

**City and County of Honolulu
Sewer Fund
Financial Statements
June 30, 2010 and 2009**

City and County of Honolulu
Sewer Fund
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June 30, 2010 and 2009

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

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

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Sewer Fund as of June 30, 2010, and the changes in its financial position and its cash flows for the year 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.

The financial statements of the Sewer Fund as of June 30, 2009 and for the year then ended were audited by other auditors whose report dated December 30, 2009 expressed an unqualified opinion on those statements.

Acuity LLP

Honolulu, Hawaii
December 27, 2010

City and County of Honolulu

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Management's Discussion and Analysis

June 30, 2010 and 2009

The following summary discussion and analysis of the financial statements for the fiscal years ended June 30, 2010 and 2009 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

- 105.6 million gallons per day of wastewater were collected and treated in fiscal year 2010, a decrease of 2.5% from fiscal year 2009. There were 108.1 million gallons per day of wastewater collected and treated in fiscal year 2009, an increase of 0.7% from fiscal year 2008. As of June 30, 2010, the Wastewater Enterprise had approximately 143,500 customer accounts and served approximately 640,000 residents.
- Total assets were \$2,515.0 million and exceeded total liabilities by \$908.8 million as of June 30, 2010. As of June 30, 2009, total assets were \$2,264.2 million and exceeded total liabilities by \$800.6 million. As of June 30, 2010, net assets (difference between assets and liabilities) increased by \$108.2 million or 13.5% from June 30, 2009, while net assets at June 30, 2009, increased by \$72.8 million or 10.0% from June 30, 2008. The increase in net assets in 2010 is primarily due to an increase in operating income of \$33.1 million or 27.2% to \$154.7 million. The increase in net assets in 2009 is primarily due to an increase in operating income of \$39.0 million or 47.2% to \$121.6 million in fiscal year 2008.
- As of June 30, 2010, total assets increased by \$250.8 million to \$2,515.0 million, representing a 11.1% increase from the prior fiscal year, while total assets increased by \$104.6 million to \$2,264.2 million at June 30, 2009, representing a 4.8% increase from June 30, 2008. The increase in fiscal year 2010 was due to additional capital assets and increased cash. The increase in fiscal year 2009 was primarily due to additional capital assets.
- Total current assets increased by 19.3% or \$74.1 million to \$457.8 million at June 30, 2010, while current assets decreased by 15.2% or \$68.8 million to \$383.7 million at June 30, 2009. The increase in 2010 was primarily due to the addition of revenue bond proceeds. The decrease in 2009 was primarily due to expenditure of revenue bond proceeds.
- 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. At June 30, 2009, total current liabilities increased by 10.0% or \$8.1 million to \$89.4 million primarily due to an increase in accounts payable and bonds payable. At June 30, 2009, total liabilities increased 2.2% or \$31.7 million to \$1,463.6 million due to an increase in notes 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 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 thousands of dollars):

Statements of Net Assets

	2010	2009	2008
Current assets	\$ 457,777	\$ 383,718	\$ 452,477
Capital assets, net	2,048,617	1,873,157	1,699,153
Other noncurrent assets	8,591	7,339	8,009
Total assets	<u>\$ 2,514,985</u>	<u>\$ 2,264,214</u>	<u>\$ 2,159,639</u>
Current liabilities	\$ 99,684	\$ 89,378	\$ 81,278
Noncurrent liabilities	1,506,529	1,374,261	1,350,621
Total liabilities	<u>1,606,213</u>	<u>1,463,639</u>	<u>1,431,899</u>
Invested in capital assets, net of related debt	586,031	574,370	558,436
Restricted for debt service	144,307	131,469	84,981
Unrestricted	178,434	94,736	84,323
Total net assets	<u>908,772</u>	<u>800,575</u>	<u>727,740</u>
Total liabilities and net assets	<u>\$ 2,514,985</u>	<u>\$ 2,264,214</u>	<u>\$ 2,159,639</u>

Net assets (the difference between assets and liabilities) may serve, over time, as a useful indicator of a government's financial position. In the case of the Wastewater Enterprise, assets exceeded liabilities by \$908.8 million and \$800.6 million at the end of fiscal year 2010 and 2009, respectively. Increases in operating income in fiscal years 2010 and 2009 resulted in increases in net assets of 13.5% and 10.0%, respectively. The largest portion of the Wastewater Enterprise's net assets represented its investment in

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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

	2010	2009	2008
Operating revenues	\$ 308,407	\$ 251,953	\$ 225,105
Operating expenses	<u>(153,680)</u>	<u>(130,346)</u>	<u>(142,477)</u>
Operating income	154,727	121,607	82,628
Nonoperating revenues (expenses)			
Interest income	957	7,080	17,884
Interest expense	(43,555)	(45,269)	(50,469)
Other	<u>(409)</u>	<u>(3,329)</u>	<u>(1,115)</u>
Income before transfers and capital contributions	111,720	80,089	48,928
Transfers out	(9,485)	(12,931)	(11,944)
Capital contributions	<u>5,962</u>	<u>5,677</u>	<u>78</u>
Change in net assets	108,197	72,835	37,062
Net assets			
Beginning of year	<u>800,575</u>	<u>727,740</u>	<u>690,678</u>
End of year	<u>\$ 908,772</u>	<u>\$ 800,575</u>	<u>\$ 727,740</u>

The change in net assets was primarily due to:

- Operating revenues, comprised mainly of sewer service charges, increased 22.4% to \$308.4 million for fiscal year 2010 compared to the prior fiscal year and increased 11.9% to \$251.9 million for fiscal year 2009 compared to fiscal year 2008. Sewer service charge rates were raised 18% at July 1, 2009.
- Operating expenses increased \$23.3 million or 17.9% to \$153.7 million for fiscal year 2010 compared to the prior fiscal year and decreased \$12.1 million or 8.5% to \$130.3 million for fiscal year 2009 compared to fiscal year 2008. The primary increase in 2010 and decrease in 2009 was in administration and general and fringe benefits.
- Interest expense decreased by \$1.7 million or 3.8% to \$43.6 million for fiscal 2010 compared to the prior fiscal year and decreased by \$5.2 million or 10.3% to \$45.3 million for fiscal 2009 compared to fiscal year 2008. The decrease in both fiscal years 2010 and 2009 was due to the refinancing of selected outstanding revenue bonds.

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- Capital contributions increased to \$6.0 million in fiscal year 2010 up from \$5.7 million in fiscal year 2009 and \$0.1 million in fiscal year 2008. Capital contributions represent assets (primarily capital assets) transferred from other city governmental funds and other entities. Approximately \$9.5 million was transferred out during fiscal year 2010 primarily for the Wastewater Enterprise's share of central administrative expenses incurred by the City and \$12.9 million during fiscal year 2009 for the Wastewater Enterprise's share of central administrative expenses incurred by the City and for the Wastewater Enterprise's share of the other postemployment benefits contribution.

Capital Asset and Debt Administration

Capital assets. The Wastewater Enterprise's capital assets amounted to \$2.1 billion and \$1.9 billion, net of accumulated depreciation, as of June 30, 2010 and 2009, respectively, an increase (decrease) of \$175.5 million or 9.4% in 2010 and an increase of \$174.0 million or 10.2% in 2009. 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 20-year capital plan.

Long-term debt. Wastewater revenue bonds and State revolving fund loans are the primary long-term financing instruments used to fund the acquisition of capital assets. Revenue bonds outstanding as of June 30, 2010 and 2009 totaled \$1,320.9 million and \$1,222.5 million, respectively. State revolving fund notes payable outstanding at June 30, 2010 and 2009 totaled \$193.1 million and \$157.3 million, respectively.

Debt service coverage was 426% and 340% on Senior Revenue Bonds, 288% and 242% on all revenue bonds, and 218% and 180% on all debt at June 30, 2010 and 2009, respectively. Debt service coverage exceeded the requirements of bond covenants and policies of the City Council in 2010 and 2009.

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.

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Statements of Net Assets
June 30, 2010 and 2009
(Amounts in thousands)

	2010	2009
Assets		
Current assets		
Cash and cash equivalents	\$ 388,640	\$ 324,297
Investments	12,707	12,707
Receivables		
Accounts, net of allowance for uncollectible accounts of \$1,561 in 2010 and \$1,622 in 2009	41,088	34,551
Interest	45	25
Employee advances	1,269	-
Due from other City funds	1,027	1,117
Inventories of materials and supplies	11,021	9,126
Prepaid expenses	1,980	1,895
Total current assets	<u>457,777</u>	<u>383,718</u>
Capital assets, net	2,048,617	1,873,157
Deferred charges	8,591	7,339
Total assets	<u>\$ 2,514,985</u>	<u>\$ 2,264,214</u>
Liabilities and Net Assets		
Current liabilities		
Accounts payable	\$ 24,472	\$ 30,715
Due to other City funds	3,532	-
Interest payable	30,146	26,284
Bonds payable	24,262	19,446
Notes payable	15,365	12,471
Accrued payroll	1,552	147
Other current liabilities	355	315
Total current liabilities	<u>99,684</u>	<u>89,378</u>
Notes payable	177,738	144,839
General obligation bonds payable, net	1,276	6,442
Revenue bonds payable, net	1,301,853	1,210,027
Other liabilities	25,662	12,953
Total liabilities	<u>1,606,213</u>	<u>1,463,639</u>
Commitments and contingencies		
Net assets		
Invested in capital assets, net of related debt	586,031	574,370
Restricted for debt service	144,307	131,469
Unrestricted	178,434	94,736
Total net assets	<u>908,772</u>	<u>800,575</u>
Total liabilities and net assets	<u>\$ 2,514,985</u>	<u>\$ 2,264,214</u>

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

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Sewer Fund
Statements of Revenues, Expenses and Change in Net Assets
Years Ended June 30, 2010 and 2009
(Amounts in thousands)

	2010	2009
Operating revenues		
Sewer service charges	\$ 299,502	\$ 250,265
Other revenue	8,905	1,688
Total operating revenues	<u>308,407</u>	<u>251,953</u>
Operating expenses		
Administrative and general	45,490	29,962
Depreciation	42,281	40,682
Fringe benefits	21,196	12,911
Utilities	16,719	17,683
Contractual services	16,223	17,054
Materials and supplies	9,625	8,957
Fuel and lubricants	1,769	2,279
Maintenance	377	818
Total operating expenses	<u>153,680</u>	<u>130,346</u>
Operating income	154,727	121,607
Nonoperating revenues (expenses)		
Interest income	957	7,080
Interest expense	(43,555)	(45,269)
Other	(409)	(3,329)
Total nonoperating expenses	<u>(43,007)</u>	<u>(41,518)</u>
Income before transfers and capital contributions	111,720	80,089
Transfers out	(9,485)	(12,931)
Capital contributions	<u>5,962</u>	<u>5,677</u>
Change in net assets	108,197	72,835
Net assets		
Beginning of year	<u>800,575</u>	<u>727,740</u>
End of year	<u>\$ 908,772</u>	<u>\$ 800,575</u>

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

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Statements of Cash Flows
Years Ended June 30, 2010 and 2009
(Amounts in thousands)

	2010	2009
Cash flows from operating activities		
Cash received from customers	\$ 302,107	\$ 249,384
Cash payments to suppliers	(61,705)	(39,526)
Cash payments to employees	(50,278)	(47,272)
Net cash provided by operating activities	<u>190,124</u>	<u>162,586</u>
Cash flows from noncapital financing activities		
Transfers out	<u>(9,485)</u>	<u>(12,931)</u>
Net cash used in noncapital financing activities	<u>(9,485)</u>	<u>(12,931)</u>
Cash flows from capital and related financing activities		
Acquisition and construction of capital assets	(200,273)	(194,431)
Proceeds from issuance of notes	49,147	53,522
Repayments on notes	(13,354)	(11,066)
Interest paid on notes	(2,048)	(2,632)
Proceeds from issuance of bonds, net of discount	288,034	-
Proceeds from grant funding	8,626	-
Repayments on bonds	(195,545)	(15,654)
Interest paid on bonds	(53,129)	(57,388)
Interest subsidies for wastewater system revenue bonds	<u>1,309</u>	<u>-</u>
Net cash used in capital and related financing activities	<u>(117,233)</u>	<u>(227,649)</u>
Cash flows from investing activities		
Purchase of investments	-	(360,448)
Proceeds from maturity of investments	-	716,822
Interest on investments	<u>937</u>	<u>9,933</u>
Net cash provided by investing activities	<u>937</u>	<u>366,307</u>
Net increase in cash and cash equivalents	64,343	288,313
Cash and cash equivalents		
Beginning of year	<u>324,297</u>	<u>35,984</u>
End of year	<u>\$ 388,640</u>	<u>\$ 324,297</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, 2010 and 2009
(Amounts in thousands)

	2010	2009
Reconciliation of operating income to net cash provided by operating activities		
Operating income	\$ 154,727	\$ 121,607
Adjustments to reconcile operating income to net cash provided by operating activities		
Depreciation	42,281	40,682
Other revenue	-	(516)
Change in		
Accounts receivable	(7,806)	(2,733)
Due from other City funds	90	-
Prepaid expenses	(85)	(70)
Inventories of materials and supplies	(1,896)	(1,109)
Accounts payable	(6,243)	2,627
Due to other City funds	3,532	(55)
Other liabilities	5,524	2,153
Net cash provided by operating activities	<u>\$ 190,124</u>	<u>\$ 162,586</u>

Supplemental disclosure of noncash capital and related financing activities

The Sewer Fund received \$6.0 million and \$5.7 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, 2010 and 2009, respectively.

Amortization of net bond premiums and discounts amounted to \$1.0 million and \$162,000 in fiscal 2010 and 2009, respectively. Amortization of bond issue costs amounted to \$784,000 and \$669,000 in fiscal 2010 and 2009, respectively.

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

City and County of Honolulu
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Notes to Financial Statements
June 30, 2010 and 2009

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 Wastewater System. The fund accounts for the operations of the City and County of Honolulu's ("City") 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 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.

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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 \$22.6 million and \$21.9 million at June 30, 2010 and 2009, 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. All infrastructure assets acquired prior to the fiscal year ended June 30, 1980 are also capitalized. Such assets are recorded at cost or estimated cost. Interest cost is capitalized as part of the cost of acquiring certain assets.

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

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

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

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

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.

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Net Assets

Net assets are comprised of the accumulated income (losses) 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.

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 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 June 2007, the GASB issued Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*. This Statement requires that all intangible assets not specifically excluded by its scope be classified as capital assets. The objective of this Statement is to establish accounting and financial reporting requirements for intangible assets to enhance comparability among state and local governments. The City adopted the provisions of this Statement in 2010 which did not have a material effect on the Sewer Fund's financial statements.

GASB Statement No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*, clarifies that when actuarially determined other postemployment benefits ("OPEB") measures are reported by an agent multiple-employer OPEB plan and its participating employers, those measures should be determined as of a common date and at a minimum frequency to satisfy the agent multiple-employer OPEB plan's financial reporting requirements. These provisions are

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effective for the Sewer Fund for years beginning after June 15, 2011. The City has not yet determined the effect this Statement will have on the Sewer Fund's financial statements.

In June 2010, the GASB issued Statement No. 59, *Financial Instruments Omnibus*. The objective of this Statement is to update and improve existing standards regarding financial reporting of certain financial instruments and external investment pools. These provisions are effective for the Sewer Fund for periods beginning after June 15, 2010. The City has not yet determined the effect this Statement will have on the Sewer Fund's financial statements.

3. Cash and Investments

The cash and investments 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.

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.

The investment of \$12.7 million at June 30, 2010 and 2009 was with FSA Capital Management LLC.

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, 2010, 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 and \$1.1 million at June 30, 2010 and 2009, respectively. Due to other City funds consists primarily of the Sewer Fund's share of retirement plan contributions for the second half of fiscal year 2010.

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6. Capital Assets

The capital assets activity for the years ended June 30, 2010 and 2009 were as follows (in thousands of dollars):

	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	<u>1,836,633</u>	<u>106,268</u>	<u>(3,651)</u>	<u>1,939,250</u>
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	<u>(318,186)</u>	<u>(42,281)</u>	<u>275</u>	<u>(360,192)</u>
	1,518,447	63,987	(3,376)	1,579,058
Land	6,101	195	(4)	6,292
Construction in progress	<u>348,609</u>	<u>190,944</u>	<u>(76,286)</u>	<u>463,267</u>
	<u>\$ 1,873,157</u>	<u>\$ 255,126</u>	<u>\$ (79,666)</u>	<u>\$ 2,048,617</u>
	Balance at July 1, 2008	Additions	Retirements/ Transfers	Balance at June 30, 2009
Depreciable assets				
Buildings and improvements	\$ 718,168	\$ 64,913	\$ -	\$ 783,081
Transmission and distribution system	1,020,625	26,268	(29,986)	1,016,907
Equipment and machinery	32,167	2,221	(1,254)	33,134
Land improvements	3,511	-	-	3,511
Total depreciable assets	<u>1,774,471</u>	<u>93,402</u>	<u>(31,240)</u>	<u>1,836,633</u>
Less: Accumulated depreciation				
Buildings and improvements	(96,093)	(17,559)	-	(113,652)
Transmission and distribution system	(163,302)	(20,649)	140	(183,811)
Equipment and machinery	(17,756)	(2,355)	549	(19,562)
Land improvements	(1,042)	(119)	-	(1,161)
Total accumulated depreciation	<u>(278,193)</u>	<u>(40,682)</u>	<u>689</u>	<u>(318,186)</u>
	1,496,278	52,720	(30,551)	1,518,447
Land	6,065	36	-	6,101
Construction in progress	<u>196,811</u>	<u>214,169</u>	<u>(62,371)</u>	<u>348,609</u>
	<u>\$ 1,699,154</u>	<u>\$ 266,925</u>	<u>\$ (92,922)</u>	<u>\$ 1,873,157</u>

Depreciation expense was \$42.3 million and \$40.7 million for the years ended June 30, 2010 and 2009, respectively.

City and County of Honolulu
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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 1993 through 2010 in the original amount totaling \$331.3 million, and maturing serially through fiscal year 2023. The general obligation bonds bear interest at rates ranging from 3.5% to 5.9% at June 30, 2010.

Wastewater system revenue bonds in the City's business-type activities were issued during fiscal years 1999 through 2010, in the original amount totaling \$1.8 billion, less discounts of \$35.5 million and adjusted for premiums of \$48.8 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, 2010 and mature at various dates through fiscal year 2040. The wastewater system revenues collateralize the revenue bonds.

In September 2009, the City issued wastewater system revenue bonds, Senior Series 2009A, 2009B Build America Bonds, and 2009C Recovery Zone Economic Development Bonds, in the aggregate amount of \$148.3 million, and Junior Series 2009A of \$127.0 million. The bonds mature annually on July 1, 2010 through July 1, 2039 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.

In March 2010, the United States Department of Agriculture ("USDA") through its Rural Development purchased \$2.8 million of City wastewater system revenue bonds (USDA Bond Resolution) Series 2010. The bonds mature annually on July 1, 2011 through 2045 and bear an interest rate of 4.0%. The proceeds were used to fund additions and improvements to the wastewater system of the City.

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 \$193.1 million and \$157.3 million at June 30, 2010 and 2009, respectively, bearing interest ranging from 0.50% to 4.02%, and require annual principal and interest payments through fiscal year 2028.

Total interest costs incurred in 2010 and 2009 were \$58.0 million and \$58.8 million, respectively, of which \$14.5 million and \$11.2 million was capitalized in 2010 and 2009, respectively.

**City and County of Honolulu
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Long-term obligations activity for the fiscal years ended June 30, 2010 and 2009 were as follows (in thousands of dollars):

	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>

	Balance at July 1, 2008	Additions	Reductions	Balance at June 30, 2009	Amount Due Within One Year
General obligation bonds	\$ 21,417	\$ -	\$ (8,019)	\$ 13,398	\$ 6,956
Revenue bonds	1,219,065	-	(7,565)	1,211,500	12,490
Notes payable	114,847	53,529	(11,066)	157,310	12,471
	<u>1,355,329</u>	<u>53,529</u>	<u>(26,650)</u>	<u>1,382,208</u>	<u>31,917</u>
Add: Unamortized net premium (discount) and deferred amount on refunding	11,179	-	(162)	11,017	-
Total long-term debt	<u>1,366,508</u>	<u>53,529</u>	<u>(26,812)</u>	<u>1,393,225</u>	<u>31,917</u>
Compensated absences	5,777	3,913	(2,338)	7,352	315
Other postretirement benefits	3,616	6,906	(7,206)	3,316	-
Arbitrage rebate	-	2,600	-	2,600	-
Total long-term obligations	<u>\$ 1,375,901</u>	<u>\$ 66,948</u>	<u>\$ (36,356)</u>	<u>\$ 1,406,493</u>	<u>\$ 32,232</u>

**City and County of Honolulu
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Notes to Financial Statements
June 30, 2010 and 2009**

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
2011	\$ 5,167	\$ 19,095	\$ 15,365	\$ 39,627	\$ 63,521
2012	1,214	28,440	15,552	45,206	60,543
2013	10	34,379	15,761	50,150	59,311
2014	11	35,461	14,669	50,141	57,788
2015	8	38,947	12,268	51,223	56,203
2016–2020	32	217,764	58,182	275,978	255,304
2021–2025	1	272,656	44,857	317,514	198,600
2026–2030	-	322,864	16,449	339,313	123,300
2031–2035	-	229,755	-	229,755	53,205
2036–2040	-	100,849	-	100,849	8,938
2041–2046	-	780	-	780	113
	<u>6,443</u>	<u>1,300,990</u>	<u>193,103</u>	<u>1,500,536</u>	<u>\$ 936,826</u>
Less: Current portion	<u>(5,167)</u>	<u>(19,095)</u>	<u>(15,365)</u>	<u>(39,627)</u>	
	<u>\$ 1,276</u>	<u>\$ 1,281,895</u>	<u>\$ 177,738</u>	<u>\$ 1,460,909</u>	

8. Net Assets

At June 30, 2010 and 2009, net assets consisted of the following (in thousands of dollars):

	2010	2009
Invested in capital assets, net of related debt		
Net property, plant and equipment	\$ 2,048,617	\$ 1,873,157
Less:		
Wastewater general obligation bonds payable	(6,443)	(13,398)
Wastewater system revenue bonds payable, net of unamortized premium, discount, and issue cost	(1,320,948)	(1,222,517)
Notes payable	(193,103)	(157,310)
Amount of debt related to unspent debt proceeds	<u>57,908</u>	<u>94,438</u>
	586,031	574,370
Restricted for debt service	144,307	131,469
Unrestricted	<u>178,434</u>	<u>94,736</u>
Total	<u>\$ 908,772</u>	<u>\$ 800,575</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 Comprehensive Annual Financial Reports ("CAFR"). The ERS CAFR can be found at the ERS website: <http://www4.hawaii.gov/ers/default.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, 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.

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 6.8% and 7.1% of the City's ARC for the fiscal years ended June 30, 2010 and 2009, respectively. The following table shows the components of the annual OPEB cost for the fiscal years ended June 30, 2010 and 2009, the amount contributed to the plan, and changes in the Sewer Fund's net OPEB obligation (in thousands of dollars):

	2010	2009
Annual required contribution	\$ 8,603	\$ 6,843
Interest on net OPEB obligation	398	289
Adjustment to annual required contribution	<u>(324)</u>	<u>(226)</u>
Annual OPEB cost	8,677	6,906
Contributions made	<u>(4,315)</u>	<u>(7,206)</u>
Increase (decrease) in net OPEB obligation	4,362	(300)
Net OPEB obligation		
Beginning of year	<u>3,316</u>	<u>3,616</u>
End of year	<u>\$ 7,678</u>	<u>\$ 3,316</u>
Percentage of annual OPEB cost contributed	49.7%	104.3%

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%

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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, 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%. 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 State Employer-Union Health Benefits Trust Fund 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 (the "Board") has an agreement with the City's Department of Environmental Services to provide certain services through June 30, 2011, relating to 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 \$1.9 million and \$1.8 million for the years ended June 30, 2010 and 2009, respectively. The fee for the year ending June 30, 2011 is currently being negotiated.

11. Commitments

Construction Contracts

The City has contractual commitments for the Sewer Fund of approximately \$506 million at June 30, 2010, 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, 2010 and 2009, accumulated sick leave, including vested and nonvested

City and County of Honolulu
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Notes to Financial Statements
June 30, 2010 and 2009

accumulated rights to receive sick leave benefits, amounted to approximately \$21.6 million and \$22.4 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. Some of these matters relate to the Sewer Fund as follows:

A lawsuit filed by the U.S. Environmental Protection Agency ("EPA") and State of Hawaii, Department of Health ("DOH") against the City in 1994 resulted in a consent decree which requires the City, among other things, to comply with the Clean Water Act, to establish a schedule under which the City will implement preventive maintenance and sewer replacement and rehabilitation necessary to reduce and prevent spills, to implement and enforce its pretreatment program to regulate industrial discharges, and to develop and implement an effluent and sludge reuse program. The court has retained continuing jurisdiction over implementation of the consent decree. Pursuant to the consent decree, the City has established and is currently implementing a \$4.7 billion, 20-year capital improvement plan (fiscal year 2000 to fiscal year 2019) to upgrade its wastewater collection and treatment system to be funded from existing funds and wastewater revenue bonds.

In July 2004, the Sierra Club and other environmental groups filed a lawsuit against the City seeking injunctive relief and penalties for alleged Clean Water Act violations arising from the City's wastewater collection and treatment system. Of the plaintiffs' original twelve claims, six have been dismissed. Partial summary judgment has been entered with respect to four of the six remaining claims in this litigation. The court has not addressed the amount of penalties, if any, that would be assessed against the City. Although the final outcome of this litigation cannot be predicted at this stage of the proceedings, the entry of the proposed consent decree identified below would result in the dismissal of this litigation.

As a result of a March 2006 sewer spill and after one year of negotiations, the EPA, the U.S. Department of Justice (the "Justice Department"), the DOH and the City signed a stipulated order that requires the City to take certain actions to evaluate, repair, rehabilitate or replace certain force mains and one pump station in its wastewater collection system, and develop site-specific spill contingency plans. This stipulated order, which has been accepted by the court, resolves the entire civil enforcement action that was simultaneously filed with the stipulated order against the City with respect to the spill. The estimated cost of the work in the stipulated order is approximately \$300 million (to be funded out of existing funds and wastewater revenue bonds) and would be included in the proposed consent decree identified below.

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On July 14, 2010, the City Council approved the terms of a proposed consent decree with the EPA, the DOH, the Sierra Club, Hawaii Chapter, Our Children's Earth Foundation, and Hawaii's Thousand Friends. The proposed consent decree would resolve the 1994, 2004, and 2006 lawsuits and the City's appeals of the EPA's January 2009 final decisions. The proposed 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 \$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 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 \$1.2 billion to upgrade the plants to secondary treatment plants. The settlement also requires the payment of a civil penalty in the amount of \$800,000 to the federal government, and \$800,000 to the State. In addition, the City will provide \$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 proposed consent decree was approved by the Justice Department and lodged with the federal court and was subject to a 30-day public comment period which ended September 15, 2010. The Justice Department filed its motion to enter the consent decree on November 15, 2010. The consent decree will become effective upon its entry by the Court. Plaintiffs' claims for attorneys' fees remain outstanding and will be resolved separately by the federal magistrate.

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

13. Subsequent Events

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, 2015 through July 1, 2040 and bear interest rates of 3.0% to 6.1%. The Junior Series 2010A bonds maturing on July 1, 2024, 2026 and 2027 are subject to redemption at the option of the City on or after July 1, 2020, 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. Since the Build America Bonds were sold as taxable bonds, the City is eligible for federal interest subsidies of 35%.

Required Supplementary Information

City and County of Honolulu
Sewer Fund
Schedule of Funding Progress (Unaudited)
June 30, 2010 and 2009
(Amounts in thousands)

Post-Retirement Health Care and 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%