King County Water Quality Enterprise

Financial Statements and
Supplemental Schedule for the
Years Ended December 31, 2002 and 2001, and
Independent Auditors' Report

KING COUNTY WATER QUALITY ENTERPRISE

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Deloitte & Touche LLP
Suite 3300
925 Fourth Ave.
Seattle, Washington 98104-1126

Tel: (206) 716-7000
Fax: (206) 965-7000
www.deloitte.com

Deloitte & Touche

INDEPENDENT AUDITORS' REPORT

King County Council
Seattle, Washington

We have audited the accompanying statements of net assets of King County Water Quality Enterprise (the "Enterprise") as of December 31, 2002 and 2001, and the related statements of revenues, expenses, and changes in net assets and of cash flows for the years then ended. These financial statements are the responsibility of the Enterprise's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Enterprise as of December 31, 2002 and 2001, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As described in Note 1 to the financial statements, in 2002, the Enterprise adopted Governmental Accounting Standards Board ("GASB") Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*; GASB Statement No. 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus—an amendment of GASB Statements No. 21 and No. 34*; and GASB Statement No. 38, *Certain Financial Statement Note Disclosures*.

The accompanying management's discussion and analysis on pages 3 through 6 is not a required part of the financial statements but is supplementary information required by the GASB. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying supplemental schedule of net revenues available for debt service for the year ended December 31, 2002, is presented as required by bond resolutions and is not a required part of the basic financial statements. This information has been subjected to the auditing procedures applied in our audits of the basic financial statements and, in our opinion, is fairly stated in all material respects when considered in relation to the basic financial statements taken as a whole.

Deloitte & Touche LLP

June 13, 2003

KING COUNTY WATER QUALITY ENTERPRISE

MANAGEMENT'S DISCUSSION AND ANALYSIS
DECEMBER 31, 2002

The management of the King County Water Quality Enterprise ("Water Quality" or the "Enterprise") offers readers of its financial statements this narrative overview and analysis of the financial activities for the fiscal year ended December 31, 2002. It is intended to be read in conjunction with the financial statements, which follow this section.

FINANCIAL HIGHLIGHTS

As of December 31, 2002, total assets exceeded total liabilities (net assets) by $337,280,978, a decrease of $995,590 (0.3%) from 2001. Of this amount, $58,343,608 is unrestricted net assets available to meet the on-going obligations of the Enterprise.

Total assets increased $69,119,960, which represents a 3.8% increase from 2001. This was principally due to an increase in net value of capital assets of $82,605,059. During 2002, the Enterprise completed construction of several projects and continued its investment in expansion and extension of sewage treatment facilities.

Total liabilities increased by $70,115,550 (4.7%). Current liabilities of all types increased $2,076,721 (1.1%), reflecting increases in notes payable (in the form of commercial paper) as offset by a reduction in the current portion of general obligation and revenue bonds payable. Noncurrent liabilities increased by $68,038,829 (5.2%) due to issuance of new revenue bonds, net of repayments, realization of bond premiums on issuance of the new bonds, and repayment of a state of Washington loan.

Operating expenses, including depreciation, decreased $5,806,403, a 3.3% reduction from 2001, due primarily to reduced energy expenses. This was offset by an increase of $2,589,034 (4.6%) in net nonoperating revenues and expenses. The largest component of nonoperating revenues and expenses is debt-related interest and amortization expense. These items decreased $1,060,094 (1.5%) as short-term borrowing rates declined in 2002.

OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis is intended to serve as an introduction to the Enterprise's basic financial statements. The basic financial statements comprise the financial statements and the notes to the financial statements, which explain certain elements of the financial statements in greater detail.

REQUIRED FINANCIAL STATEMENTS

The Enterprise's financial statements provide information with respect to all of its activities and use accounting methods similar to those used by private-sector companies. The statements provide both long-term and short-term information about the Enterprise's financial status.

The comparative statements of net assets present information on all of the Enterprise's assets and liabilities, with the difference between assets and liabilities presented as net assets as of each year end. The statements of net assets provide information about the nature and amount of investments in resources (assets) and obligations to creditors (liabilities). Over time, it provides a measure of Water Quality's financial health by providing a basis for the reader to evaluate capital structure, liquidity, and financial flexibility.

The two most recent years' operating and nonoperating revenues and expenses of the Enterprise are accounted for in the statements of revenues, expenses, and changes in net assets. The statements illustrate the current and prior period results of operations and recovery of costs by receipt of fees and are instrumental in demonstrating continued creditworthiness. All changes in net assets are reported as soon as the underlying event occurs, irrespective of the timing of related cash flows. Readers should note that the principal support for Water Quality's activities (about 90% in 2002) is receipt of monthly sewage disposal charges from 35 agencies in King and Snohomish counties.

The statements of cash flows report cash receipts, cash payments, and net changes in cash derived from operations, financing, and investment activities. From the statements, the reader can discern the Enterprise's sources and applications of cash during 2002, reasons for differences between operating cash flows and operating income, and the effect on the statements of net assets from investing, capital, and financing activities.

The notes to financial statements provide additional information essential to obtain a full understanding of the data provided in the basic statements.

FINANCIAL ANALYSIS

Statements of Net Assets**—**Net assets serve as a useful indicator of the Enterprise's financial position. As of December 31, 2002, assets of the Enterprise exceeded liabilities by $337,280,978.

Of the assets of the Enterprise, at year-end 2002, 85.7% are invested in capital assets such as treatment plants, pumping and regulator stations, interceptors, and other equipment. The Enterprise uses its capital assets to provide wholesale wastewater collection and treatment services in King and Snohomish counties. The Enterprise's investment in capital assets does not provide cash flow required to service or retire outstanding debt. Current operating and debt service requirements are met by operating and nonoperating revenues composed of monthly sewage disposal charges, a capacity charge for new customers, other special-handling septage charges, and investment earnings.

Net assets decreased $995,590 in 2002 compared to a decrease of $19,367,700 in 2001. The improvement in change of net assets (reduction in decrease) was attributable to positive operating results, principally due to an increase in sewage disposal fees.

The Enterprise reports its investment in capital assets, net of debt related to capital asset acquisition, as $204,792,287, a decrease of $18,000,093 (8.1%) over 2001, as construction cash balances declined. Resources of the Enterprise may be restricted for use in construction, to meet debt service requirements, to satisfy bond covenants, or to meet regulatory restrictions. Restricted net assets at year-end 2002 declined $18,695,588 (20.1%), as restricted cash balances declined while liabilities payable from restricted assets increased. Unrestricted net assets increased by $35,700,091 (158%) as operating cash increased at year-end 2002.

Statements of Revenues, Expenses, and Changes in Net Assets**—**While the statements of net assets show changes in assets, liabilities, and net assets, the statements of revenues, expenses, and changes in net assets provide insight into the source of these changes. During 2002, the statements report that operating revenues increased by $26,149,309 (14%) and operating expenses decreased by $5,806,403 (3.3%). These changes were influenced by several factors:

- The Enterprise collected a monthly sewage disposal charge of $23.40 (per residential customer equivalent) in 2002, up from $19.75 in 2001, an 18.5% increase. This resulted in an increase in total sewage disposal fees of $24.8 million (14.8%) from 2001 to 2002.

- Other operating revenues, including capacity charge for new customers and other treatment charges, rose $1.4 million (7%), reflecting an increase in the per month capacity charge from $10.50 in 2001 to $17.20 in 2002 (64%) and increases in other charges.

- Nondepreciation-related operating expenses decreased $9.4 million (10.6%). A decrease in electricity costs of $7.1 million represents 75% of the total decrease. Electricity costs were reduced by a decline in market rates and Water Quality's entry into long-term, reduced-rate contracts with local utilities provider Puget Sound Energy.

The increase in nonoperating revenues and expenses (net expenses) of $2,589,034 (4.6%) was primarily affected by:

- Investment earnings decreased $0.2 million from 2001 as a decline in market yields on short-term investments offset the effect of increased cash balances.

- Other nonoperating revenues declined $3.7 million (53%) as nonoperating reimbursements declined in 2002.

- Interest expense and debt-related amortization decreased $1.1 million as interest incurred on newly issued debt was offset by savings from a bond refunding, low short-term borrowing rates, and debt repayments.

The statements also report comparative amounts of capital grant revenues for 2002 and 2001:

- Capital grant revenues derived from federal and state agencies decreased $10.3 million in 2002 as reduced federal funding was received for the Enterprise's Denny Way and Renton projects.

CAPITAL ASSETS

At December 31, 2002, the Enterprise's investment in capital assets, net of accumulated depreciation, is $1,632,026,255. This is an increase of $82,605,059 (5.3%) over the 2001 investment in capital assets, net of accumulated depreciation. The change is a result of replacement and additions to the interceptor and siphon systems, completion of a pump station, extensions of sewer trunk lines, and continued efforts to control odor and improve sewage-handling technology.

The increase of $79,327,857 (35.1%) in work in progress is directly related to continued implementation of the Enterprise's Regional Wastewater Services Plan. Capital expenditures in work in progress relate to continued system-wide improvement and expansion. Large construction projects underway include:

- Denny Way Combined Sewer Overflow, a joint venture with Seattle Public Utilities also partially funded by federal grants, incurred 2002 additions of $26 million

- $14 million in 2002 conveyance system improvements

- $10 million for the Henderson/Martin Luther King Way Combined Sewer Overflow project

- $14.2 million expended on the North Creek storage facility

- $9.7 million spent toward eventual completion of the North treatment plant

DEBT ADMINISTRATION

The Enterprise has $457,075,000 of general obligation bonds outstanding. Although repaid from a portion of receipts from sewage disposal fees and other income, the full faith and credit of King County guarantees repayment of principal and interest on general obligation bonds.

The Enterprise has $952,420,000 of sewer revenue bonds outstanding. Revenue bonds are repaid from and secured by a pledge of earnings, revenues, and money received by the Enterprise and King County from or on account of operation of the sewer system, to include receipts from sewage disposal fees and other income of the Enterprise. Revenue bonds are not guaranteed by the full faith and credit of King County.

At time of the issuance of the Sewer Revenue Refunding Bonds, Series 2002B, the Enterprise's bond ratings, as conditioned upon the delivery of an accompanying municipal bond insurance policy, are:

Moody's Investor Services	Standard & Poor's
Aaa	AAA

Underlying ratings (those assigned by the ratings services without benefit of an accompanying municipal bond insurance policy) are "A1" for Moody's Investor Services and "AA-" for Standard & Poor's.

During 2002, the Enterprise obtained benefit from declining interest rates. Rates paid on commercial paper and variable rate debt are substantially below projected amounts. In November 2002, proceeds from issuance of Sewer Revenue Refunding Bonds, Series 2002B, were used for advance refunding of existing debt. Although a loss was recognized on defeasance, the transaction will reduce aggregate debt service payments by $29,253,547 over the life of the bonds. The present value of the reduction of aggregate debt service is $16,451,111. In March 2003, the Enterprise refunded an issue of general obligation bonds with issuance of Sewer Revenue Refunding Bonds, Series 2003A. The refunding activity resulted in a reduction of future aggregate debt service of $10,241,386, the present value of which is $5,305,428.

REQUESTS FOR INFORMATION

This financial report is designed to provide an overview of the Enterprise's financial condition at December 31, 2002, and results for the period then ended. Questions concerning this report or requests for additional information should be addressed to Connie Griffith, Chief Accountant for King County, 500 Fourth Avenue, Room 653, Seattle, Washington 98104.

KING COUNTY WATER QUALITY ENTERPRISE

STATEMENTS OF NET ASSETS
DECEMBER 31, 2002 AND 2001

ASSETS	2002	2001
CURRENT ASSETS:		
Cash and cash equivalents	$ 30,453,117	$ 10,387,794
Interest receivable		649
Accounts receivable	12,974,824	12,431,322
Due from other governments		16,820
Inventory of supplies	4,232,433	4,166,014
	47,660,374	27,002,599
NONCURRENT ASSETS:		
Revenue fund:		
Cash and cash equivalents	29,826,841	17,322,843
Interest receivable		549
Construction fund:		
Cash and cash equivalents	54,492,722	97,660,914
Interest receivable		4,177
Grants receivable	1,413,943	2,466,043
Accounts receivable	730,429	
Due from other governments	190,741	1,873,917
Bond fund:		
Cash and cash equivalents	122,541,239	91,333,060
Investments, at fair value		35,016,276
Interest receivable		144,293
	209,195,915	245,822,072
CAPITAL ASSETS:		
Building and land improvements	1,215,002,799	1,137,788,974
Plant in service and other equipment	852,374,477	846,050,692
Less accumulated depreciation	(776,059,971)	(694,522,358)
	1,291,317,305	1,289,317,308
Land	35,185,252	33,908,047
Construction work in progress	305,523,698	226,195,841
	1,632,026,255	1,549,421,196
OTHER:		
Deferred environmental remediation costs	7,048,694	7,797,189
Other deferred charges	8,138,266	4,906,488
	15,186,960	12,703,677
TOTAL	$ 1,904,069,504	$ 1,834,949,544

See notes to financial statements.

LIABILITIES AND NET ASSETS	2002	2001
CURRENT LIABILITIES:		
Accounts payable	$ 9,751,466	$ 3,249,483
Interest payable	279,906	1,141,787
Wages and benefits payable	10,553,560	9,280,659
Notes payable	93,300,000	83,500,000
Obligations under reverse repurchase agreements	458,504	
State loans payable	1,340,484	2,864,434
Due to other funds	1,384,438	3,486,292
Estimated claims settlement	865,894	1,715,322
	117,934,252	105,237,977
CURRENT LIABILITIES PAYABLE FROM RESTRICTED ASSETS:		
Accounts payable	20,146,539	17,821,715
Interest payable	29,216,396	27,880,024
Wages and benefits payable	700,870	958,455
Due to other funds	1,720,049	2,772,713
Obligations under reverse repurchase agreements	3,333,872	656,968
General obligation bonds payable—current portion	6,605,000	8,635,000
Revenue bonds payable—current portion	10,835,000	23,775,000
Estimated claims settlement	6,662,042	7,339,447
	79,219,768	89,839,322
NONCURRENT LIABILITIES:		
General obligation bonds payable	450,470,000	457,075,000
Revenue bonds payable	941,585,000	866,780,000
Deferred bond premium, discount, and refunding losses	(59,275,841)	(78,670,348)
State loans payable	36,855,347	55,909,942
Environmental and property remediation costs		501,083
	1,369,634,506	1,301,595,677
Total liabilities	1,566,788,526	1,496,672,976
NET ASSETS:		
Invested in capital assets—net of related debt	204,792,287	222,792,380
Restricted	74,145,082	92,840,670
Unrestricted	58,343,609	22,643,518
Total net assets	337,280,978	338,276,568
TOTAL	$ 1,904,069,504	$ 1,834,949,544

KING COUNTY WATER QUALITY ENTERPRISE

STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
YEARS ENDED DECEMBER 31, 2002 AND 2001

	2002	2001
OPERATING REVENUES:		
Sewage disposal fees	$ 192,123,662	$ 167,360,642
Other operating revenues	21,099,526	19,713,237
	213,223,188	187,073,879
OPERATING EXPENSES:		
Sewage treatment, disposal, and transmission	70,024,576	76,613,411
General and administrative	9,615,021	12,460,032
Depreciation and amortization	88,381,507	84,754,064
	168,021,104	173,827,507
OPERATING INCOME	45,202,084	13,246,372
NONOPERATING REVENUES (EXPENSES):		
Investment earnings	7,385,863	7,596,531
Other	3,291,533	6,977,667
Interest	(53,088,532)	(58,904,258)
Amortization of bond premium, discount, and issuance costs	(15,747,927)	(10,992,295)
Loss on disposal of fixed assets and remediation	(1,188,358)	(1,436,032)
	(59,347,421)	(56,758,387)
LOSS BEFORE CAPITAL CONTRIBUTIONS AND TRANSFERS	(14,145,337)	(43,512,015)
GRANT REVENUES	13,914,612	24,219,722
TRANSFERS	(764,865)	(75,407)
CHANGE IN NET ASSETS	(995,590)	(19,367,700)
NET ASSETS:		
Beginning of year	338,276,568	357,644,268
End of year	$ 337,280,978	$ 338,276,568

See notes to financial statements.

KING COUNTY WATER QUALITY ENTERPRISE

STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 31, 2002 AND 2001

	2002	2001
CASH FLOWS FROM OPERATING ACTIVITIES:		
Cash received from customers	$ 213,649,253	$ 188,528,895
Cash payments to suppliers for goods and services	(41,086,196)	(47,353,665)
Cash payments for employee services	(31,932,216)	(31,185,526)
Net cash provided by operating activities	140,630,841	109,989,704
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:		
Operating transfers out	(764,865)	(75,407)
Interest paid on short-term loans	(14,266)	(1,109,962)
Net cash used in noncapital financing activities	(779,131)	(1,185,369)
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:		
Acquisition of capital assets	(156,601,534)	(147,257,655)
Principal paid on general obligation bonds	(8,635,000)	(7,550,000)
Interest paid on general obligation bonds	(24,488,919)	(24,921,158)
Proceeds of new bond issuance	446,130,000	370,060,000
Principal paid on revenue bonds by refunding	(360,490,000)	(162,624,000)
Principal paid on revenue bonds	(23,775,000)	(6,970,000)
Interest paid on revenue bonds	(37,627,682)	(38,413,727)
Principal paid on notes payable	9,800,000	(16,500,000)
Interest paid on notes payable	(1,501,236)	(3,161,419)
Issuance costs of bonds and notes payable	461,726	(5,949,878)
Principal paid on state loans	(45,035,544)	(2,746,666)
Proceeds of new state loan	24,457,000	1,500,000
Interest paid on state loans	(1,308,274)	(2,501,737)
Capital grants received	14,289,307	17,254,603
Amortization of deferred charges	(604,462)	(1,196,372)
Net cash used in capital and related financing activities	(164,929,618)	(30,978,009)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of investment securities	(15,393,057,500)	(12,757,295,000)
Proceeds from sales of investment securities	15,428,073,777	12,777,332,024
Interest on investments	10,670,939	8,787,460
Net cash provided by investing activities	45,687,216	28,824,484
NET INCREASE IN CASH AND CASH EQUIVALENTS	20,609,308	106,650,810

(Continued)

KING COUNTY WATER QUALITY ENTERPRISE

STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 31, 2002 AND 2001

	2002	2001
NET INCREASE IN CASH AND CASH EQUIVALENTS	$ 20,609,308	$ 106,650,810
CASH AND CASH EQUIVALENTS:		
Beginning of year	216,704,611	110,053,801
End of year	$ 237,313,919	$ 216,704,611
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Operating income	$ 45,202,084	$ 13,246,372
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation and amortization	88,381,507	84,754,064
Changes in assets:		
Due from other governments	1,699,996	2,169,712
Accounts receivable	(1,273,931)	(714,697)
Inventory of supplies	(66,419)	455,146
Changes in liabilities:		
Accounts payable	8,826,807	7,897,289
Due to other funds	(3,154,518)	2,730,246
Wages and benefits payable	1,015,315	(548,428)
Total adjustments	95,428,757	96,743,332
NET CASH PROVIDED BY OPERATING ACTIVITIES	$ 140,630,841	$ 109,989,704
NONCASH INVESTING ACTIVITIES—Changes in fair value of investments	$ 2,510,372	$ 505,050

See notes to financial statements.

(Concluded)

1. OPERATIONS AND ACCOUNTING POLICIES

Summary of Operations—The King County Water Quality Enterprise (the "Enterprise") is an enterprise fund operated by the King County Department of Natural Resources in accordance with Chapter 35.58 of the Revised Code of Washington ("RCW") to provide water pollution abatement services to the urbanized areas of King County, Washington (the "County").

The Enterprise is an integral part of the County reporting entity and is included, as an enterprise fund, in the County's comprehensive annual financial report.

As an enterprise fund, the Enterprise is funded and operated separately from other operations of the County. Revenues, bond proceeds, and grants-in-aid are restricted by purpose. Accordingly, the Enterprise has separate accounting records and financial statements.

The Enterprise has long-term sewage disposal agreements with the cities and sewer districts that operate sewage collection systems within its service area. The monthly sewage disposal charge to the contracting cities and districts is based on the Enterprise's estimated annual monetary requirements, including operating costs and debt service. Revenues from the Enterprise's largest customer, the City of Seattle ("Seattle Public Utilities"), represent approximately 44% and 48% of total sewage disposal fees in 2002 and 2001, respectively.

The Enterprise purchases goods and services from other County agencies, including reimbursement of the County's General Fund for a share of general government. Expenses incurred in doing business with other County agencies amounted to $24,978,000 and $26,449,000 in 2002 and 2001, respectively.

Significant Accounting Policies—The Enterprise is accounted for on a flow of economic resources measurement focus similar to that of a private enterprise organized for profit. The Enterprise's financial statements are prepared in accordance with accounting principles generally accepted in the United States of America as applied to governmental units using the accrual basis of accounting. Under this method, revenues are recorded when earned, and expenses are recorded at the time liabilities are incurred. The Enterprise, in accordance with Governmental Accounting Standards Board ("GASB") Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, elected not to apply all statements of the Financial Accounting Standards Board issued subsequent to November 30, 1989.

a. *Cash and Cash Equivalents*—The Enterprise considers as cash and cash equivalents all balances held with the King County Treasurer in the King County Investment Pool (the "Pool") and petty cash. Unrealized gain or loss on the Enterprise's proportionate share of the Pool is reported as a component of investment earnings.

b. *Due to/from Other County Funds*—Due to/from other funds consists of payments for services or advances provided to or by other funds and for cash collected on behalf of or due from another fund.

c. *Inventory of Supplies*—Inventory is recorded at the lower of cost or market using the weighted-average cost method. Inventory is written off in the year that it is determined obsolete.

d. *Restricted Assets*—In accordance with the Enterprise's bond resolutions, state law, or other agreements, separate restricted assets have been established. These assets are restricted for specific purposes, including debt service payments and funding of capital projects. These funds are maintained in the revenue fund, construction fund, and bond fund on the statements of net assets.

e. *Capital Assets*—The provision for depreciation is made on a straight-line basis over the estimated useful lives of the Enterprise's capital assets, which range from two to 50 years.

   Total interest incurred was $65,414,868 and $66,000,818 during the years ended December 31, 2002 and 2001, respectively, of which $12,326,336 and $7,096,560 was capitalized.

   Repairs and maintenance are expensed as incurred; major renewals, replacements, and betterments are capitalized.

f. *Environmental and Property Remediation Costs*—In prior years, the Enterprise settled lawsuits related to certain environmentally damaged sites. In these settlements, the Enterprise agreed to pay its portion of remediation and cleanup costs.

   The Enterprise funds the majority of its environmental expenditures with debt proceeds. The Enterprise also receives grant funding to offset a portion of these costs. The initial settlement costs, net of the partial grant funding and other recoveries, are deferred and are being amortized over 40 years as revenues are collected from the Enterprise's customers. Current remediation activities are expensed in the year incurred. Previously, the Enterprise agreed to pay a portion of remediation costs to clean up contaminated sediments and restore aquatic habitats in Elliott Bay and the Lower Duwamish River. During 2002, the Enterprise incurred $552,085 of costs associated with this obligation.

g. *Compensated Absences*—Employees earn vacation based upon their date of hire and years of service. They may accumulate a maximum of 480 hours. Unused vacation at retirement or normal termination is considered vested and payable to the employee.

   Employees also earn up to 12 days of sick leave per year and may accumulate sick leave balances without limit. Employees or their beneficiaries are paid 35% of the accrued unused sick leave upon retirement or death. No amounts are paid for unused sick leave upon termination.

   The Enterprise records additions to wages and benefits payable for accrued and unused vacation and sick leave in the period earned.

h. *Amortization*—Bond issue costs and discounts are amortized to interest expense using the effective interest rate method over the term of the bonds.

   The excess costs incurred over the carrying value of bonds refunded on early extinguishment of debt are amortized as a component of interest expense using the straight-line method over the shorter of the remaining term of the refunded bond or the term of the new bond.

i. *Deferred Compensation*—The County offers a consolidated deferred compensation plan that complies with Internal Revenue Code Section 457. The plan permits employees to defer a portion of annual compensation until future years. Participation in the plan is voluntary. No amounts related to these obligations are recorded in the financial statements.

j. *Use of Estimates*—The preparation of the 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 amounts reported in the financial statements. Changes in these estimates and assumptions are considered reasonably possible and may have a material impact on the financial statements.

k. *Reclassifications*—Certain reclassifications have been made to the prior year statements to conform to the current year presentation.

l. *Capital Grant Revenues*—Assets acquired through contributions from third parties are recorded as additions to the appropriate utility plant accounts. Pursuant to GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, contributions are included in nonoperating revenues as capital grant revenues. The Enterprise received capital grant revenues of $13,914,612 and $24,219,722 for the years ended December 31, 2002 and 2001, respectively.

m. *Net Assets*—Pursuant to GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, grant revenues, a portion of sales tax revenues, and resources set aside for repayment of bonds, net of related liabilities are classified as restricted net assets on the statement of net assets as their use is limited by externally-imposed restrictions. Capital assets are reported as a separate component of net assets, net of related debt. Any net assets not subject to classification as restricted or invested in capital assets are reported as unrestricted.

New Accounting Standards Adopted—With respect to the year ended December 31, 2002, the Enterprise adopted GASB Statements No. 34, No. 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus—an amendment of GASB Statements No. 21 and No. 34*, and No. 38, *Certain Financial Statement Note Disclosures*.

In addition to other presentation changes, Statement No. 34 (as amended by Statement No. 37) requires that amounts reported as contributed capital and retained earnings in prior years be reported as net assets within a statement of net assets. Statement No. 34 also requires that the basic financial statements be preceded by a Management's Discussion and Analysis, which is required supplementary information. Pursuant to Statement No. 38, certain note disclosures have been added or amended.

2. CASH AND INVESTMENTS

The King County Treasurer is the custodian of the Enterprise's cash and investments. In prior years, most Enterprise funds were invested solely in direct obligations of the U.S. Treasury. A refunding of bonds, issued with various restrictive covenants, has removed this investment restriction and enabled the Enterprise to invest all funds in the Pool.

The Enterprise's pooled deposits and investments are categorized by risk into three basic categories. Risk Category 1 includes deposits insured or collateralized with securities held by the entity or by its agent in the entity's name. Risk Category 2 includes deposits collateralized with securities held by the pledging financial institution's trust department or agent in the entity's name. Risk Category 3 includes deposits that are uncollateralized, including any bank balance that is collateralized with securities held by the pledging financial institution, or by its trust department or agent, but not in the entity's name. At year-end 2002, all of the County's pooled deposits are in Risk Category 1.

Statutes permit the Pool to enter into reverse repurchase agreements. The Enterprise has been allocated a proportionate share of the pooled investments and liabilities associated with reverse repurchase agreements based on total equity in the Pool. Reverse repurchase agreements are recorded as an increase to assets and an offsetting increase to liabilities. The Enterprise's share of the reverse repurchase agreements was $3,792,376 and $656,968 as of December 31, 2002 and 2001, respectively. County policy prohibits use of these agreements as a borrowing mechanism. The proceeds from the repurchase agreements are reinvested in other instruments with the same maturity as the collateral securities, resulting in a matched position.

The amount of cash received in reverse repurchase agreements is normally less than the market value of the underlying securities to provide a margin to the dealers against market fluctuations. Should the dealers default on their obligations to resell these securities to the County, the County would be faced with an economic loss equal to the difference in market value plus accrued interest of the underlying securities and the agreement obligation, including accrued interest. During the fiscal years ended December 31, 2002 and 2001, no losses were incurred as a result of default.

3. RISK MANAGEMENT

The Enterprise is exposed to a wide range of risks of loss, including those related to tort; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters.

The Enterprise participates in three County internal service funds to account for and finance property/casualty, workers' compensation, and employee medical and dental benefits self-insurance programs. The County contracts with a plan administrator to process medical and dental claims. County fund/claims managers, together with the Civil Division of the King County Prosecuting Attorney's Office, are responsible for processing all tort and workers' compensation claims.

Claims settlements and loss expenses are accrued in the three internal service funds for the estimated settlement value of both reported and unreported claims. These funds are responsible for collecting interfund premiums from insured funds and departments, for paying claim settlements, and for purchasing certain policies. Premiums attributable to the Enterprise are assessed by the County's internal service funds on the basis of claims experience, an actuarial evaluation of future claims risk, and adequacy of available reserves. Premiums are recorded as an expense in the year paid or accrued.

The Enterprise retains all risk associated with environmental claims. See Note 1.

4. LONG-TERM LIABILITIES AND NOTES PAYABLE

Sewer Revenue Bonds**—**As of December 31, 2002, bonds outstanding include $483,230,000 of serial bonds maturing from January 1, 2003 through 2023, bearing interest at stated rates of 3% to 6.25% per annum, and $469,190,000 of term bonds maturing on January 1 in the years 2018 through 2035, bearing interest at stated rates of 5% to 6.2% per annum.

In August 2002, the Enterprise issued $100,000,000 of sewer revenue bonds maturing from January 1, 2017 to 2035. The issue includes $5,040,000 of serial bonds maturing from January 1, 2017 through 2021, bearing interest at a stated rate of 5.5%, and $94,960,000 of term bonds, maturing January 1, 2028 to 2035, bearing interest at stated rates from 5% to 5.25%. In November 2002, the Enterprise issued $346,130,000 of sewer revenue refunding bonds. The issue includes $293,920,000 of serial bonds maturing from January 1, 2003 through 2021, bearing interest at stated rates from 3.0% to 5.5%, and $52,210,000 of term bonds, maturing January 1, 2024 to 2033, bearing interest at stated rates from 5.125% to 5.5%.

Certain serial bonds may not be redeemed prior to maturity; other bonds may be redeemed at declining premiums after the lapse of specific periods of time. Monies in the sewer revenue bond fund may be used to purchase term bonds prior to maturity.

Payments from revenues of the Enterprise are required to be made to the sewer revenue bond fund in annual amounts sufficient to retire serial or term bonds on or before maturity.

Pursuant to bond resolutions and covenants, amounts of $66,847,524 and $85,963,567 as of December 31, 2002 and 2001, respectively, have been designated as net assets restricted for debt service. At year-end 2001, net assets restricted for debt service represent the minimum required balance in the bond reserve, the actual amounts of the term bond fund, contingency reserve, operating reserve, betterment reserve, and 2001 revenue bond debt service reduced by current principal and accrued interest. The issuance of Sewer Revenue Refunding Bonds, Series 2002B removed certain bond covenants. At year-end 2002, net assets restricted for debt service represents only the minimum required balance in the Bond Reserve.

Defeased Debt**—**In November 2002, the Enterprise issued $346,130,000 of Sewer Revenue Refunding Bonds, Series 2002B. Bond proceeds were used for advance refunding of existing debt and to pay costs of issuance, bond insurance, and underwriter's discount. The loss recognized on defeasance was $7,022,600, which will be amortized over the life of the old bonds. The transaction will reduce aggregate debt service payments by $29,253,547 over the life of the bonds. The present value of the reduction of aggregate debt service is $16,451,111.

The following outstanding bonds were considered defeased as of December 31, 2002:

Issue	
Sewer Revenue Refunding Bonds, Series X	$129,615,000
Sewer Revenue Refunding Bonds, Series Y	107,155,000
Sewer Revenue Refunding Bonds, Series Z	123,720,000
Sewer Refunding Revenue Bonds, Series 1993W	90,000,000
Limited Tax General Obligation Bonds, 1994 Series A	151,990,000
	$ 602,480,000

At the time of defeasance, amounts are placed in irrevocable escrow accounts to provide for all future debt service on the defeased bonds. As a result, the bonds are considered to be defeased and are not included in the Enterprise's financial statements.

General Obligation Bonds**—**As of December 31, 2002, bonds outstanding include $116,135,000 of serial bonds maturing January 1, 2003 through 2018, bearing interest at stated rates of 4.75% to 5.875% per annum. General obligation bonds outstanding also include $340,940,000 of term bonds maturing on January 1, 2017 through 2035, bearing interest at stated rates of 4.75% to 6.25% per annum.

Certain serial bonds cannot be redeemed prior to maturity; other bonds may be redeemed at declining premiums after the lapse of specific periods of time.

State Loans**—**The Enterprise received loans from the Washington Department of Ecology under the Water Pollution Control State Revolving Fund Loan Program. An August 2000 loan requires semiannual payments of $398,884 of principal and interest from 2001 through 2020 and bears an interest rate of 1.5%. The balance due on the August 2000 loan is $12,238,831 as of December 31, 2002. An August 2002 loan requires semiannual payments of $421,085 of principal and interest from 2003 through 2022 and bears an interest rate of 1.5%. The balance due on the August 2002 loan is $14,207,000 as of December 31, 2002. An earlier 1990 loan was repaid on February 28, 2002, with proceeds received from issuance of bonds in November 2001.

As of year-end 2002, the Enterprise has received three loans from the Washington Public Works Trust Fund. The loans require annual payments of principal over various terms extending from 2003 to 2022 plus interest of 0.5%. As of December 31, 2002, the balance due on the loans is $11,750,000.

Total principal due on all state loans is $38,195,831 as of December 31, 2002.

Maturities of Long-Term Liabilities—As of December 31, 2002, required principal and interest payments are as follows:

Date Payment Due	Sewer Revenue Bonds	Variable Rate Revenue Bonds	General Obligation Bonds	State Loans	Total
1/1/2003	$ 38,478,779	$ 1,600,000	$ 30,863,499	$ 1,772,650	$ 72,714,928
1/1/2004	62,727,093	1,600,000	30,853,871	2,464,790	97,645,754
1/1/2005	62,179,593	1,600,000	32,500,784	2,460,958	98,741,335
1/1/2006	64,002,343	1,600,000	29,682,347	2,457,127	97,741,817
1/1/2007	64,645,843	1,600,000	29,158,734	2,453,294	97,857,871
1/1/2008–2012	323,333,255	8,000,000	145,639,463	11,280,861	488,253,579
1/1/2013–2017	302,365,236	8,000,000	140,934,271	11,208,494	462,508,001
1/1/2018–2022	195,183,784	8,000,000	142,751,619	8,641,647	354,577,050
1/1/2023–2027	196,543,996	8,000,000	172,599,658		377,143,654
1/1/2028–2032	186,037,699	108,000,000	144,359,416		438,397,115
1/1/2033–2034	142,740,111		74,646,364		217,386,475
Less interest	(785,817,732)	(48,000,000)	(516,915,026)	(4,543,990)	(1,355,276,748)
Net principal	$ 852,420,000	$ 100,000,000	$ 457,075,000	$ 38,195,831	$ 1,447,690,831

The future annualized interest payments for the variable rate revenue bonds are estimated to be equivalent to the rate of 1.60% incurred during the period that included December 31, 2002.

Changes in Long-Term Liabilities—Long-term liability activity for the years ended December 31, 2002 and 2001, was as follows:

	Revenue Bonds Payable	General Obligation Bonds Payable	State Loans Payable
January 1, 2001	$ 690,089,000	$ 473,260,000	$ 60,021,042
Additions	370,060,000		1,500,000
Reductions	(169,594,000)	(7,550,000)	(2,746,666)
December 31, 2001	890,555,000	465,710,000	58,774,376
Additions	446,130,000		24,457,000
Reductions	(384,265,000)	(8,635,000)	(45,035,545)
December 31, 2002	$ 952,420,000	$ 457,075,000	$ 38,195,831
Due within one year	$ 10,835,000	$ 6,605,000	$ 1,340,484

Compliance with Bond Resolutions—With respect to the year ended December 31, 2002, the Enterprise complied with all covenants stipulated by its bond resolutions except for providing audited financial statements within 120 days of year end. The Enterprise has six months beyond the 120 days to comply with the covenants by providing such financial statements. It is management's intention to remedy noncompliance within the applicable six-month period.

Commercial Paper (Notes Payable)—In December 1995, the Enterprise initiated a commercial paper program that gives the Enterprise the ability to issue up to $100,000,000. The program is supported by an annually renewable line of credit that is scheduled to expire August 13, 2003. It is the intent of the Enterprise to obtain an extension of the line of credit prior to its expiration. As of December 31, 2002, $93,300,000 was issued and outstanding under this program. The commercial paper has maturities ranging between 62 and 111 days and is classified as a current liability of the Enterprise's operating fund.

Variable Rate Revenue Bonds—The variable rate bonds are supported by an annually renewable letter of credit scheduled to expire August 12, 2003. It is the intent of the Enterprise to obtain an extension of the line of credit prior to its expiration.

5. CHANGES IN CAPITAL ASSETS

Changes in capital assets for the years ended December 31, 2002 and 2001, are shown in the following tables:

	December 31, 2000	Increases	Decreases	December 31, 2001
Building and land improvements	$ 1,111,957,640	$ 25,831,334	$ –	$ 1,137,788,974
Major equipment and vehicles	7,906,918			7,906,918
Shop and other equipment	739,958,439	87,818,101	(2,323,625)	825,452,915
Software development	12,690,859			12,690,859
Land	33,908,047			33,908,047
Work in progress	175,090,378	160,125,901	(109,020,438)	226,195,841
	2,081,512,281	273,775,336	(111,344,063)	2,243,943,554
Less accumulated depreciation and amortization:				
Building and land improvements	(356,006,701)	(7,573,377)		(363,580,078)
Major equipment and vehicles	(1,096,144)	(694,096)		(1,790,240)
Shop and other equipment	(240,597,170)	(76,660,875)	736,805	(316,521,240)
Software development	(12,574,441)	(56,359)		(12,630,800)
	(610,274,456)	(84,984,707)	736,805	(694,522,358)
	$ 1,471,237,825	$ 188,790,629	$(110,607,258)	$ 1,549,421,196

	December 31, 2001	Increases	Decreases	December 31, 2002
Building and land improvements	$ 1,137,788,974	$ 77,219,825	$ (6,000)	$ 1,215,002,799
Major equipment and vehicles	7,906,918	320,856	(358,014)	7,869,760
Shop and other equipment	825,452,915	20,061,013	(9,435,434)	836,078,494
Software development	12,690,859		(4,264,636)	8,426,223
Land	33,908,047	1,277,205		35,185,252
Work in progress	226,195,841	158,699,103	(79,371,246)	305,523,698
	2,243,943,554	257,578,002	(93,435,330)	2,408,086,226
Less accumulated depreciation and amortization:				
Building and land improvements	(363,580,078)	(30,399,776)	3,544,419	(390,435,435)
Major equipment and vehicles	(1,790,240)	(686,991)	39,847	(2,437,384)
Shop and other equipment	(316,521,240)	(61,221,463)	2,978,066	(374,764,637)
Software development	(12,630,800)	(56,352)	4,264,637	(8,422,515)
	(694,522,358)	(92,364,582)	10,826,969	(776,059,971)
	$ 1,549,421,196	$ 165,213,420	$ (82,608,361)	$ 1,632,026,255

6. EMPLOYEE BENEFIT PLANS

Defined Benefit Pension Plans**—**Substantially all full-time and qualifying part-time employees participate in the Public Employees' Retirement System ("PERS"). PERS is a statewide local governmental retirement system administered by the Washington State Department of Retirement Systems, under cost-sharing, multiple-employer defined benefit public employee retirement systems.

Historical trend and other information regarding PERS is presented in the Washington State Department of Retirement Systems' 2002 Comprehensive Annual Financial Report. A copy of this report may be obtained from Department of Retirement Systems, P.O. Box 48380, Olympia, Washington, 98504-8380.

Public Employees Retirement System**—**The Washington State Legislature (the "Legislature") established PERS in 1947 under RCW chapter 41.40. PERS is a cost-sharing, multiple-employer defined benefit system.

The PERS plan contains three tiers. Participants who joined the system by September 30, 1977, are plan I members. Those joining thereafter are enrolled in plan II unless the employee chooses plan III. Retirement benefits for all plans are financed from employee and employer contributions and investment earnings. Retirement benefits are vested after various minimum periods of eligible service.

Plan I members are eligible for retirement after 30 years of service, at the age of 60 with five years of service, or at the age of 55 with 25 years of service. The annual pension is 2% of the final average salary per year of service, capped at 60%. If qualified, after reaching age 66, a limited cost of living allowance is granted.

Plan II members may retire at the age of 65 with five years of service or at 55 with 20 years of service, with an allowance of 2% per year of service of the final average salary. Plan II retirements prior to the age of 65 are actuarially reduced. There is no cap on years-of-service credit and a limited cost-of-living allowance is granted.

Plan III commenced September 1, 2002. Plan III members may retire with 10 years of service or with five service years, including one year earned after age 54, five service years under plan II prior to transfer to plan III. Plan III retirements prior to age 65 are actuarially reduced. With respect to the defined benefit portion of plan III, there is no cap on years-of-service credit, and a limited cost of living allowance is granted.

Each biennium, the Legislature establishes plan I employer contribution rates, plan II employer and employee contribution rates, and plan III employer contribution rates. Employee contribution rates for plan I are not necessarily adequate to fully fund the system. The employer and employee contribution rates for plan II and the employer contribution rates for plan III are developed by the Office of the State Actuary to fully fund future pension obligations. All employers are required to contribute at the level established by the Legislature.

The Enterprise's contribution rates expressed as a percentage of covered payroll as of December 31, 2002, were:

	PERS Plan I 1/1–3/31	PERS Plan I 4/1–4/30	PERS Plan I 5/1–12/31	PERS Plan II 1/1–3/1	PERS Plan II 4/1–4/30	PERS Plan II 5/1–12/31
Employer	1.77%	1.33%	1.32%	1.77%	1.33%	1.32%
Employee	6.00%	6.00%	6.00%	0.88%	0.65%	0.65%
	7.77%	7.33%	7.32%	2.65%	1.98%	1.97%

Employer contributions to plan III are the same as those required for plan II. Employee contributions to plan III are made to a separate defined contribution account and may vary from 5 to 15%.

Both the Enterprise and employees made the required contributions. The Enterprise's required employer contributions for the years ended December 31 were:

	PERS Plan I	PERS Plans II and III
2002	$ 82,958	$ 472,152
2001	211,000	1,035,000
2000	281,000	1,246,000

7. OPERATING SUBSIDIES AND GRANT REVENUES

Various federal and state government agencies make grants to the Enterprise to aid in financing construction costs (capital grants), including those on various projects included in the comprehensive plan, and for operating costs (operating subsidies). Operating subsidies are recorded as revenues in the statements of revenues, expenses, and changes in retained earnings. Capital grants amounted to $13,914,612 and $24,219,722 for the years ended December 31, 2002 and 2001, respectively.

Capital grants and operating subsidies are subject to audit. Expenditures subsequently determined to be disallowed may result in liabilities for the Enterprise to the original granting organization. Management uses its best efforts to determine that grant-funded expenditures are in accordance with grant terms. During 2000, completion of an Environmental Protection Agency ("EPA") audit of the Fort Lawton sewer construction project resulted in a claim against the Enterprise of $6,662,042, representing unsupported and ineligible costs previously paid with grant funds. While the Enterprise intends to appeal the EPA finding, it recorded the full amount of the claim as a liability at December 31, 2000. As of December 31, 2002, the matter remains unresolved and under appeal.

8. COMMITMENTS AND CONTINGENCIES

***Construction Program*—**The Federal Water Pollution Control Act requires that municipal sewage be subjected to secondary treatment. Major facilities have been included in the Enterprise's construction plan to meet this requirement, including five treatment plants that are being improved or modified to provide secondary treatment under compliance schedules that have been or will be established by permit, by court-approved consent decree, or by administrative order.

The Enterprise is continuing to design, acquire, and construct treatment facilities and transmission lines within the guidelines of the construction plan. As of December 31, 2002, the Enterprise plans to expend approximately $1,672,000,000 through 2007 to complete the requirements of the construction plan. The majority of the expenditures will be used for construction of secondary treatment facilities (including an additional sewage treatment plant) and combined sewer overflow control facilities.

Contingencies and Claims**—**The Enterprise has received claims from contractors involved in construction projects. The contractors have claimed an amount in excess of the original contract sum. The Enterprise intends to defend its case in these actions and cannot assess the likelihood of an adverse outcome; however, management believes any adverse outcome would not have a material impact on the Enterprise.

Office Facilities**—**The Enterprise currently rents office space from the Department of Construction and Facilities Maintenance of King County. The Enterprise has not entered into a formalized legal contract for the use of these spaces but is expected to continue to rent office space for future years. Rent expenses incurred in 2002 and 2001 were approximately $1,242,000 and $955,000, respectively.

9. TRANSFERS

During 2002 and 2001, the King County Council approved ordinances and/or motions authorizing the Enterprise to contribute $764,865 and $75,407, respectively, to various County funds. These amounts are shown as transfers on the statements of revenues, expenses, and changes in net assets.

10. SUBSEQUENT EVENT

In March 2003, the Enterprise issued $96,470,000 of Sewer Revenue Refunding Bonds, Series 2003A. Bond proceeds were used for advance refunding of existing general obligation debt and to pay costs of issuance, bond insurance, and underwriter’s discount.

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KING COUNTY WATER QUALITY ENTERPRISE

SUPPLEMENTAL SCHEDULE OF NET REVENUES AVAILABLE FOR DEBT SERVICE YEAR ENDED DECEMBER 31, 2002

The Enterprise is obligated by applicable bond ordinances to set sewage disposal rates at a level adequate to provide net revenue equal to at least 1.15 times the annual debt service requirements for sewer revenue and general obligation bonds payable from revenues of the Enterprise. It is adopted policy of the Enterprise to achieve a debt service coverage ratio of 1.25.

Coverage (1.15 required by covenant, adopted policy 1.25)	1.75

In 2001 the Enterprise adopted a new debt service target of 1.15 times the annual debt service for bonds, obligations, notes, and loans of the Enterprise.

Coverage (1.15 adopted target)	1.66

The Enterprise is required to generate revenues sufficient to pay all costs of operation of the sewage treatment system and debt service on obligations of the Enterprise.

Coverage (1.00 required by covenant)	1.32

In 2001 the Enterprise issued an additional tier of revenue bonds. The bond covenants of the Junior Lien Variable Rate Demand Sewer Revenue Bonds, Series 2001A and Series 2001B, require that sewage disposal rates provide net revenue equal to at least 1.10 times the annual debt service requirements for all Junior Lien obligations after payment of senior lien requirements.

Coverage (1.10 required by covenant)	33.53