

City and County of Honolulu Sewer Fund

Financial Statements

June 30, 2013 and 2012

City and County of Honolulu
Sewer Fund
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June 30, 2013 and 2012

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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 position of the City and County of Honolulu, Sewer Fund ("Sewer Fund"), as of June 30, 2013 and 2012, and the related statements of revenues, expenses and change in net position and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

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 from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditors consider internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

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, 2013 and 2012, and the respective changes in its financial position and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter

As discussed in Note 1, the financial statements referred to above include only the financial activities of the Sewer Fund, and are not intended to present fairly the financial position of the City and County of Honolulu as of June 30, 2013 and 2012, 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. Our opinion is not modified with respect to this matter.

Other Matters**Required Supplementary Information**

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 3 through 6 and schedule of funding progress on page 22 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Accuity LLP

Honolulu, Hawaii
November 22, 2013

City and County of Honolulu

Sewer Fund

Management's Discussion and Analysis

June 30, 2013 and 2012

The following summary discussion and analysis of the financial statements for the fiscal years ended June 30, 2013 and 2012 are provided by the City and County of Honolulu's wastewater enterprise ("Wastewater Enterprise"). The summary is designed to provide an introduction to the Sewer Fund financial statements and the financial condition of the Wastewater Enterprise. We encourage readers to also review the financial statements as a whole.

Financial Highlights

- 99.5 million gallons per day of wastewater were collected and treated in fiscal year 2013, a decrease of 0.5% from fiscal year 2012. There were 100 million gallons per day of wastewater collected and treated in fiscal year 2012, 4.8% less than fiscal year 2011. As of June 30, 2013, the Wastewater Enterprise had approximately 144,300 customer accounts and served approximately 780,000 residents.
- Total assets were \$3,430.9 million and exceeded total liabilities by \$1,320.7 million as of June 30, 2013. As of June 30, 2012, total assets were \$3,194.4 million and exceeded total liabilities by \$1,213.8 million. As of June 30, 2013, net position (difference between assets and liabilities) increased by \$106.9 million, or 8.8%, from June 30, 2012, while net position at June 30, 2012, increased by \$175.3 million, or 16.9%, from June 30, 2011. The increase in net position in 2013 was due to increased capital assets, investments and operating income. The increase in net position in 2012 was due to increased capital assets, cash and operating income.
- As of June 30, 2013, total assets increased by \$236.5 million to \$3,430.9 million, representing a 7.4% increase from the prior fiscal year, while total assets increased by \$346.8 million to \$3,194.4 million at June 30, 2012, representing an 12.2% increase from June 30, 2011. The increase in fiscal year 2013 was due to additional capital assets and increased investments. The increase in fiscal year 2012 was due to additional capital assets and increased cash.
- Total current assets increased by 17.9% or \$155.4 million to \$1,023.2 million at June 30, 2013, while current assets increased by 34.4% or \$222.1 million to \$867.8 million at June 30, 2012. The increases in 2013 and 2012 were primarily due to the addition of revenue bond proceeds and increased sewer service charge revenues.
- As of June 30, 2013, total current liabilities increased by 11.3% or \$14.3 million to \$140.9 million primarily due to an increase in accounts payable. Total liabilities also increased 6.5% or \$129.6 million to \$2,110.2 million due to an increase in accounts payable and bonds payable. As of June 30, 2012, total current liabilities increased by 11.3% or \$12.8 million to \$126.6 million primarily due to an increase in interest payable and bonds payable. Total liabilities also increased by 9.5% or \$171.6 million to \$1,980.6 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.

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.

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

The statements of revenues, expenses and change in net position present information showing how the Wastewater Enterprise's net position changed during the past two fiscal years. All changes in net position 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 position for the Wastewater Enterprise (in thousands of dollars):

Statements of Net Position

	2013	2012	2011
Current assets	\$ 1,023,198	\$ 867,836	\$ 645,710
Capital assets, net	2,397,031	2,316,168	2,191,602
Other noncurrent assets	10,663	10,394	10,264
Total assets	<u>\$ 3,430,892</u>	<u>\$ 3,194,398</u>	<u>\$ 2,847,576</u>
Current liabilities	\$ 140,923	\$ 126,611	\$ 113,773
Noncurrent liabilities	1,969,280	1,853,999	1,695,265
Total liabilities	<u>2,110,203</u>	<u>1,980,610</u>	<u>1,809,038</u>
Net investment in capital assets	642,454	645,433	591,927
Restricted for debt service	177,890	171,010	158,662
Unrestricted	500,345	397,345	287,949
Total net position	<u>1,320,689</u>	<u>1,213,788</u>	<u>1,038,538</u>
Total liabilities and net position	<u>\$ 3,430,892</u>	<u>\$ 3,194,398</u>	<u>\$ 2,847,576</u>

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Net Position

Net position (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 \$1,320.7 million and \$1,213.8 million at the end of fiscal years 2013 and 2012, respectively. Operating income generated and additions of capital assets resulted in an 8.8% increase in net position from 2012 to 2013. The largest portion of the Wastewater Enterprise's net position 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 position (in thousands of dollars):

Statements of Revenues, Expenses and Change in Net Position

	2013	2012	2011
Operating revenues	\$ 372,394	\$ 362,586	\$ 347,038
Operating expenses	<u>(209,246)</u>	<u>(179,741)</u>	<u>(162,579)</u>
Operating income	163,148	182,845	184,459
Nonoperating revenues (expenses)			
Interest income	1,378	1,041	1,082
Interest expense	(50,489)	(57,011)	(50,832)
Forgiveness of advance	-	8,626	-
Other	<u>4,505</u>	<u>6,066</u>	<u>3,786</u>
Income before transfers and capital contributions	118,542	141,567	138,495
Transfers out	(12,885)	(9,184)	(9,552)
Capital contributions	<u>1,244</u>	<u>42,867</u>	<u>823</u>
Change in net position	106,901	175,250	129,766
Net position			
Beginning of year	<u>1,213,788</u>	<u>1,038,538</u>	<u>908,772</u>
End of year	<u>\$ 1,320,689</u>	<u>\$ 1,213,788</u>	<u>\$ 1,038,538</u>

The changes in net position were primarily due to:

- Operating revenues, comprised mainly of sewer service charges, increased 2.7% to \$372.4 million for the fiscal year 2013 compared to the prior fiscal year and increased 4.5% to \$362.6 million for fiscal year 2012 compared to fiscal year 2011. Sewer service charge rates were raised 4% at July 1, 2012, and rate structure changes were implemented effective July 1, 2012, for residential customers and January 22, 2013, for non-residential customers.
- Operating expenses increased \$29.5 million or 16.4% to \$209.2 million for fiscal year 2013 compared to the prior fiscal year and increased \$17.2 million or 10.6% to \$179.7 million for fiscal year 2012 compared to fiscal year 2011. The primary increases in 2013 were in administration and general, depreciation expense, and contractual services. The primary increases in 2012 were in administration and general, fringe benefits, and utilities.

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- Interest expense decreased by \$6.5 million or 11.4% to \$50.5 million for fiscal 2013 compared to the prior fiscal year and increased by \$6.2 million or 12.2% to \$57.0 million for fiscal 2012 compared to fiscal year 2011. The decrease in 2013 was due to issuance of refunding revenue bonds with lower interest rates and the increase in 2012 was due to the issuance of additional revenue bonds.
- Contributed capital decreased to \$1.2 million in fiscal year 2013 down from \$42.9 million in fiscal year 2012 and \$0.8 million in fiscal year 2011. Contributed capital represents assets (primarily capital assets) transferred from other city governmental funds and other entities. Approximately \$12.9 million and \$9.2 million was transferred out during fiscal years 2013 and 2012, 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 investment in capital assets amounted to \$2.4 billion and \$2.3 billion, net of accumulated depreciation, as of June 30, 2013 and 2012, respectively, an increase of \$80.9 million or 3.5% in 2013 and \$124.6 million or 5.7% in 2012. 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 of capital assets. Revenue bonds outstanding as of June 30, 2013 and 2012 totaled \$1,727.6 million and \$1,625.2 million, respectively. State revolving fund notes payable outstanding at June 30, 2013 and 2012 totaled \$221.1 million and \$222.5 million, respectively.

Debt service coverage was 277% on Senior Revenue Bonds, 188% on all revenue bonds, and 160% on all debt at June 30, 2013, compared to 343% on Senior Revenue Bonds, 225% on all revenue bonds, and 191% on all debt at June 30, 2012. Debt service coverage exceeded the requirements of bond covenants and policies of the City Council in 2013 and 2012.

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

Currently Known Facts, Decisions or Conditions

Sewer service charge rates were increased by 4% and changes to the sewer service charge rate structure for equity amongst customers was effective July 1, 2012. Rate structure changes were implemented July 1, 2012, for residential customers and January 22, 2013, for non-residential customers. Sewer service charges increased 4% on July 1, 2013.

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 Position
June 30, 2013 and 2012
(Amounts in thousands)

	2013	2012
Assets		
Current assets		
Cash and cash equivalents	\$ 438,953	\$ 715,473
Investments	492,500	90,181
Receivables		
Accounts, net of allowance for uncollectible accounts of \$2,300 in 2013 and \$2,288 in 2012	59,170	46,890
Interest	279	102
Employee advances	1,066	1,136
Due from other City funds	521	1,009
Inventories of materials and supplies	19,028	10,830
Prepaid expenses	11,681	2,215
Total current assets	<u>1,023,198</u>	<u>867,836</u>
Capital assets, net	2,397,031	2,316,168
Deferred charges	10,663	10,394
Total assets	<u>\$ 3,430,892</u>	<u>\$ 3,194,398</u>
Liabilities and Net Position		
Current liabilities		
Accounts payable	\$ 50,483	\$ 33,197
Due to other City funds	7	103
Interest payable	33,271	38,359
Bonds payable	35,947	34,389
Notes payable	19,044	18,623
Accrued payroll	1,483	1,572
Other current liabilities	688	368
Total current liabilities	<u>140,923</u>	<u>126,611</u>
Notes payable	202,087	203,886
General obligation bonds payable, net	825	748
Revenue bonds payable, net	1,739,755	1,625,180
Other liabilities	26,613	24,185
Total liabilities	<u>2,110,203</u>	<u>1,980,610</u>
Net position		
Net investment in capital assets	642,454	645,433
Restricted for debt service	177,890	171,010
Unrestricted	500,345	397,345
Total net position	<u>1,320,689</u>	<u>1,213,788</u>
Total liabilities and net position	<u>\$ 3,430,892</u>	<u>\$ 3,194,398</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 Position
Years Ended June 30, 2013 and 2012
(Amounts in thousands)

	2013	2012
Operating revenues		
Sewer service charges	\$ 368,125	\$ 357,159
Other revenue	4,269	5,427
Total operating revenues	<u>372,394</u>	<u>362,586</u>
Operating expenses		
Administrative and general	75,143	54,549
Depreciation	58,262	49,665
Utilities	27,436	26,464
Contractual services	21,398	14,927
Fringe benefits	20,457	19,947
Materials and supplies	4,781	12,196
Fuel and lubricants	1,331	1,555
Maintenance	438	438
Total operating expenses	<u>209,246</u>	<u>179,741</u>
Operating income	163,148	182,845
Nonoperating revenues (expenses)		
Interest income	1,378	1,041
Interest expense	(50,489)	(57,011)
Forgiveness of advance	-	8,626
Other	4,505	6,066
Total nonoperating expenses	<u>(44,606)</u>	<u>(41,278)</u>
Income before transfers and capital contributions	118,542	141,567
Transfers out	(12,885)	(9,184)
Capital contributions	<u>1,244</u>	<u>42,867</u>
Change in net position	106,901	175,250
Net position		
Beginning of year	<u>1,213,788</u>	<u>1,038,538</u>
End of year	<u>\$ 1,320,689</u>	<u>\$ 1,213,788</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, 2013 and 2012
(Amounts in thousands)

	2013	2012
Cash flows from operating activities		
Cash received from customers	\$ 360,148	\$ 363,922
Cash payments to suppliers	(81,295)	(75,207)
Cash payments to employees	(55,114)	(56,598)
Net cash provided by operating activities	<u>223,739</u>	<u>232,117</u>
Cash flows from noncapital financing activities		
Transfers out	(12,885)	(9,184)
Net cash used in noncapital financing activities	<u>(12,885)</u>	<u>(9,184)</u>
Cash flows from capital and related financing activities		
Acquisition and construction of capital assets	(124,509)	(106,547)
Proceeds from issuance of notes	18,267	39,359
Repayments on notes	(19,645)	(17,242)
Interest paid on notes	(2,729)	(2,651)
Proceeds from issuance of bonds, net of premium	284,685	182,595
Repayments on bonds	(164,611)	(29,652)
Interest paid on bonds	(83,273)	(71,209)
Interest subsidies for wastewater system revenue bonds	5,566	5,350
Net cash provided by (used in) capital and related financing activities	<u>(86,249)</u>	<u>3</u>
Cash flows from investing activities		
Purchase of investments	(1,312,048)	(1,249,629)
Proceeds from maturity of investments	909,723	1,212,457
Interest on investments	1,200	1,012
Net cash used in investing activities	<u>(401,125)</u>	<u>(36,160)</u>
Net increase (decrease) in cash and cash equivalents	(276,520)	186,776
Cash and cash equivalents		
Beginning of year	<u>715,473</u>	<u>528,697</u>
End of year	<u>\$ 438,953</u>	<u>\$ 715,473</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, 2013 and 2012
(Amounts in thousands)

	2013	2012
Reconciliation of operating income to net cash provided by operating activities		
Operating income	\$ 163,148	\$ 182,845
Adjustments to reconcile operating income to net cash provided by operating activities		
Depreciation	58,262	49,665
Writeoff of capital assets	18,840	-
Change in		
Accounts receivable	(12,209)	501
Due from other City funds	489	6
Inventories of materials and supplies	(8,198)	210
Prepaid expenses	-	(140)
Accounts payable	845	6,777
Other liabilities	2,658	(3,995)
Due to other City funds	(96)	(3,752)
Net cash provided by operating activities	<u>\$ 223,739</u>	<u>\$ 232,117</u>

Supplemental disclosure of noncash capital and related financing activities

The Sewer Fund received \$1.2 million and \$42.9 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, 2013 and 2012, respectively.

Amortization of net bond premiums and discounts amounted to \$5.2 million and \$2.5 million in fiscal 2013 and 2012, respectively. Amortization of bond issue costs amounted to \$1.0 million and \$0.9 million in fiscal years 2013 and 2012, 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, 2013 and 2012

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 Sewer Fund is included in the City and County of Honolulu's Enterprise Fund. The Sewer Fund's financial statements are intended to present the financial position, change in its financial position and its cash flows of only that portion of the funds of the City's Enterprise Fund that is attributable to the transactions of the Sewer Fund.

The accompanying financial statements of the Sewer Fund have been prepared in conformity with accounting principles generally accepted in the United States of America prescribed by the Governmental Accounting Standards Board ("GASB").

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.

In 2013, the Sewer Fund adopted GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 Financial Accounting Standards Board and American Institute of Certified Public Accountants Pronouncements*, which superseded GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and other Governmental Entities that Use Proprietary Fund Accounting*, and all other pre-November 30, 1989 guidance not issued by the GASB.

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.

City and County of Honolulu
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Investments

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

Inventories of Materials and Supplies

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

Receivables

Sewer service charge revenues are accrued by the City based on estimated billings for services provided through the end of the fiscal year. Receivables included estimated unbilled sewer charges amounting to approximately \$22.2 million and \$24.0 million at June 30, 2013 and 2012, respectively. The allowance for doubtful accounts is based on the aging of accounts receivable. Approximately 90% of balances over 120 days are regarded as uncollectible.

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 position.

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.

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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 position.

Net Position

Net position is comprised of the accumulated income from operating and nonoperating revenues, expenses, transfers and capital contributions. Net position is classified in the following three components: net investment in capital assets; restricted for debt service; and unrestricted net position. Net investment in capital assets 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 of net investment in capital assets. Restricted for debt service consists of net position 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 position consists of all other net position not included in the above categories. When an expense is incurred for purposes for which both restricted and unrestricted net position is 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.

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.

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New Accounting Pronouncements

In 2013, the Sewer Fund adopted GASB Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*. This Statement provides financial reporting guidance for deferred outflows of resources and deferred inflows of resources and net position.

In April 2012, the GASB issued Statement No. 65, *Items Previously Reported as Assets and Liabilities*. The objective of this Statement is to clarify the appropriate reporting of deferred outflows and deferred inflows of resources to ensure consistency in financial reporting. The requirements of this Statement are effective for reporting periods beginning after December 15, 2012. Management is currently evaluating the effect this Statement will have on the Sewer Fund financial statements.

In April 2012, the GASB issued Statement No. 66, *Technical Corrections – 2012*. The objective of this Statement is to enhance usefulness of financial reports by resolving conflicting accounting and financial reporting guidance that could diminish the consistency of financial reporting. The requirements of this Statement are effective for reporting periods beginning after December 15, 2012. Management is currently evaluating the effect this Statement will have on the Sewer Fund financial statements.

In June 2012, the GASB issued Statement No. 68, *Accounting and Financial Reporting for Pensions*. The Statement revises and establishes new financial reporting requirements for most governments that provide their employees with pension benefits. The requirements of this Statement are effective for reporting periods beginning after June 15, 2014. Management is currently evaluating the effect this Statement will have on the Sewer Fund financial statements.

3. Cash and Investments

The cash and investment balances reported in the accompanying statements of net position 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, 2013 and 2012. The remaining balance at June 30, 2013 is invested in the City's pooled investment fund.

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The customer base is concentrated among commercial, industrial, residential and governmental customers located within Honolulu, Hawaii. Although the City is directly affected by Honolulu's economy, management does not believe significant credit risk exists at June 30, 2013, 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 \$0.5 million and \$1.0 million at June 30, 2013 and 2012, respectively. Due to other City funds consists primarily of the Sewer Fund's share of retirement plan contributions for the second half of the fiscal years 2013 and 2012.

6. Capital Assets

The capital assets activity for the years ended June 30, 2013 and 2012 were as follows (in thousands of dollars):

	Balance at July 1, 2012	Additions	Retirements/ Transfers	Balance at June 30, 2013
Depreciable assets				
Buildings and improvements	\$ 913,115	\$ 142,427	\$ -	\$ 1,055,542
Transmission and distribution system	1,490,293	117,808	(114,033)	1,494,068
Equipment and machinery	44,354	14,626	(1,064)	57,916
Land improvements	3,511	-	-	3,511
Total depreciable assets	<u>2,451,273</u>	<u>274,861</u>	<u>(115,097)</u>	<u>2,611,037</u>
Less: Accumulated depreciation				
Buildings and improvements	(170,373)	(22,977)	-	(193,350)
Transmission and distribution system	(256,136)	(27,921)	245	(283,812)
Equipment and machinery	(27,479)	(7,245)	969	(33,755)
Land improvements	(1,518)	(119)	-	(1,637)
Total accumulated depreciation	<u>(455,506)</u>	<u>(58,262)</u>	<u>1,214</u>	<u>(512,554)</u>
	1,995,767	216,599	(113,883)	2,098,483
Land	41,214	903	(18)	42,099
Construction in progress	<u>279,187</u>	<u>117,470</u>	<u>(140,208)</u>	<u>256,449</u>
	<u>\$ 2,316,168</u>	<u>\$ 334,972</u>	<u>\$ (254,109)</u>	<u>\$ 2,397,031</u>

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	Balance at July 1, 2011	Additions	Retirements/ Transfers	Balance at June 30, 2012
Depreciable assets				
Buildings and improvements	\$ 867,109	\$ 46,045	\$ (39)	\$ 913,115
Transmission and distribution system	1,245,825	260,295	(15,827)	1,490,293
Equipment and machinery	42,097	2,968	(711)	44,354
Land improvements	3,511	-	-	3,511
Total depreciable assets	<u>2,158,542</u>	<u>309,308</u>	<u>(16,577)</u>	<u>2,451,273</u>
Less: Accumulated depreciation				
Buildings and improvements	(149,946)	(21,464)	1,037	(170,373)
Transmission and distribution system	(230,357)	(25,779)	-	(256,136)
Equipment and machinery	(25,176)	(2,303)	-	(27,479)
Land improvements	(1,399)	(119)	-	(1,518)
Total accumulated depreciation	<u>(406,878)</u>	<u>(49,665)</u>	<u>1,037</u>	<u>(455,506)</u>
	1,751,664	259,643	(15,540)	1,995,767
Land	33,070	8,185	(41)	41,214
Construction in progress	406,868	132,799	(260,480)	279,187
	<u>\$ 2,191,602</u>	<u>\$ 400,627</u>	<u>\$ (276,061)</u>	<u>\$ 2,316,168</u>

Depreciation expense was \$58.3 million and \$49.7 million for the years ended June 30, 2013 and 2012, respectively.

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 2013 in the original amount totaling \$206.7 million, and maturing serially through fiscal year 2028. The general obligation bonds bear interest at rates ranging from 0.8% to 8.0% at June 30, 2013.

Wastewater system revenue bonds in the City's business-type activities were issued during fiscal years 1999 through 2013, in the original amount totaling \$2.2 billion, less discounts of \$36.1 million and adjusted for premiums of \$108.7 million, which are being amortized over the related term of the bonds. The bonds bear interest at 2.00% to 6.34% at June 30, 2013 and mature at various dates through fiscal year 2046. The wastewater system revenues collateralize the revenue bonds.

In October 2012, the City issued wastewater system revenue bonds, Senior Series 2012A and 2012B, in the amounts of \$134.2 million and \$131.4 million, respectively. The Senior Series 2012A bonds mature annually on July 1, 2017 through July 1, 2042, bear interest at 2.0% to 5.0% and are subject to redemption at the option of the City on or after July 1, 2022. The Senior Series 2012B bonds mature annually on July 1, 2013 through July 1, 2030 and bear interest at 2.0% to 5.0%. The Senior Series 2012B bonds are subject to redemption at the option of the City on or after July 1, 2022 except for the bonds maturing on July 1, 2027 and July 1, 2029. The proceeds from both the Senior Series 2012A and 2012B 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.

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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 \$221.1 million and \$222.5 million at June 30, 2013 and 2012, respectively, bearing interest ranging from 0.8% to 4.0%, and require annual principal and interest payments through fiscal year 2032.

Total interest costs incurred in 2013 and 2012 were \$66.3 million and \$74.5 million, respectively, of which \$15.8 million and \$17.5 million was capitalized in 2013 and 2012, respectively.

Long-term obligations activity for the fiscal years ended June 30, 2013 and 2012 were as follows (in thousands of dollars):

	Balance at July 1, 2012	Additions	Reductions	Balance at June 30, 2013	Amount Due Within One Year
General obligation bonds	\$ 831	\$ 28	\$ (38)	\$ 821	\$ 11
Revenue bonds	1,625,196	265,610	(163,220)	1,727,586	35,936
Notes payable	222,509	18,267	(19,645)	221,131	19,044
	<u>1,848,536</u>	<u>283,905</u>	<u>(182,903)</u>	<u>1,949,538</u>	<u>54,991</u>
Add: Unamortized net premium (discount) and deferred amount on refunding	34,290	19,047	(5,217)	48,120	-
Total long-term debt	<u>1,882,826</u>	<u>302,952</u>	<u>(188,120)</u>	<u>1,997,658</u>	<u>54,991</u>
Compensated absences	7,375	2,399	(1,996)	7,778	384
Other postretirement benefits	16,961	9,600	(7,653)	18,908	-
Arbitrage rebate	217	94	-	311	-
Total long-term obligations	<u>\$ 1,907,379</u>	<u>\$ 315,045</u>	<u>\$ (197,769)</u>	<u>\$ 2,024,655</u>	<u>\$ 55,375</u>

	Balance at July 1, 2011	Additions	Reductions	Balance at June 30, 2012	Amount Due Within One Year
General obligation bonds	\$ 1,276	\$ 768	\$ (1,213)	\$ 831	\$ 10
Revenue bonds	1,484,445	169,190	(28,439)	1,625,196	34,379
Notes payable	200,392	39,359	(17,242)	222,509	18,623
	<u>1,686,113</u>	<u>209,317</u>	<u>(46,894)</u>	<u>1,848,536</u>	<u>53,012</u>
Add: Unamortized net premium (discount) and deferred amount on refunding	24,171	12,637	(2,518)	34,290	-
Total long-term debt	<u>1,710,284</u>	<u>221,954</u>	<u>(49,412)</u>	<u>1,882,826</u>	<u>53,012</u>
Compensated absences	7,276	2,542	(2,443)	7,375	368
Other postretirement benefits	13,369	10,511	(6,919)	16,961	-
Deferred revenue	8,626	-	(8,626)	-	-
Arbitrage rebate	2,600	-	(2,383)	217	-
Total long-term obligations	<u>\$ 1,742,155</u>	<u>\$ 235,007</u>	<u>\$ (69,783)</u>	<u>\$ 1,907,379</u>	<u>\$ 53,380</u>

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

Year ending June 30,	General Obligation Bonds	Revenue Bonds	Notes Payable	Total Principal	Total Interest
2014	\$ 11	\$ 35,936	\$ 19,044	\$ 54,991	\$ 84,573
2015	8	39,432	16,664	56,104	81,407
2016	9	45,564	16,747	62,320	79,647
2017	58	50,771	16,901	67,730	77,641
2018	60	55,588	16,726	72,374	75,488
2019–2023	300	314,549	71,243	386,092	338,161
2024–2028	375	394,872	55,068	450,315	254,046
2029–2033	-	374,593	8,738	383,331	156,491
2034–2038	-	285,659	-	285,659	71,272
2039–2043	-	130,209	-	130,209	13,780
2044–2046	-	413	-	413	33
	<u>821</u>	<u>1,727,586</u>	<u>221,131</u>	<u>1,949,538</u>	<u>\$ 1,232,539</u>
Less: Current portion	<u>(11)</u>	<u>(35,936)</u>	<u>(19,044)</u>	<u>(54,991)</u>	
	<u>\$ 810</u>	<u>\$ 1,691,650</u>	<u>\$ 202,087</u>	<u>\$ 1,894,547</u>	

8. Net Position

At June 30, 2013 and 2012, net position consisted of the following (in thousands of dollars):

	2013	2012
Net investment in capital assets		
Net property, plant and equipment	\$ 2,397,031	\$ 2,316,168
Less:		
Wastewater general obligation bonds payable	(821)	(831)
Wastewater system revenue bonds payable, net of unamortized premium, discount, and issue cost	(1,775,706)	(1,659,486)
Notes payable	(221,131)	(222,509)
Amount of debt related to unspent debt proceeds	<u>243,081</u>	<u>212,091</u>
	642,454	645,433
Restricted for debt service	177,890	171,010
Unrestricted	<u>500,345</u>	<u>397,345</u>
Total	<u>\$ 1,320,689</u>	<u>\$ 1,213,788</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.hawaii.gov/financials.htm>.

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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. Contributions made to the plan were \$5.7 million, \$5.6 million and \$5.2 million for the fiscal years ended June 30, 2013, 2012 and 2011, respectively.

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 6.7% of the City's ARC for the fiscal years ended June 30, 2013 and 2012, respectively. The following table shows the components of the annual OPEB cost for the fiscal years ended June 30, 2013 and 2012, the amount contributed to the plan, and changes in the Sewer Fund's net OPEB obligation (in thousands of dollars):

	2013	2012
Annual required contribution	\$ 9,426	\$ 10,329
Interest on net OPEB obligation	1,294	1,015
Adjustment to annual required contribution	<u>(1,120)</u>	<u>(833)</u>
Annual OPEB cost	9,600	10,511
Contributions made	<u>(7,653)</u>	<u>(6,919)</u>
Increase in net OPEB obligation	1,947	3,592
Net OPEB obligation		
Beginning of year	<u>16,961</u>	<u>13,369</u>
End of year	<u>\$ 18,908</u>	<u>\$ 16,961</u>
Percentage of annual OPEB cost contributed	79.7%	65.8%

Contributions made to the plan were \$7.7 million, \$6.9 million and \$3.9 million for the fiscal years ended June 30, 2013, 2012 and 2011, respectively.

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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, 2011 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 a blended annual health cost trend rate of 8.8% for 2013, reduced in decrements to an ultimate rate of 5% after seven years, and projected payroll 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 EUTF issues a stand-alone financial report that includes financial statements and required supplementary information, which may be obtained at the following address: State of Hawaii Employer-Union Health Benefits Trust Fund, 201 Merchant Street, Suite 1520, Honolulu, Hawaii 96813.

10. Management Agreement

The Board of Water Supply ("BWS") 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 BWS and the corresponding expense in the Sewer Fund. Service fees in addition to credit card fees incurred amounted to \$1.4 million and \$1.5 million for the years ended June 30, 2013 and 2012, respectively.

11. Commitments

Construction Contracts

The City has contractual commitments for the Sewer Fund of approximately \$413 million at June 30, 2013, 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, 2013 and 2012, accumulated sick leave, including vested and nonvested

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accumulated rights to receive sick leave benefits, amounted to approximately \$21.9 million and \$21.7 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 complying with the terms of a consent decree entered on December 17, 2010 by the United States District Court to resolve the claims of the United States Environmental Protection Agency ("EPA"), the State of Hawaii Department of Health ("DOH"), and various non-governmental entities related to the City's compliance with the federal Clean Water Act and State law. In March 2012, the consent decree was modified to allow substitution of the Kaneohe-Kailua gravity tunnel and associated pump station in place of a required force main replacement. The consent decree allows 10 years for completion of work on the collection system, 14 years for the upgrade of the Honouliuli Wastewater Treatment Plant ("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.

The City is expected to incur approximately \$3.5 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. This amount also includes a portion of the costs of treatment plant upgrades at Sand Island and Honouliuli. 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.

Required Supplementary Information

City and County of Honolulu
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Schedule of Funding Progress (Unaudited)
June 30, 2013 and 2012
(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, 2011	\$ 40,177	\$ 1,776,061	\$ 1,735,884	2.3%	\$ 548,355	316.6%
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%