Financial Statement Presentation

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 Financial Accounting Standards Board ("FASB") pronouncements on accounting and financial reporting that were issued after November 30, 1989.

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.

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.

Cash and Cash Equivalents

Cash includes amounts in demand and time deposits primarily with various financial institutions in the State of Hawaii ("State"). Cash on deposit with financial institutions is collateralized in accordance with State statutes. Investments with original maturity of three months or less when purchased are considered cash equivalents.

Investments

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

Inventories of Materials and Supplies

Inventories of materials and supplies are stated at weighted average cost. The costs of inventories are recorded as expenditures when consumed rather than when purchased.

City and County of Honolulu
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Receivables

Sewer service charge revenues are accrued by the City based on estimated billings for services provided through the end of the fiscal year. Receivables included estimated unbilled sewer charges amounting to approximately \$22.8 million and \$22.6 million at June 30, 2011 and 2010, respectively.

Capital Assets

Capital assets include property, plant and equipment, including infrastructure (sewer system, network of pipes and sewer mains). Assets with an initial individual cost of \$5,000 or more for equipment and \$100,000 for buildings, structures and infrastructure, and an estimated useful life of more than one year are capitalized. 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.

Bond Issue Costs

Bond issue costs are deferred and are amortized over the life of the respective issue on a straight-line basis.

Original Issue Discounts or Premiums

Original issue discounts or premiums on bonds are amortized ratably over the terms of the respective issues and are offset against the bonds payable in the statements of net assets.

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.

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.

City and County of Honolulu
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Net Assets

Net assets are comprised of the accumulated income from operating and nonoperating revenues, expenses, operating transfers and capital contributions. Net assets are classified in the following three components: invested in capital assets, net of related debt; restricted for debt service; and unrestricted net assets. Invested in capital assets, net of related debt, consists of capital assets, net of accumulated depreciation and is reduced by outstanding debt that is attributable to the acquisition, construction or improvement of those assets. Debt related to unspent proceeds or other restricted cash and investments at fiscal year-end are not included in the calculation of the amount invested in capital assets, net of related debt. Restricted for debt service consists of net assets for which constraints are placed thereon by external parties, such as lenders, grantors, contributors, laws, regulations and enabling legislation, including self-imposed legal mandates. Unrestricted net assets consist of all other net assets not included in the above categories. When an expense is incurred for purposes for which both restricted and unrestricted net assets are available, restricted resources are applied first, then unrestricted resources as they are needed.

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.

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.

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 City's General Fund for expenditures paid by the general fund on behalf of the Sewer Fund in prior fiscal years.

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.

New Accounting Pronouncements

In December 2010, the GASB issued Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*. The objective of this Statement is to enhance the usefulness of the Codification of Governmental Accounting and Financial Reporting Standards by incorporating guidance that previously could only be found in certain FASB and American Institute of Certified Public Accountants pronouncements. The requirements of this Statement are effective for reporting periods beginning after December 15, 2011. The City does not expect that this Statement will have a material effect on the Sewer Fund's financial statements.

City and County of Honolulu
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3. 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 substantially used by 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, which is disclosed in the City's Comprehensive Annual Financial Report ("CAFR") available at City's website: <http://www1.honolulu.gov/budget/cafr.htm>.

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.

4. Credit Risk

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

Investments include \$12.7 million with FSA Capital Management LLC at June 30, 2011 and 2010. The remaining balance at June 30, 2011 is invested in the City's pooled investment fund.

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, 2011, except as provided in the allowance for uncollectible accounts. The City manages its credit exposure through procedures designed to identify and monitor credit risk.

5. Due From and Due To 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 \$1.0 million at June 30, 2011 and 2010. Due to other City funds consists primarily of the Sewer Fund's share of retirement plan contributions for the second half of fiscal years 2011 and 2010.

**City and County of Honolulu
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Notes to Financial Statements
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6. Capital Assets

The capital assets activity for the years ended June 30, 2011 and 2010 were as follows (in thousands of dollars):

	Balance at July 1, 2010	Additions	Retirements/ Transfers	Balance at June 30, 2011
Depreciable assets				
Buildings and improvements	\$ 792,663	\$ 74,446	\$ -	\$ 867,109
Transmission and distribution system	1,104,257	142,428	(860)	1,245,825
Equipment and machinery	38,819	4,990	(1,712)	42,097
Land improvements	3,511	-	-	3,511
Total depreciable assets	1,939,250	221,864	(2,572)	2,158,542
Less: Accumulated depreciation				
Buildings and improvements	(130,984)	(18,962)	-	(149,946)
Transmission and distribution system	(205,902)	(24,765)	310	(230,357)
Equipment and machinery	(22,026)	(3,475)	325	(25,176)
Land improvements	(1,280)	(119)	-	(1,399)
Total accumulated depreciation	(360,192)	(47,321)	635	(406,878)
	1,579,058	174,543	(1,937)	1,751,664
Land	6,292	26,778	-	33,070
Construction in progress	463,267	147,290	(203,689)	406,868
	<u>\$ 2,048,617</u>	<u>\$ 348,611</u>	<u>\$ (205,626)</u>	<u>\$ 2,191,602</u>
	Balance at July 1, 2009	Additions	Retirements/ Transfers	Balance at June 30, 2010
Depreciable assets				
Buildings and improvements	\$ 783,081	\$ 9,582	\$ -	\$ 792,663
Transmission and distribution system	1,016,907	90,700	(3,350)	1,104,257
Equipment and machinery	33,134	5,986	(301)	38,819
Land improvements	3,511	-	-	3,511
Total depreciable assets	1,836,633	106,268	(3,651)	1,939,250
Less: Accumulated depreciation				
Buildings and improvements	(113,652)	(17,332)	-	(130,984)
Transmission and distribution system	(183,811)	(22,244)	153	(205,902)
Equipment and machinery	(19,562)	(2,586)	122	(22,026)
Land improvements	(1,161)	(119)	-	(1,280)
Total accumulated depreciation	(318,186)	(42,281)	275	(360,192)
	1,518,447	63,987	(3,376)	1,579,058
Land	6,101	195	(4)	6,292
Construction in progress	348,609	190,944	(76,286)	463,267
	<u>\$ 1,873,157</u>	<u>\$ 255,126</u>	<u>\$ (79,666)</u>	<u>\$ 2,048,617</u>

Depreciation expense was \$47.3 million and \$42.3 million for the years ended June 30, 2011 and 2010, respectively.

City and County of Honolulu
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Notes to Financial Statements
June 30, 2011 and 2010

7. 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 fiscal years 1993 through 2010 in the original amount totaling \$281.8 million, and maturing serially through fiscal year 2021. The general obligation bonds bear interest at rates ranging from 3.5% to 8.0% at June 30, 2011.

Wastewater system revenue bonds in the City's business-type activities were issued during fiscal years 1999 through 2011, in the original amount totaling \$1.9 billion, less discounts of \$35.9 million and adjusted for premiums of \$56.7 million, which are being amortized over the related term of the bonds. The bonds bear interest at 2.0% to 6.3% at June 30, 2011 and mature at various dates through fiscal year 2046. The wastewater system revenues collateralize the revenue bonds.

In November 2010, the City issued wastewater system revenue bonds, Senior Series 2010A, and 2010B Build America Bonds, in the aggregate amount of \$204.4 million, and Junior Series 2010A of \$100.8 million. The bonds mature annually on July 1, 2011 through July 1, 2041 and bear interest at 2.0% to 6.3%. The bonds maturing on and after July 1, 2020 are subject to redemption by the City on or after July 1, 2019, in whole or in part at any time, from any maturity. The proceeds from the bonds will be used to pay for the cost of certain additions and improvements to the wastewater system, to fund a common reserve account and to refund certain City wastewater system revenue bonds.

The notes payable to the State are for the construction of necessary treatment works and for other projects intended for wastewater reclamation or waste management. The notes amounted to \$200.4 million and \$193.1 million at June 30, 2011 and 2010, respectively, bearing interest ranging from 0.75% to 4.02%, and require annual principal and interest payments through fiscal year 2028.

Total interest costs incurred in 2011 and 2010 were \$65.7 million and \$58.0 million, respectively, of which \$14.9 million and \$14.5 million was capitalized in 2011 and 2010, respectively.

City and County of Honolulu
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June 30, 2011 and 2010

Long-term obligations activity for the fiscal years ended June 30, 2011 and 2010 were as follows (in thousands of dollars):

	Balance at July 1, 2010	Additions	Reductions	Balance at June 30, 2011	Amount Due Within One Year
General obligation bonds	\$ 6,443	\$ -	\$ (5,167)	\$ 1,276	\$ 1,213
Revenue bonds	1,300,990	305,190	(121,735)	1,484,445	28,440
Notes payable	193,103	22,991	(15,702)	200,392	16,900
	<u>1,500,536</u>	<u>328,181</u>	<u>(142,604)</u>	<u>1,686,113</u>	<u>46,553</u>
Add: Unamortized net premium (discount) and deferred amount on refunding	19,958	5,782	(1,569)	24,171	-
Total long-term debt	<u>1,520,494</u>	<u>333,963</u>	<u>(144,173)</u>	<u>1,710,284</u>	<u>46,553</u>
Compensated absences	7,113	2,243	(2,080)	7,276	337
Other postretirement benefits	7,678	9,561	(3,870)	13,369	-
Deferred revenue	8,626	-	-	8,626	-
Arbitrage rebate	2,600	-	-	2,600	-
Total long-term obligations	<u>\$ 1,546,511</u>	<u>\$ 345,767</u>	<u>\$ (150,123)</u>	<u>\$ 1,742,155</u>	<u>\$ 46,890</u>

	Balance at July 1, 2009	Additions	Reductions	Balance at June 30, 2010	Amount Due Within One Year
General obligation bonds	\$ 13,398	\$ -	\$ (6,955)	\$ 6,443	\$ 5,167
Revenue bonds	1,211,500	278,080	(188,590)	1,300,990	19,095
Notes payable	157,310	49,147	(13,354)	193,103	15,365
	<u>1,382,208</u>	<u>327,227</u>	<u>(208,899)</u>	<u>1,500,536</u>	<u>39,627</u>
Add: Unamortized net premium (discount) and deferred amount on refunding	11,017	9,954	(1,013)	19,958	-
Total long-term debt	<u>1,393,225</u>	<u>337,181</u>	<u>(209,912)</u>	<u>1,520,494</u>	<u>39,627</u>
Compensated absences	7,352	2,227	(2,466)	7,113	355
Other postretirement benefits	3,316	8,677	(4,315)	7,678	-
Deferred revenue	-	8,626	-	8,626	-
Arbitrage rebate	2,600	-	-	2,600	-
Total long-term obligations	<u>\$ 1,406,493</u>	<u>\$ 356,711</u>	<u>\$ (216,693)</u>	<u>\$ 1,546,511</u>	<u>\$ 39,982</u>

**City and County of Honolulu
Sewer Fund
Notes to Financial Statements
June 30, 2011 and 2010**

Scheduled maturities of long-term debt are as follows (in thousands of dollars):

	General Obligation Bonds	Revenue Bonds	Notes Payable	Total Principal	Total Interest
Year ending June 30,					
2012	\$ 1,213	\$ 28,440	\$ 16,900	\$ 46,553	\$ 73,765
2013	10	34,379	17,114	51,503	70,872
2014	11	35,461	16,029	51,501	69,339
2015	8	38,947	13,633	52,588	67,743
2016	9	45,059	13,701	58,769	66,049
2017-2021	25	253,533	62,298	315,856	299,417
2022-2026	-	318,202	51,289	369,491	231,447
2027-2031	-	348,573	9,428	358,001	144,800
2032-2036	-	263,743	-	263,743	66,449
2037-2041	-	117,445	-	117,445	13,570
2042-2046	-	663	-	663	82
	<u>1,276</u>	<u>1,484,445</u>	<u>200,392</u>	<u>1,686,113</u>	<u>\$ 1,103,533</u>
Less: Current portion	<u>(1,213)</u>	<u>(28,440)</u>	<u>(16,900)</u>	<u>(46,553)</u>	
	<u>\$ 63</u>	<u>\$ 1,456,005</u>	<u>\$ 183,492</u>	<u>\$ 1,639,560</u>	

8. Net Assets

At June 30, 2011 and 2010, net assets consisted of the following (in thousands of dollars):

	2011	2010
Invested in capital assets, net of related debt		
Net property, plant and equipment	\$ 2,191,602	\$ 2,048,617
Less:		
Wastewater general obligation bonds payable	(1,276)	(6,443)
Wastewater system revenue bonds payable, net of unamortized premium, discount, and issue cost	(1,508,616)	(1,320,948)
Notes payable	(200,392)	(193,103)
Amount of debt related to unspent debt proceeds	<u>110,609</u>	<u>57,908</u>
	591,927	586,031
Restricted for debt service	158,662	144,307
Unrestricted	<u>287,949</u>	<u>178,434</u>
Total	<u>\$ 1,038,538</u>	<u>\$ 908,772</u>

9. Employee Benefit Plans

Substantially all employees of the Sewer Fund participate in the City's various employee benefit plans, including the State's Employees Retirement System ("ERS"), post-employment healthcare and life insurance plan, and a deferred compensation plan. For more information on the State's benefit plans in which the City's employees participate, refer to the City and ERS CAFR. The ERS CAFR can be found at the ERS website: <http://ers.ehawaii.gov/Financials.htm>.

City and County of Honolulu
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Employees' Retirement System

The ERS is a cost-sharing, multiple-employer public employee retirement plan. The ERS provides retirement benefits as well as death and disability benefits. All contributions, benefits and eligibility requirements are established by Chapter 88, Hawaii Revised Statutes ("HRS"), and can be amended by legislative action.

Post-Employment Healthcare and Life Insurance Benefits

The City contributes to the Hawaii Employer-Union Health Benefits Trust Fund ("EUTF"), an agent multiple-employer defined benefit plan. The EUTF was established to provide a single delivery system of health benefits for state and county workers, retirees, and their dependents. The eligibility requirements for retiree health benefits are based on date of hire. Act 88 established the EUTF during the State's 2001 legislative session and is codified in Chapter 87A, HRS.

City Policy

The actuarial valuation of the EUTF does not provide OPEB information by department or agency. Accordingly, the City's policy on the accounting and reporting for OPEB is to allocate a portion of the City's Annual Required Contribution ("ARC"), interest, and any adjustment to the ARC, to proprietary funds that are reported separately in stand-alone financial statements or in the City's CAFR. The basis for the allocation is the proportionate share of contributions made by each proprietary fund for retiree health benefits.

Allocated OPEB Cost

The Sewer Fund's OPEB expense is allocated by the City based on the Sewer Fund's proportionate share of contributions for retiree health benefits and was calculated at 6.3% and 6.8% of the City's ARC for the fiscal years ended June 30, 2011 and 2010, respectively. The following table shows the components of the annual OPEB cost for the fiscal years ended June 30, 2011 and 2010, the amount contributed to the plan, and changes in the Sewer Fund's net OPEB obligation (in thousands of dollars):

	2011	2010
Annual required contribution	\$ 9,447	\$ 8,603
Interest on net OPEB obligation	578	398
Adjustment to annual required contribution	<u>(464)</u>	<u>(324)</u>
Annual OPEB cost	9,561	8,677
Contributions made	<u>(3,870)</u>	<u>(4,315)</u>
Increase in net OPEB obligation	5,691	4,362
Net OPEB obligation		
Beginning of year	<u>7,678</u>	<u>3,316</u>
End of year	<u>\$ 13,369</u>	<u>\$ 7,678</u>
Percentage of annual OPEB cost contributed	40.5%	49.7%

**City and County of Honolulu
Sewer Fund
Notes to Financial Statements
June 30, 2011 and 2010**

The funded status of the plan for the City as of the most recent valuation date is as follows (in thousands of dollars):

Actuarial Valuation Date	Actuarial Value of Assets	Actuarial Accrued Liability ("AAL")	Unfunded AAL ("UAAL")	Funded Ratio	Covered Payroll	UAAL as a Percentage of Covered Payroll
July 1, 2009	\$ 40,110	\$ 1,924,859	\$ 1,884,749	2.1%	\$ 556,742	338.5%

Actuarial valuations of an ongoing plan involve estimates of the value of reported amounts and assumptions about the probability of occurrence of events far into the future. Examples include assumptions about future employment, mortality, and the healthcare cost trend. Amounts determined regarding the funded status of the plan and the annual required contributions of the employer are subject to continual revision as actual results are compared with past expectations and new estimates are made about the future. The schedule of funding progress, presented as required supplementary information following the notes to the financial statements, presents multi-year trend information that shows whether the actuarial value of plan assets is increasing or decreasing over time relative to the actuarial accrued liabilities for benefits.

Projections of benefits for financial reporting purposes are based on the substantive plan and include the types of benefits provided at the time of each valuation and the historical pattern of sharing of benefit costs between the employer and plan members to that point. The actuarial methods and assumptions used include techniques that are designed to reduce short-term volatility in actuarial accrued liabilities and the actuarial value of assets, consistent with the long-term perspective of the calculations.

In the July 1, 2009 actuarial valuation, the entry age normal actuarial cost method was used. The actuarial assumptions included a discount rate of 7%, which was based on the City's anticipated funding level. Actuarial assumptions also included an annual health cost trend rate of 9.75% for 2010, reduced in decrements to an ultimate rate of 5% after eight years, and projected salary increases of 3.5%. Actuarial assumptions also included an inflation rate of 3.0%, which was based on long-term expectations of inflation. The unfunded actuarial accrued liability is being amortized over a 30-year period as a level percentage of projected payroll on a closed basis.

The financial information of the EUTF may be found in the Comprehensive Annual Financial Report for the State of Hawaii. Questions on such financial information may be addressed to the Comptroller, Department of Accounting and General Services, P.O. Box 119, Honolulu, Hawaii 96810-0119.

10. Management Agreement

The Board of Water Supply (the "Board") has an agreement with the City's Department of Environmental Services to provide certain services through June 30, 2015 for the billing and collection of sewer service charges. The revenue related to these fees is included in other operating revenues of the Board and the corresponding expense in the Sewer Fund. Service fees in addition to credit card fees incurred amounted to \$1.4 million and \$1.9 million for the years ended June 30, 2011 and 2010, respectively.

City and County of Honolulu
Sewer Fund
Notes to Financial Statements
June 30, 2011 and 2010

11. Commitments

Construction Contracts

The City has contractual commitments for the Sewer Fund of approximately \$422 million at June 30, 2011, 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, 2011 and 2010, accumulated sick leave, including vested and nonvested accumulated rights to receive sick leave benefits, amounted to approximately \$22.0 million and \$21.6 million, respectively.

Deferred Compensation Plan

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

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

12. Litigation

The City is a party to various legal proceedings arising in the normal course of business.

Several related matters were settled through a 2010 consent decree which was approved on December 17, 2010 by the U.S. Environmental Protection Agency ("EPA"), the State Department of Health ("DOH"), the Sierra Club, Hawaii Chapter, Our Children's Earth Foundation, and Hawaii's Thousand Friends, and entered by the United States District Court in Hawaii. The 1994, 2004, and 2007 lawsuits alleging violations of the federal clean water act, several National Pollution Discharge Elimination Systems and DOH permits held by the City have been dismissed. The City's appeal of the EPA's January 2009 final decisions denying the City's applications to renew its permit for variances from secondary treatment for the Honouliuli and Sand Island wastewater treatment plants ("WWTP") was dismissed on February 2, 2011. The consent decree allows 10 years for completion of work on the collection system, 14 years for the upgrade of the Honouliuli WWTP to secondary treatment, and up to 25 years, with the possibility of a three-year extension, for the upgrade of the Sand Island WWTP to secondary treatment.

City and County of Honolulu
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The City is expected to incur approximately \$3.4 billion in capital costs through fiscal year 2020, which coincides with the term of the collection system portion of the consent decree. This amount will largely be spent on the collection system, and much of it will go toward work that was already required or planned. Costs for the treatment plant upgrades include approximately \$550 million to replace primary treatment facilities at both plants and \$1.15 billion to upgrade the plants to secondary treatment plants. As part of the settlement, the City has paid a civil penalty in the amount of \$800,000 to the U.S. Department of Justice, and \$800,000 to the State. In addition, the City has paid \$800,000 to the Sierra Club, Hawaii Chapter, Our Children's Earth Foundation, and Hawaii's Thousand Friends, to fund four identified supplemental environmental projects. The City has also settled the nonprofit organizations' claims for their attorneys' fees and costs for an additional payment of \$1.1 million.

13. Subsequent Events

In November 2011, the City issued wastewater system revenue bonds, Senior Series 2011A for \$169.2 million. The bonds mature annually on July 1, 2016 through July 1, 2041 and bear interest rates of 2.0% to 5.25%. The bonds are subject to redemption at the option of the City on or after July 1, 2021 except for the bonds maturing on July 1, 2028, July 1, 2031 and bifurcated serial bonds maturing on July 1, 2032 through July 1, 2036. The proceeds from the bonds will be used to pay for the costs of certain additions and improvements to the wastewater system and to fund a common reserve account.

Required Supplementary Information

City and County of Honolulu
Sewer Fund
Schedule of Funding Progress (Unaudited)
June 30, 2011 and 2010
(Amounts in thousands)

Post-Retirement Health Care and Life Insurance Benefits

The following schedule presents the actuarially-determined funding progress for the post-retirement health care and life insurance benefits for the City as a whole, of which the Sewer Fund is one of its various enterprise funds.

Actuarial Valuation Date	Actuarial Value of Assets	Actuarial Accrued Liability ("AAL")	Unfunded AAL ("UAAL")	Funded Ratio	Covered Payroll	UAAL as a Percentage of Covered Payroll
July 1, 2009	\$ 40,110	\$ 1,924,859	\$ 1,884,749	2.1%	\$ 556,742	338.5%
July 1, 2007	\$ -	\$ 1,242,255	\$ 1,242,255	0.0%	\$ 524,258	237.0%