

Washington State Auditor's Office
Financial Statements Audit Report

Water Quality Enterprise
King County

Audit Period
January 1, 2008 through December 31, 2008

Report No. 1002364

Issue Date
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WASHINGTON
BRIAN SONNTAG
STATE AUDITOR



**Washington State Auditor
Brian Sonntag**

October 26, 2009

King County Council and Executive
King County
Seattle, Washington

Report on Financial Statements

Please find attached our report on the King County Water Quality Enterprise's financial statements.

We are issuing this report in order to provide information on the Enterprise's financial condition.

Sincerely,

BRIAN SONNTAG, CGFM
STATE AUDITOR

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King County
January 1, 2008 through December 31, 2008**

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Schedule of Audit Findings and Responses

Water Quality Enterprise King County January 1, 2008 through December 31, 2008

1. King County does not have adequate internal controls to ensure accurate accounting and financial reporting for the Water Quality Enterprise.

Background

County management, the state Legislature, state and federal agencies and bondholders rely on the information included in the financial statements and reports to make decisions. It is the responsibility of the County management to design and follow internal controls that provide reasonable assurance regarding the reliability of financial reporting. Controls must ensure that financial data is reliably authorized, processed and reported. Our audit identified significant deficiencies in controls that adversely affect the County's ability to produce reliable financial statements.

Government Auditing Standards, prescribed by the Comptroller General of the United States, require the auditor to communicate significant deficiencies, as defined below in the Applicable Laws and Regulations section, as a finding.

Description of Condition

We identified the following, which represent a significant deficiency in internal controls over financial reporting:

- A sufficient detailed review and reconciliation of the financial statements was not performed to ensure they were accurate, complete and adequately supported. In two instances County personnel bypassed financial statement review and approval controls by providing revised financial statements for audit, which were later retracted by upper management.
- The County requested the Enterprise's financial statement audit be completed by June 30, 2009. The necessary staff time or resources were not dedicated to ensure annual financial reports were accurate, complete and available for audit in a timely manner. The final accurate reporting package was provided on August 25, 2009, after the audit worked through five versions of the financial statements and notes.

Cause of Condition

The County has not prioritized accurate and timely financial reporting. In addition, the County lacks sufficient enforcement of policies and procedures to ensure that the financial information provided for audit is accurate.

Effect of Condition

The original and subsequent revisions of the financial statements received for audit contained errors and missing notes to the financial statements. However, the delay afforded the County the additional time and opportunity to make corrections and prepare materially accurate financial statements and add the required missing notes to the financial statements.

Our audit identified the following significant errors:

- During our review of cash and investments we found \$17 million of restricted funds that were misclassified as unrestricted. Subsequently, the County corrected this item.
- Additionally, in response to audit inquiry, the County has reclassified \$48.2 million between unrestricted and restricted cash and cash equivalents to correctly present assets in accordance with accounting standards.
- The notes to the financial statements lacked the required disclosure for inter-fund loans and restricted assets. Subsequently, the County corrected this item.

There were additional less significant errors noted that were corrected by the County. These deficiencies in internal controls make it reasonably possible that more serious misstatements could occur and not be prevented or detected by the County in the future.

Recommendation

We recommend the County:

- Dedicate sufficient resources to ensure complete and timely financial reporting.
- Follow its internal controls and policies over the review of the financial statements.
- Utilize appropriate resources, such as the *Governmental Accounting, Auditing and Financial Reporting* (GAAFR) manual, to determine the appropriate presentation of the Enterprise's financial statements and notes.

County's Response

The County has internal controls related to the preparation of financial statements which includes review by both Water Quality and the central Finance supervisory staff. Statements are prepared in conformity with generally accepted accounting principles (GAAP). Governmental Accounting, Auditing, and Financial Reporting (GAAFR) and government Finance Officers Association (GFOA) checklists are an element of the review process. We agree that the County needs to assure that all internal controls for review of financial reporting are followed in advance of submission to the auditors.

To accelerate future year's financial statement preparation processes central Finance is currently working with the department staff to move-up financial system closing and reporting dates.

Regarding the releasing of financial statements without review, the first early release was a procedural lapse, discussed with the accountant. The second release was in response to an auditor proposed adjustment and was forwarded as “a preview of the statement effects” in the interest of expediency. We have clarified with staff there are to be no further ‘previews’ on proposed adjustments.

The auditor cites the County for providing five versions of the financial statement and notes. The changes to the financial statement were in asset classification, operating expenses and note disclosures. These changes in ‘totals’ were insignificant. The differences in total assets between the first and last version of the financial statement was \$169,000 or 0.005 percent of \$3.5 billion in total assets; net assets changed by \$297,000 or 0.05 percent of \$577 million in total net assets; operating expenses changed by \$190,000 or 0.1 percent of operating expenses of \$175 million and operating revenues did not change.

We appreciate the auditor’s and County staff accountant’s review of the statement of net assets presentation of the cash and cash equivalents allocations (although total cash in the statements did not change). We agree that these changes were necessary to better present assets in accordance with accounting standards. The county has taken corrective action and the issue will not reoccur. We note in this response that all cash was presented on the incorrect financial statement line item, and that no cash was missing.

The County agrees that the interfund loan disclosure improves the Water Quality financial statements. We do not agree that it is required by standards and therefore do not believe it should be an audit exception. The most frequently used checklist for an enterprise fund, and the checklist used by the county, is the Government Finance Officers Association Stand-Alone Business-Type checklist. This checklist includes many items but makes no mention of inter-fund loan disclosure. Other authoritative documents we review when preparing financial statements from the Governmental Accounting Standards Board and the American Institute of Certified Public Accountants are mostly silent on individual fund statements or indicate interest in providing future guidance.

Auditor’s Remarks

Although the County asserts that the changes to the financial statements are insignificant, we reaffirm our finding. If the significant deficiencies identified in our finding were left unreported and undetected, it is possible that the County’s financial statements could include material misstatements.

Applicable Laws and Regulations

RCW 43.09.200 states:

The state auditor shall formulate, prescribe, and install a system of accounting and reporting for all local governments, which shall be uniform for every public institution, and every public office, and every public account of the same class.

The system shall exhibit true accounts and detailed statements of funds collected, received, and expended for account of the public for any purpose whatever, and by all public officers, employees, or other persons.

The accounts shall show the receipt, use and disposition of all public property, and the income, if any, derived therefrom; all sources of public income, and the amounts due and received from each source; all receipts, vouchers, and other documents kept, or required to be kept, necessary to isolate and prove the validity of every transaction; all statements and reports made or required to be made, for the internal administration of the office to which they pertain; and all reports published or required to be published, for the information of the people regarding any and all details of the financial administration of public affairs.

Government Auditing Standards, July 2007 Revision, Section 5.11, states in part:

For all financial statement audits, auditors should report the following deficiencies in internal controls:

1. Significant deficiency: a deficiency in internal control, or a combination of deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with GAAP such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected.
2. Material weakness: a significant deficiency, or combination or significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected.

**Independent Auditor's Report on Internal
Control over Financial Reporting and on
Compliance and Other Matters in Accordance
with *Government Auditing Standards***

**Water Quality Enterprise
King County
January 1, 2008 through December 31, 2008**

King County Council and Executive
Water Quality Enterprise
Seattle, Washington

We have audited the basic financial statements of the King County Water Quality Enterprise, an enterprise fund of King County, Washington, as of and for the years ended December 31, 2008 and 2007, and have issued our report thereon dated October 7, 2009.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to the financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

INTERNAL CONTROL OVER FINANCIAL REPORTING

In planning and performing our audits, we considered the Enterprise's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Enterprise's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Enterprise's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies involving the internal control over financial reporting that we consider to be significant deficiencies.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Enterprise's ability to initiate, authorize, record, process or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the Enterprise's financial statements that is more than inconsequential will not be prevented or detected by the Enterprise's internal control over financial reporting. We

consider the deficiency described in the accompanying Schedule of Audit Findings and Responses to be a significant deficiency in internal control over financial reporting, and is reported as Finding 1.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the Enterprise's internal control. Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we believe that none of the significant deficiencies described above is a material weakness.

COMPLIANCE AND OTHER MATTERS

As part of obtaining reasonable assurance about whether the Enterprise's financial statements are free of material misstatement, we performed tests of the Enterprise's compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion.

The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

The County's response to the finding identified in our audit is described in the accompanying Schedule of Audit Findings and Responses. We did not audit the County's response and, accordingly, we express no opinion on it.

This report is intended for the information and use of management, and the Council. However, this report is a matter of public record and its distribution is not limited. It also serves to disseminate information to the public as a reporting tool to help citizens assess government operations.



BRIAN SONNTAG, CGFM
STATE AUDITOR

October 7, 2009

Independent Auditor's Report on Financial Statements

Water Quality Enterprise King County January 1, 2008 through December 31, 2008

King County Council and Executive
King County
Seattle, Washington

We have audited the accompanying basic financial statements of the King County Water Quality Enterprise, an enterprise fund of King County, Washington, as of and for the years ended December 31, 2008 and 2007, as listed on page 9. 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 and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. 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 King County Water Quality Enterprise, as of December 31, 2008 and 2007, and the changes in financial position and cash flows thereof for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1, the financial statements present only King County Water Quality Enterprise and do not purport to, and do not, present fairly the financial position of King County, Washington, as of December 31, 2008 and 2007, the changes in its financial position, or, where applicable, its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report on our consideration of the Enterprise's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audits.

The management's discussion and analysis on pages 10 through 16 is not a required part of the basic financial statements but is 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 express no opinion on it.

The Supplemental Schedule of Net Revenues Available For Debt Service is not a required part of the basic financial statements but is supplementary information presented for purposes of additional analysis. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on it.

A handwritten signature in black ink, appearing to read "Brian Sonntag". The signature is fluid and cursive, with the first name "Brian" and last name "Sonntag" clearly distinguishable.

BRIAN SONNTAG, CGFM
STATE AUDITOR

October 7, 2009

Financial Section

**Water Quality Enterprise
King County
January 1, 2008 through December 31, 2008**

REQUIRED SUPPLEMENTAL INFORMATION

Management's Discussion and Analysis – 2008 and 2007

BASIC FINANCIAL STATEMENTS

Statement of Net Assets – 2008 and 2007
Statement of Revenues, Expenditures and Changes in Net Assets – 2008 and 2007
Statement of Cash Flows – 2008 and 2007
Notes to Financial Statements – 2008 and 2007

SUPPLEMENTAL INFORMATION

Supplemental Schedule of Net Revenues Available for Debt Service – 2008

KING COUNTY WATER QUALITY ENTERPRISE
MANAGEMENT'S DISCUSSION AND ANALYSIS
December 31, 2008 and 2007

The management of King County Water Quality Enterprise ("Water Quality") presents to readers of its financial statements this narrative overview and analysis of its activities and financial performance for the fiscal years ending December 31, 2008, and 2007.

THE SEWER SYSTEM

Water Quality provides wastewater treatment services to King County, part of Snohomish County, and part of Pierce County with a service area encompassing over 420 square miles. The major wastewater treatment facilities include two large secondary treatment plants at West Point and Renton, two smaller secondary treatment plants at Vashon Island and Carnation, 335 miles of interceptors, 42 pump stations, and 38 combined sewer outflow (CSO) control locations. The sewer system collects and treats an average of 179 million gallons per day from approximately 1.4 million residents.

FINANCIAL HIGHLIGHTS

During 2008 Water Quality provided sewage treatment services to 705,090 residential customer equivalents (RCE) up from 702,946 in 2007 and 690,934 in 2006. An RCE is one single-family residence or an equivalent unit of 750 cubic feet of monthly water consumption for all other customers such as multifamily residential, commercial, and industrial properties. The capacity charge program added 11,331 new connections to its customer billing base in 2008. The program added 12,271 and 10,896 new connections in 2007 and 2006, respectively. The average flow of the four treatment plants was 162 million gallons per day (MGD) with a peak daily flow of 444 MGD. The addition of the Carnation Treatment Plant increased system maximum capacity by a million gallons per day to 767 MGD. The average daily flow fluctuated between a peak of 198 in 2006, 178 in 2007, and a low of 162 MGD in 2008. The amount of annual precipitation largely determines annual fluctuations in flows, with 2008 considered a low flow year.

Water Quality produced 51,701 wet tons of biosolids at its West Point Treatment Plant and 64,365 wet tons at its South Treatment Plant in 2008. The entire system produced 28,434 dry tons of biosolids. About 293 million gallons of reclaimed water were used for landscape irrigation, industrial processes, and for heating and cooling in 2008. Completion of the Carnation Treatment Plant in 2008 has added 480,000 gallons of Class A reclaimed water capacity per day to the system. Reclaimed water capacity will expand again when the Brightwater treatment plant begins service in 2011.

The Industrial Pretreatment Program conducted 435 inspections and took 2,258 compliance samples in 2008. The program currently tracks 319 facilities with discharge authorization permits and 134 significant industrial users.

Water Quality currently has 38 Combined Sewer Overflow facilities. An aggressive effort conducted in concert with the City of Seattle has resulted in a significant reduction in combined sewer overflows from 2.3 billion gallons per year baseline in 1980-1983 to 815 million gallons currently.

The Metropolitan King County Council adopted the Regional Wastewater Services Plan (RWSP) in 1999 to construct additional capacity for Water Quality to protect public health and water quality and to provide for future projected population growth in its service area through 2030.

Major RWSP projects include the building of the County's third major treatment plant (Brightwater), improvements to the regional conveyance system, construction of 21 combined sewer overflow (CSO) control projects, and expansion of the South Treatment Plant to 135 million gallons per day capacity by 2029. RWSP also includes projects to control infiltration and inflow into the conveyance system to process additional biosolids and produce additional reclaimed water. Total Water Quality capital program expenditures were \$474.1 million for 2008 and \$340.1 million for 2007.

Construction continued on the new Brightwater Treatment Plant located in southern Snohomish County and the associated conveyance system. Current cost estimates for the Brightwater project total \$1.8 billion. The \$369.8 million project expenditure in 2008 pushed life to date expenditures to \$1.0 billion. The project made major progress in 2008 with completion scheduled in 2011.

Another, smaller treatment plant located in the City of Carnation began service in May 2008. Total expenditures to date at December 31, 2008, were \$20.9 million with \$3.2 million spent in 2008.

Water Quality operating revenues increased by 8.1% in 2008 to \$284.2 million, while operating expenses before depreciation increased by \$2.8 million to \$98.4 million. Operating revenues increased by 9.0% in 2007 to \$262.9 million, and operating expenses before depreciation increased by \$4.5 million to \$95.6 million.

The monthly sewer rate remained at \$27.95 per RCE in 2008 after increasing in 2007. The capacity charge rate increased to \$46.25 per RCE in 2008 from \$42.00 in 2007. Capacity charge revenues increased by \$7.9 million (or 29.2%) in 2008, and \$4.9 million (or 22.1%) in 2007. Residential Customer Equivalents (RCE) billed for sewer treatment services increased to 705,090 in 2008 and to 702,946 in 2007. The Rate Stabilization Reserve was reduced by \$3 million in 2008, after being increased by \$8.25 million in 2007. The decrease of \$3 million in the reserve balance increases operating revenues for the year and has been included in the calculation of debt service coverage for 2008. Future deposits to the Rate Stabilization Reserve will decrease operating revenues and debt service coverage in the year of the deposit.

The Rate Stabilization Reserve, as mandated by the Metropolitan King County Council as part of its rate setting activities, requires Water Quality to set aside a portion of current revenue for future periods in order to moderate the impact of rate increases over time.

Water Quality issued \$350.0 million in new revenue bonds in July 2008 at an average coupon rate of 5.3%. An additional \$237 million limited tax general obligation bond refunding issue in January 2008 retired \$244.3 million in outstanding bonds. In 2008, the \$100.0 million 2006 Junior Lien Multi-modal Sewer Revenue Bond issue was retired when the MBIA debt insurance for the issue became noninvestment grade. This refunding was financed by a loan from the King County Metro Transit Construction Fund. This fund also provided a loan to the Water Quality Construction fund as bridge financing until the \$300 million LGTO Bond Issue in March, 2009. This temporary financing created a negative unrestricted net assets balance of \$51.3 million at December 31, 2008. Debt from state loans increased \$10.7 million during 2008 as new, low-rate loans were received from the State of Washington to help fund the capital program at interest rates between 0.5% and 3.1%. This compares to \$250.0 million in new revenue bonds and an additional \$50.0 million drawn against existing variable debt in 2007.

The results of operations for 2008 and 2007 produced a debt service coverage ratio on senior lien debt of 1.41, in excess of the coverage covenant requirement of 1.15 in both years. The

total debt coverage ratio of 1.23 in 2008 and 1.19 in 2007 exceeded the 1.15 policy minimum in both years.

OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis is intended to serve as an introduction to Water Quality's basic financial statements. The basic financial statements are comprised of the comparative statements of net assets; statements of revenues, expenses and changes in net assets; statements of cash flows; and the notes to the financial statements, which explain certain elements of the financial statements in greater detail.

REQUIRED FINANCIAL STATEMENTS

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

The comparative statement of net assets presents information on all of Water Quality's assets and liabilities, with the difference between assets and liabilities presented as net assets as of each year-end. The statement of net assets provides information about the nature and amount of investments in resources (assets) and obligations to creditors (liabilities). Over time, the statements demonstrate 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' of Water Quality operating and nonoperating revenues and expenses 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 Water Quality's 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 (84.5% of operating revenues in 2008 and 86.6% in 2007) is the receipt of monthly sewage treatment charges. Water Quality is a wholesale provider of sewage treatment services to thirty-five municipal and three nonmunicipal participants in King, Pierce, and Snohomish counties. The receipt of the monthly payments is governed by service agreements majority of which expire in July, 2036.

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 Water Quality's sources and applications of cash during 2008 and 2007, 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.

In the following comparative analysis of the financial statements, percentages and ratios were calculated and rounded using the actual detail from the financial statements.

FINANCIAL ANALYSIS OF THE STATEMENTS OF NET ASSETS

Comparative data, stated in millions of dollars:

	December 31		
	<u>2008</u>	<u>2007</u> ^{3/}	<u>2006</u> ^{3/}
Current assets ^{1/}	\$ 175.3	\$ 175.6	\$ 165.2
Noncurrent assets ^{2/}	140.5	102.0	96.3
Capital assets	3,167.1	2,731.0	2,429.5
Other	<u>57.6</u>	<u>59.3</u>	<u>59.0</u>
 Total assets	 <u>3,540.5</u>	 <u>3,067.9</u>	 <u>2,750.0</u>
 Long term liabilities	 2,531.4	 2,298.3	 2,063.3
Other Liabilities	<u>431.8</u>	<u>231.0</u>	<u>177.1</u>
 Total liabilities	 <u>2,963.2</u>	 <u>2,529.3</u>	 <u>2,240.4</u>
 Net assets invested in capital assets	 582.8	 377.0	 378.5
Net assets-restricted	45.8	110.7	92.6
 Net assets-unrestricted	 <u>(51.3)</u>	 <u>51.0</u>	 <u>38.4</u>
 Total Net assets	 <u>\$ 577.3</u>	 <u>\$ 538.7</u>	 <u>\$ 509.5</u>

^{1/} Current assets have been restated to include construction fund cash, cash used to pay the current year's bond principal and interest, policy reserves, and the current portion of construction related retainage.

^{2/} Includes the noncurrent portion of construction related retainage.

^{3/} Prior period balances are shown as adjusted in the financial statements.

Net assets serve as a useful indicator of Water Quality's financial position. As of December 31, 2008 and 2007, assets exceeded liabilities by \$577.3 million and \$538.7 million, respectively.

Of the total assets of Water Quality, 89.5% at year-end 2008 and 89.0% at year-end 2007 are invested in capital assets such as treatment plants, pumping and regulator stations, interceptors, and other equipment. Water Quality uses its capital assets to provide wholesale wastewater collection and treatment services in King, Pierce, and Snohomish counties. Current operating and debt service requirements are met by operating and nonoperating revenues composed of monthly sewage treatment charges, a capacity charge for new customers, other special-handling charges, miscellaneous operating revenues, and investment earnings.

Net assets increased \$38.6 million (7.2%) in 2008 and \$29.2 million (5.7%) in 2007. This relative stability in change of net assets was attributable to stable operating results and increased revenues. Restricted assets decreased by \$64.9 million (58.6%) in 2008 after increasing by \$18.1 million in 2007 (19.6%). Unrestricted net assets decreased in 2008 by \$102.3 million (200.7%) and increased by \$12.5 million (32.6%) in 2007.

Water Quality reported its investment in capital assets, net of debt related to capital asset acquisition, as \$582.8 million and \$377.0 million at year-end 2008 and 2007, respectively.

FINANCIAL ANALYSIS OF THE STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

Comparative data, stated in millions of dollars:

	December 31		
	2008	2007	2006
Sewage treatment fees	\$ 237.0	\$ 236.0	\$ 212.1
Rate stabilization	3.0	(8.3)	-
Capacity charge revenue	35.0	27.1	22.2
Other revenue	9.2	8.1	7.0
Operating revenues	284.2	262.9	241.3
Operating expenses	174.8	170.4	166.9
Operating income	109.4	92.6	74.4
Non operating revenues(expenses)	(72.9)	(64.4)	(66.3)
Grant revenues	2.3	1.2	2.3
Change in net assets	38.6	29.2	10.4
Net assets beginning of year	538.7	509.5	499.1
Net assets end of year	\$ 577.3	\$ 538.7	\$ 509.5

While the statement of net assets shows 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 2008 and 2007, operating revenues increased by \$21.2 million (8.1%) and \$21.6 million (9.0%), while operating expenses increased by \$4.4 million (2.6%) and \$3.4 million (2.1%).

- Water Quality collected a monthly sewage treatment charge of \$27.95 per RCE in 2008 and 2007. Total sewer disposal revenues before rate stabilization was \$237.0 million in 2008, a 0.4% increase over 2007. Total sewage treatment revenues increased to \$236.0 million before rate stabilization in 2007, an 11.3% increase from 2006.
- Other operating revenues, including capacity charges for new customers and other treatment charges, increased \$8.9 million in 2008 (25.3%) and \$6.1 million in 2007 (20.8%). Early payoff revenues were \$10.2 million in 2008 or 29.1% of the total capacity charge revenues for the year. Early payoff revenues were \$5.3 million in 2007, 19.7% of the annual total. Actual new capacity charge connections increased by 11,331 in 2008 and 12,271 in 2007.
- Operating expenses excluding depreciation increased \$2.8 million (2.9%) in 2008 and \$4.5 million (4.9%) in 2007.
- Net nonoperating revenues and expenses were a negative \$72.9 million in 2008, an increase of \$8.5 million (13.2%), and a negative \$64.4 million in 2007, and a decrease of \$1.9 million (2.9%).
- Capital grant revenues received from federal and state agencies were \$2.3 million in 2008, an increase of \$1.1 million (98.5%), and \$1.2 million in 2007, a decrease of \$1.1 million (48.7%). Low interest loans have largely replaced grants as the primary method of state agency support *in recent years*.

CAPITAL ASSETS

At December 31, 2008, Water Quality's investment in capital assets, net of accumulated depreciation, was \$3.2 billion as compared to \$2.7 billion in 2007. These represent increases of \$436.1 million (16.0%) in 2008 and \$301.5 million (12.4%) in 2007. The changes are a result of replacement and additions to the interceptor and siphon systems, purchases of land, additional storage capacity, extensions of sewer trunk lines, and continued efforts to control odor and improve sewage-handling technology.

The increases are directly related to continued implementation of Water Quality's Regional Wastewater Services Plan.

Large 2008 construction project expenditures include:

- \$3.2 million for the Carnation Treatment Plant construction;
- \$6.8 million for Juanita Bay Pump Station construction;
- \$6.9 million for the Hidden Lake Pump Station;
- \$7.2 million for the North Creek Pipeline;
- \$369.8 million spent toward the Brightwater Treatment Plant and conveyance.

Large 2007 construction project expenditures include:

- \$8.4 million for Juanita Bay Pump Station construction;
- \$10.1 million for the Bellevue Pump Station Upgrade;
- \$10.5 million for the Carnation Treatment Plant construction;
- \$10.5 million for the Hidden Lake Pump Station;
- \$224.3 million spent toward the Brightwater Treatment Plant and conveyance.

For more detailed information on capital assets please refer to the notes to the financial statements.

DEBT ADMINISTRATION

Water Quality issued \$237 million of refunding bonds in January 2008 with an average life of 16.4 years at an average coupon rate of 4.8%. The new bonds refunded \$244.3 million of bonds. The refunding resulted in a net present value savings of \$13 million. An additional \$350.0 million in revenue bonds was issued in July 2008, with an average coupon rate of 5.3% and an average life of 31.9 years.

Water Quality received \$17.3 million in low-interest loans from the state of Washington in 2008 and \$5.9 million in 2007. The loans carry below-market rates of 0.5% to 3.1% and repayment terms up to 20 years.

Water Quality has \$1.9 billion and \$1.7 billion of sewer revenue bonds and variable rate revenue bonds outstanding at the end of 2008 and 2007, respectively. Revenue bonds are repaid from and secured by a pledge of earnings, revenues and money received by Water Quality from or on account of operation of the sewer system, to include receipts from sewage treatment fees and other income of Water Quality. Revenue bonds are not guaranteed by the full faith and credit of King County.

At the end of 2008 and 2007, Water Quality had \$437.0 million and \$450.5 million of general obligation bonds outstanding, respectively. Although repaid from a portion of receipts from sewage treatment fees and other income, the full faith and credit of King County guarantees repayment of principal and interest on general obligation bonds.

King County received a AAA rating from Standard and Poors for the limited tax general obligation bond issue refunding issue in January 2008 with ratings of “Aa1” from Moody’s Investor’s Service and “AA+” from Fitch Ratings. At the time of the issuance of the sewer revenue bonds in 2008, Water Quality’s bond ratings were:

Moody’s Investor’s Service
Aa3

Standard & Poor’s
AA+

As required by bond covenant, Water Quality maintains a bond reserve account, which is funded by cash balances and surety policies. At December 31, 2008, the cash balance in the reserve account was \$101.2 million. It was \$67.2 million at the end of 2007. In addition to bond covenant reserves, Water Quality also maintains financial policy reserves. At December 31, 2008 and 2007, the rate stabilization, liquidity, and asset management financial policy reserves totaled \$49.8 and \$52.3 million, respectively.

For more detailed information on debt please refer to the notes to the financial statements.

DEBT SERVICE COVERAGE RATIOS

	<u>FY 2008</u>	<u>FY 2007</u>
Parity Debt	1.41	1.39
Total Debt	1.23	1.19

Two debt service coverage ratios closely monitored by bond rating agencies are coverage on parity debt and coverage on total debt. By bond ordinance, Water Quality sets sewer rates at a level adequate to provide net revenue equal to at least 1.15 times the annual debt service requirement on parity debt. Water Quality has an adopted policy to achieve a ratio of at least 1.25 on parity debt or 0.10 above the ratio required by bond ordinance. To further strengthen coverage performance, Water Quality established a minimum coverage policy of 1.15 on total debt in 2001.

REQUESTS FOR INFORMATION

This financial report is designed to provide an overview of Water Quality’s financial condition as of the years ending December 31, 2008 and 2007. Questions concerning this report or requests for additional information should be addressed to Pete Anthony, Chief Accountant for King County, 500 Fourth Avenue, Room 653, Seattle, Washington 98104.

KING COUNTY WATER QUALITY ENTERPRISE

STATEMENTS OF NET ASSETS DECEMBER 31, 2008 AND DECEMBER 31, 2007 (IN THOUSANDS)

	2008	2007
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 35,331	\$ 55,319
Restricted cash and cash equivalents	108,811	92,761
Accounts receivable, net	21,564	20,721
Inventory of supplies	5,572	5,249
Due from other funds	3,900	1,440
Prepayments	117	108
	<u>175,295</u>	<u>175,598</u>
NONCURRENT ASSETS:		
Revenue fund:		
Cash and cash equivalents	28,066	29,087
Accounts receivable, net	406	413
Construction fund—cash and cash equivalents	13,043	4,530
Bond fund—cash and cash equivalents	98,935	68,018
	<u>140,450</u>	<u>102,048</u>
Capital assets:		
Building and land improvements	2,113,091	1,996,634
Plant in service and other equipment	584,447	514,924
Less accumulated depreciation	(1,077,580)	(1,008,311)
	<u>1,619,958</u>	<u>1,503,247</u>
Land	152,498	149,997
Construction work in progress	1,394,646	1,077,781
	<u>3,167,102</u>	<u>2,731,025</u>
Other noncurrent:		
Regulatory assets - environmental remediation	39,506	40,262
Deferred environmental remediation costs	5,624	5,862
Other deferred charges	12,456	13,175
	<u>57,586</u>	<u>59,299</u>
TOTAL ASSETS	<u><u>3,540,433</u></u>	<u><u>3,067,970</u></u>

See notes to financial statements.

(Continued)

KING COUNTY WATER QUALITY ENTERPRISE

STATEMENTS OF NET ASSETS DECEMBER 31, 2008 AND DECEMBER 31, 2007 (IN THOUSANDS)

	2008	2007
LIABILITIES		
CURRENT LIABILITIES:		
Accounts payable	\$ 44,370	\$ 34,784
Interest payable	55,832	50,753
Wages and benefits payable	2,741	2,568
Compensated absences	547	518
Notes payable	100,000	100,000
State loans payable	7,029	6,580
Due to other funds	2,761	3,242
Interfund loans payable	184,041	-
General obligation bonds payable—current portion	3,905	6,270
Revenue bonds payable—current portion	30,540	26,315
	<u>431,766</u>	<u>231,030</u>
NONCURRENT LIABILITIES:		
Retainage payable	13,043	4,530
Compensated absences	8,824	8,427
Other post-employment benefits	336	134
General obligation bonds payable	433,045	444,270
Revenue bonds payable	1,917,365	1,697,905
Deferred bond premium, discount, and refunding losses	(17,245)	(31,348)
Rate stabilization	19,750	22,750
Environmental remediation costs	34,141	39,669
State loans payable	122,157	111,944
	<u>2,531,416</u>	<u>2,298,281</u>
Total liabilities	<u>2,963,182</u>	<u>2,529,311</u>
NET ASSETS		
Invested in capital assets—net of related debt	582,761	376,995
Restricted for:		
Capital projects	-	60,636
Debt service	34,825	32,595
Litigation	10,990	17,477
Unrestricted	(51,325)	50,956
	<u>(51,325)</u>	<u>50,956</u>
Total net assets	<u>\$ 577,251</u>	<u>\$ 538,659</u>

See notes to financial statements.

(Concluded)

KING COUNTY WATER QUALITY ENTERPRISE

STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS YEARS ENDED DECEMBER 31, 2008 AND DECEMBER 31, 2007 (IN THOUSANDS)

	2008	2007
OPERATING REVENUES:		
Sewage disposal fees	\$ 240,001	\$ 227,665
Other operating revenues	44,172	35,265
Total operating revenues	<u>284,173</u>	<u>262,930</u>
OPERATING EXPENSES:		
Sewage treatment, disposal, and transmission	83,627	81,529
General and administrative	14,743	14,045
Depreciation and amortization	76,399	74,781
Total operating expenses	<u>174,769</u>	<u>170,355</u>
OPERATING INCOME	<u>109,404</u>	<u>92,575</u>
NONOPERATING REVENUES (EXPENSES):		
Investment earnings	5,066	6,853
Interest	(63,594)	(68,590)
Amortization of bond premium, discount, and issuance costs	(7,319)	(3,936)
Gain (loss) on disposal of capital assets and environ. remediation	(7,838)	677
Other	781	593
Total nonoperating expenses	<u>(72,904)</u>	<u>(64,403)</u>
INCOME BEFORE GRANTS, CONTRIBUTIONS, AND TRANSFERS	36,500	28,172
Capital grant revenues	2,311	1,164
Transfers	(219)	(161)
CHANGE IN NET ASSETS	38,592	29,175
NET ASSETS—Beginning of year	<u>538,659</u>	<u>509,484</u>
NET ASSETS—End of year	<u>\$ 577,251</u>	<u>\$ 538,659</u>

See notes to financial statements.

KING COUNTY WATER QUALITY ENTERPRISE

STATEMENTS OF CASH FLOWS YEARS ENDED DECEMBER 31, 2008 AND 2007 (IN THOUSANDS)

	2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES:		
Cash received from customers	\$ 280,324	\$ 272,723
Cash payments to suppliers for goods and services	(45,058)	(52,455)
Cash payments for employee services	(37,675)	(37,145)
Net cash provided by operating activities	<u>197,591</u>	<u>183,123</u>
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:		
Transfers out	(219)	(161)
Interfund loan principal received	184,041	-
Interest paid on short-term loans	(2,128)	(44)
Net cash used in noncapital financing activities	<u>181,694</u>	<u>(205)</u>
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:		
Acquisition of capital assets	(467,528)	(337,455)
Principal paid on general obligation bonds	(6,270)	(6,005)
Interest paid on general obligation bonds	(15,986)	(25,204)
Proceeds of new bond issuance	586,950	250,000
Principal paid on bonds by refunding	(244,270)	-
Principal paid on revenue bonds	(126,315)	(24,885)
Interest paid on revenue bonds	(87,948)	(69,867)
Principal paid on notes payable	-	50,000
Interest paid on notes payable	(2,170)	(3,451)
Principal paid on state loans	(6,253)	(5,472)
Proceeds of state loans	16,914	5,374
Interest paid on state loans	(1,565)	(1,773)
Capital grants received	2,311	1,164
Deferred costs	2,250	3,628
Net cash used in capital and related financing activities	<u>(349,880)</u>	<u>(163,946)</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Interest and changes in reverse repurchase obligations	<u>5,066</u>	<u>(2,975)</u>
Net cash provided (used) by investing activities	<u>5,066</u>	<u>(2,975)</u>

See notes to financial statements.

(Continued)

KING COUNTY WATER QUALITY ENTERPRISE

STATEMENTS OF CASH FLOWS YEARS ENDED DECEMBER 31, 2008 AND 2007 (IN THOUSANDS)

	2008	2007
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	\$ 34,471	\$ 15,997
CASH AND CASH EQUIVALENTS—Beginning of year	<u>249,715</u>	<u>233,718</u>
CASH AND CASH EQUIVALENTS—End of year	<u>\$ 284,186</u>	<u>\$ 249,715</u>
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Operating income	<u>\$ 109,404</u>	<u>\$ 92,575</u>
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation and amortization	76,399	74,781
Changes in assets:		
Accounts receivable	(851)	1,469
Inventory of supplies	(322)	(258)
Changes in liabilities:		
Accounts payable	9,586	5,688
Retainage payable	8,513	2,280
Wages and benefits payable	801	105
Rate stabilization	(3,000)	8,250
Due to other funds	(2,939)	(1,767)
Total adjustments	<u>88,187</u>	<u>90,548</u>
NET CASH PROVIDED BY OPERATING ACTIVITIES	<u>\$ 197,591</u>	<u>\$ 183,123</u>
SUPPLEMENTAL DISCLOSURE OF NONCASH CAPITAL AND RELATED FINANCING ACTIVITIES—Contribution of capital assets from government	<u>\$ 211</u>	<u>\$ 296</u>
SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING ACTIVITIES—Changes in fair value of investments (held in investment pool)	<u>\$ (5,745)</u>	<u>\$ (8,533)</u>
See notes to financial statements.		(Concluded)

KING COUNTY WATER QUALITY ENTERPRISE

NOTES TO FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

1. OPERATIONS AND ACCOUNTING POLICIES

Summary of Operations—The King County Water Quality Enterprise (Water Quality) 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 sewage treatment and water pollution abatement services to the urbanized areas of King County, Washington (the County).

Water Quality 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, Water Quality is funded and operated separately from other operations of the County. Revenues, bond proceeds, and grants are restricted by purpose. Accordingly, Water Quality maintains separate accounting records and issues stand-alone financial statements.

Water Quality 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 Water Quality's estimated annual monetary requirements, including operating costs and debt service. Revenues from Water Quality's largest customer, the City of Seattle (Seattle Public Utilities), represent approximately 41.0 percent of total sewage disposal fees in 2008 and 40.3 percent in 2007.

Water Quality 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 \$29.2 million and \$28.7 million in 2008 and 2007, respectively.

Significant Accounting Policies—Water Quality is accounted for using the flow of economic resources measurement focus similar to that of a private enterprise organized for profit. Water Quality'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. Water Quality, regardless of the timing of cash flows, applies all applicable Governmental Accounting Standards Board (GASB) pronouncements as well as Financial Accounting Standards Board (FASB) Statements and Interpretations, Accounting Principles Board (APB) Opinions and Accounting Research Bulletins (ARB) of the Committee on Accounting Procedures issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB Pronouncements. Water Quality, in accordance with 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 FASB issued subsequent to November 30, 1989.

- a. **Cash and Cash Equivalents**—Water Quality considers as cash and cash equivalents all balances held with the King County Treasurer in the King County Investment Pool (the Pool), cash with escrow agents or held in trust, and petty cash. Unrealized gain or

loss on Water Quality's proportionate share of the Pool is reported as a component of investment earnings.

- b. *Due to/From Other Funds*—Due to/from other funds consists of current receivables/payables from or to other funds within the King County primary government. These typically arise from exchange transactions, reimbursements, and from authorized transfers to or from the other funds.
- c. *Interfund loans payable/receivable*—Interfund loans consist of authorized short-term borrowing/lending between Water Quality and other funds within the King County primary government.
- d. *Inventory of Supplies*—Inventory is recorded at the lower of cost or market using the weighted-average cost method. Materials and supplies are expensed as consumed. Inventory is written off in the year that it is determined obsolete.
- e. *Restricted Assets*—In accordance with Water Quality's bond resolutions, state law, King County codes, 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.
- f. *Capital Assets*— Water Quality's capitalization threshold was changed in 2008 in accordance with King County's new capitalization policy: equipment at \$5 thousand; software at \$25 thousand; and buildings and improvements at \$50 thousand. Below-threshold equipment and software were removed from capital assets in 2008. For buildings and improvements the new threshold changes were applied prospectively. Provision for depreciation is made on a straight-line basis over the estimated useful lives of Water Quality's capital assets, which range from 3 to 50 years.

Water Quality capitalizes certain interest income and expense related to tax-free borrowings until the assets are ready for their intended use. The amount capitalized is the difference between the interest revenue and interest expense associated the applicable tax free borrowings. Total interest incurred was \$114.9 million and \$106.6 million during the years ended December 31, 2008 and 2007, respectively, of which \$51.3 million and \$38.0 million, respectively, was capitalized.

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

Water Quality annually reviews long-lived assets for impairment to determine whether any events or circumstances indicate the carrying value of the assets may not be recoverable. No material impairment was identified in 2008 or 2007.

- 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 percent of the accrued unused sick leave upon retirement or death. No amounts are paid for unused sick leave upon termination.

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

In addition, Water Quality accrues estimated excess compensation liabilities to the Washington State Department of Retirement Systems based on an employee's accrued vacation and sick leave. An excess compensation liability is incurred when an employee whose retirement benefits are based in part on excess compensation receives a termination or severance payment defined by the State as excess compensation. This includes, but is not limited to, a cash-out of unused annual leave in excess of 240 hours and a cash-out of any other form of leave.

- 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 over the shorter of the remaining term of the refunded bond or the term of the new bond.

- i. *Operating and Nonoperating Revenues and Expenses*— Operating revenues result from exchange transactions of Water Quality's activities. Expenses associated with providing wastewater treatment services and operating Water Quality's treatment facilities are considered operating. Nonoperating revenues result from nonexchange transactions such as operating subsidies and investment earnings.
- j. *Deferred Compensation*—The County offers a consolidated deferred compensation plan that complies with Internal Revenue Code Section (IRC) 457. The plan permits employees to defer a portion of annual compensation until future years. Participation in the plan is voluntary. The assets are not the property of Water Quality and not recorded in the financial statements.
- k. *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. Specific estimates have been made in the areas of allowance for uncollectible accounts, environmental remediation costs, useful lives of capital assets, and future interest rates. Actual results could differ from these estimates.
- l. *Reclassifications*—Certain reclassifications have been made to the prior year statements to conform to the current year presentation. (See Note 15 – Prior Period Adjustments).
- m. *Capital Grant Revenues*—Pursuant to GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, grant revenues are reported separately from operating and nonoperating revenues as capital grant revenues. Water Quality received capital grant revenues of \$2.3 million and \$1.2 million for the years ended December 31, 2008 and 2007, respectively.
- n. *Net Assets*—Pursuant to GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, grant 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, net of related debt, are

reported as a separate component of net assets. Any net assets not subject to classification as restricted or invested in capital assets are reported as unrestricted.

New Accounting Standard Adopted— GASB Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*, establishes accounting and financial reporting standards for pollution remediation obligations. The requirements of this statement are effective for fiscal periods beginning after December 15, 2007. Water Quality is implementing this pronouncement initially in the 2008 fiscal period with retroactive adjustments to the comparative prior periods presented in this report. (See Note 7 – Environmental Remediation)

2. DEPOSITS AND INVESTMENTS

The King County Treasurer is the custodian of Water Quality's cash. Water Quality's cash on deposit with the King County Treasurer is pooled with cash from other County funds and other jurisdictions and either deposited in the County's bank account or invested by the County. The King County Investment Pool (the Pool) functions essentially as a demand deposit account where Water Quality receives an allocation of its proportionate share of pooled earnings as interest.

The Pool is not registered with the Securities and Exchange Commission (SEC) as an investment company. Oversight is provided by the King County Executive Finance Committee (EFC) pursuant to RCW 36.29.020. The EFC consists of the Chair of the County Council, the County Executive, Chief Budget Officer, and Director of the Finance and Business Operations Division. All investments are subject to written policies and procedures adopted by the EFC. The EFC reviews pool performance monthly.

The County has deposit and investment policies addressing risks that have the potential to result in losses of deposits and investments. All deposits not covered by the Federal Depository Insurance Corporation (FDIC) are covered by the Public Deposit Protection Commission of the State of Washington (PDPC), a statutory authority established under chapter 39.58 RCW. To the extent that uninsured public deposits of a financial institution exceed the PDPC's total collateral, equivalent proportions of the County's deposits in those institutions are deemed exposed to custodial credit risk. The custodial credit risk for deposits is the risk that Water Quality's deposits may not be returned to it in the event of a bank failure. Assessing Water Quality's risk exposure, \$15.0 million and \$19.9 million of Water Quality's cash and cash equivalents balance of \$284.6 million and \$249.7 million (as of December 31, 2008 and December 31, 2007, respectively) was exposed to custodial credit risk as uninsured and uncollateralized.

Statutes permit the Pool to enter into reverse repurchase agreements to enhance yield. The proceeds from these agreements are reinvested in other instruments with the same maturity as the collateral securities resulting in a matched position. County policy sets maturity limits and maximum amounts and prohibits the use of these contracts as borrowing mechanisms. There were no reverse repurchase agreements outstanding as of December 31, 2008 and December 31, 2007.

The County operates under the GASB *Codification, Section 2300.601* definition of derivatives and similar transactions. During the year, the County did not buy, sell, or hold any derivative instrument except for certain US agency collateralized mortgage obligations purchased by the Pool. Although these securities are sensitive to early prepayments by mortgagees, County policies are in place to ensure that only the lowest risk securities of this type are acquired.

At the start of 2008, the Pool held four commercial paper securities that were impaired and were part of an enforcement event. During the year, the County completed the restructuring of three of the four securities. At December 31, 2008, the Pool has only one outstanding impaired security under restructuring. The Pool has suspended investments in commercial paper securities since 2007. Water Quality's share of the unrealized loss from the Pool's impaired investments was \$3.1 million at December 31, 2008 and \$6.5 million at December 31, 2007. Losses from impaired investments are offset against other investment earnings.

3. RESTRICTED ASSETS

A significant portion of Water Quality's assets is restricted as to use by legal and contractual provisions and by fiscal management policy. Restricted assets comprise \$249.3 million in 2008 and \$194.8 million in 2007 to pay for debt service and to comply with bond reserve requirements.

4. RISK MANAGEMENT

Water Quality 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.

Water Quality participates in three County internal service funds to account for and finance its (1) property/casualty, (2) workers' compensation and (3) employee medical and dental benefits, through 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 inter-fund premiums from insured funds and departments, for paying claim settlements, and for purchasing certain policies. The County's internal service funds assess premiums attributable to Water Quality on the basis of claims experience, actuarial evaluation of future claims risk, and adequacy of available reserves. Premiums are recorded as an expense in the year paid or accrued.

Water Quality retains all risk associated with environmental claims.

5. LONG-TERM LIABILITIES AND NOTES PAYABLE

Sewer Revenue Bonds—As of December 31, 2008, bonds outstanding include \$781.3 million of serial bonds maturing from January 1, 2009 through 2033, bearing interest at stated rates of 3.00 percent to 5.50 percent per annum, and \$1,166.6 million of term bonds maturing on January 1 in the years 2024 through 2048, bearing interest at stated rates of 4.38 percent to 5.75 percent per annum.

In 2008, Water Quality issued \$350.0 million of sewer revenue bonds maturing from January 1, 2017 to 2048. The new issues includes \$45.8 million of serial bonds maturing from January 1, 2017 through 2033, bearing interest at stated rate of 5.50 percent, and \$304.2 million of term bonds, maturing in the years 2038 through 2048, bearing interest at stated rates between 5.00 percent and 5.75 percent.

Bond issues provide funding for Water Quality's construction plan. 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. Amounts from the sewer revenue bond fund may be used to purchase term bonds prior to maturity.

The bonds are secured by a pledge of the revenue of the Sewer System subject to payment of all operating and maintenance expenses of the Sewer System. Payments from revenues of Water Quality 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. At December 31, 2008 Water Quality designated restricted cash balances of \$90.5 million as amounts to repay principal and interest due on revenue bonds on January 1, 2009. Annual principal and interest payments on the bonds are expected to require less than 60 percent of net revenues. Principal and interest incurred in the current year and total customer net revenues were \$112.0 million and \$185.8 million, respectively.

Additional amounts of \$101.2 million and \$67.2 million held in the bond fund as bond reserves, as of December 31, 2008 and 2007, respectively, have been designated as net assets restricted for future debt service. Water Quality met additional reserve requirements required by the issuance of Sewer Revenue Bonds, Series 2008, by purchase of a surety policy issued by a private insurer. The amount required in the cash reserves and surety policies are based on the highest year of debt service over the life of all outstanding revenue bonds. As of December 31, 2008, Water Quality is in compliance with the combined amount required for the reserve and surety policies.

The following table summarizes Water Quality's revenue bonds (in thousands):

	<u>Final Maturity</u>	<u>Interest Rates</u>	<u>Original Issue Amount</u>	<u>Outstanding at 12/31/08</u>
1999 (2nd Series)	1/1/09	5.25%	\$ 60,000	\$ 1,125
2001A-B Jr. lien var. rate	1/1/32	(variable)	100,000	100,000
2001 Refunding	1/1/35	5.00-5.25%	270,060	226,730
2002A	1/1/35	5.50%	100,000	94,960
2002B Refunding	1/1/33	4.00-5.50%	346,130	271,105
2003A Refunding	1/1/35	3.00-5.50%	96,470	92,325
2004A	1/1/35	4.50-4.75%	185,000	185,000
2004B Refunding	1/1/35	3.00-5.00%	61,760	59,375
2006 Refunding	1/1/36	5.00%	124,070	124,070
2006 (2nd Series) Refunding	1/1/36	3.50-5.00%	193,435	193,215
2007	1/1/47	5.00%	250,000	250,000
2008	1/1/48	5.00-5.75%	350,000	350,000
			<u>\$ 2,136,925</u>	<u>\$ 1,947,905</u>

General Obligation Bonds—As of December 31, 2008, bonds outstanding include \$292.1 million of serial bonds maturing January 1, 2009 through 2031, bearing interest at stated rates of 3.25 percent to 5.25 percent per annum. General Obligation Bonds outstanding also include \$144.9 million of term bonds maturing on January 1, 2020 through 2035, bearing interest at stated rates of 4.6 percent to 4.75 percent. The bonds were issued to provide funding for Water Quality's construction plan. 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.

The following table summarizes Water Quality's general obligation bonds (in thousands).

	<u>Final Maturity</u>	<u>Interest Rates</u>	<u>Original Issue Amount</u>	<u>Outstanding at 12/31/08</u>
2005 LTGO	1/1/35	4.50-5.00%	\$ 200,000	\$ 200,000
2008 LTGO	1/1/34	3.25-5.25%	236,950	236,950
			<u>\$ 436,950</u>	<u>\$ 436,950</u>

State Loans— Water Quality has received loans from the Washington Department of Ecology under the Water Pollution Control State Revolving Fund Loan Program and the Washington Public Works Trust Fund. The loans require annual payments of principal and interest from 2009 through 2030 and bear interest at stated rates from 0.5 percent and 3.1 percent. As of December 31, 2008, the balance due on all state loans is \$129.2 million. Water Quality maintains separate cash reserves of \$8.4 million. These reserves are treated as restricted, being required under the Revolving Fund Loan Program.

At December 31, 2008, the required principal and interest payments for all classes of long-term debt are as follows (in thousands):

Year(s) Beginning	Revenue Bonds		Variable Rate Revenue Bonds	
	Principal	Interest	Principal	Interest
January 1, 2009	\$ 30,540	\$ 81,473	\$ -	\$ 4,950
January 1, 2010	32,090	91,501	-	4,950
January 1, 2011	33,710	89,905	-	4,950
January 1, 2012	35,395	88,235	-	4,950
January 1, 2013	36,855	86,794	-	4,950
January 1, 2014–2018	192,115	403,305	-	24,750
January 1, 2019–2023	206,810	354,709	-	24,750
January 1, 2024–2028	264,200	298,210	-	24,750
January 1, 2029–2033	337,370	226,034	100,000	19,800
January 1, 2034–2038	255,840	141,756	-	-
January 1, 2039–2043	196,280	91,049	-	-
January 1, 2044–2048	226,700	33,946	-	-
	<u>\$ 1,847,905</u>	<u>\$ 1,986,917</u>	<u>\$ 100,000</u>	<u>\$ 118,800</u>

Year(s) Beginning	General Obligation Bonds		State Loans		Total
	Principal	Interest	Principal	Interest	
January 1, 2009	\$ 3,905	\$ 20,163	\$ 7,029	\$ 1,874	\$ 149,934
January 1, 2010	2,530	21,282	7,159	1,782	161,294
January 1, 2011	2,630	21,156	7,325	1,686	161,362
January 1, 2012	2,730	21,024	7,501	1,583	161,418
January 1, 2013	2,795	20,936	7,614	1,480	161,424
January 1, 2014–2018	38,980	102,258	39,734	5,767	806,909
January 1, 2019–2023	88,810	86,222	36,702	2,933	800,936
January 1, 2024–2028	112,485	61,522	15,290	665	777,122
January 1, 2029–2033	141,725	31,091	840	23	856,883
January 1, 2034–2038	40,360	2,790	-	-	440,746
January 1, 2039–2043	-	-	-	-	287,329
January 1, 2044–2048	-	-	-	-	260,646
	<u>\$ 436,950</u>	<u>\$ 388,444</u>	<u>\$ 129,194</u>	<u>\$ 17,793</u>	<u>\$ 5,026,003</u>

The future annualized interest payments for the variable rate revenue bonds are based on an interest rate of 4.95 percent which represents 90 percent of the Revenue Bond Index assumed by the County for financial planning purposes.

Commercial Paper (Notes Payable)—In December 1995, Water Quality initiated a commercial paper program that gives Water Quality the ability to issue up to \$100.0 million. The program is supported by an annually renewable line of credit that expires November 30, 2015. As of December 31, 2008, \$100.0 million was issued and outstanding under this program. The commercial paper has maturities ranging between 30 and 154 days and is classified as a current liability of Water Quality’s operating fund.

Variable Rate Revenue Bonds—The variable rate bonds are supported by an annually renewable letter of credit that expires December 31, 2015.

Financial Policy Reserves—In addition to bond reserves related to Sewer Revenue Bonds, Water Quality maintains liquidity and asset management reserves totaling \$29.8 million at December 31, 2008.

Compliance With Bond Resolutions—With respect to the year ended December 31, 2008, Water Quality complied with all covenants stipulated by its bond resolutions.

Changes in Long-Term Liabilities—Long-term liability activity for the years ended December 31, 2008 and 2007 was as follows (in thousands):

	Balance 1/1/2008	Additions	Reductions	Balance 12/31/2008	Due Within One Year
Bonds payable	\$ 2,174,760	\$ 350,000	\$ (139,905)	\$ 2,384,855	\$ 34,445
Bond premiums	35,071	12,931	(808)	47,194	2,434
Issuance costs	(13,175)	(765)	1,484	(12,456)	(837)
Refunding losses	(66,419)	(20,004)	21,984	(64,439)	(5,404)
Total bonds payable	<u>2,130,237</u>	<u>342,162</u>	<u>(117,245)</u>	<u>2,355,154</u>	<u>30,638</u>
Retainage payable	4,530	8,922	(409)	13,043	3,984
State loans	118,524	16,915	(6,253)	129,186	7,029
Compensated absences	8,811	560	-	9,371	547
Other post-employment benefits	134	202	-	336	-
Environmental remediation	39,669	-	(5,528)	34,141	-
Rate stabilization	22,750	-	(3,000)	19,750	-
Total long-term liabilities	<u>\$ 2,324,655</u>	<u>\$ 368,761</u>	<u>\$ (132,435)</u>	<u>\$ 2,560,981</u>	<u>\$ 42,198</u>

	Balance 1/1/2007	Additions	Reductions	Balance 12/31/2007	Due Within One Year
Bonds payable	\$ 1,955,650	\$ 250,000	\$ (30,890)	\$ 2,174,760	\$ 32,585
Bond premiums	31,520	5,950	(2,399)	35,071	2,531
Issuance costs	(12,633)	(1,366)	824	(13,175)	(834)
Refunding losses	(74,846)	(293)	8,720	(66,419)	(5,310)
Total bonds payable	<u>1,899,691</u>	<u>254,291</u>	<u>(23,745)</u>	<u>2,130,237</u>	<u>28,972</u>
Retainage payable	2,250	3,147	(867)	4,530	1,846
State loans	118,622	5,374	(5,472)	118,524	6,580
Compensated absences	8,770	661	(620)	8,811	518
Other post-employment benefits	-	134	-	134	-
Environmental remediation	44,200	-	(4,531)	39,669	-
Rate stabilization	14,500	8,250	-	22,750	-
Total long-term liabilities	<u>\$ 2,088,033</u>	<u>\$ 271,857</u>	<u>\$ (35,235)</u>	<u>\$ 2,324,655</u>	<u>\$ 36,070</u>

* Prior year's liabilities for retainage payable and environmental remediation have been adjusted for prior period effects (See Note 15 - Prior Period Adjustments).

6. CHANGES IN CAPITAL ASSETS

Changes in capital assets for the years ended December 31, 2008 and 2007 are shown in the following table (in thousands):

	Balance 01/01/08	Increases	Decreases	Balance 12/31/08
Land	\$ 149,997	\$ 2,501	\$ -	\$ 152,498
Work in progress	1,077,781	473,650	(156,785)	1,394,646
Total nondepreciable assets	<u>1,227,778</u>	<u>476,151</u>	<u>(156,785)</u>	<u>1,547,144</u>
Building and land improvements	\$ 1,996,634	\$ 116,457	\$ -	\$ 2,113,091
Major equipment and vehicles	8,441	-	(143)	8,298
Shop and other equipment	498,585	69,069	(47)	567,607
Software development	7,898	644	-	8,542
Total depreciable assets	<u>2,511,558</u>	<u>186,170</u>	<u>(190)</u>	<u>2,697,538</u>
Accumulated depreciation and amortization:				
Building and land improvements	(650,485)	(44,714)	2,718	(692,481)
Major equipment and vehicles	(6,034)	(744)	143	(6,635)
Shop and other equipment	(343,946)	(30,949)	4,323	(370,572)
Software development	(7,846)	(17)	(29)	(7,892)
Total depreciation and amortization	<u>(1,008,311)</u>	<u>(76,424)</u>	<u>7,155</u>	<u>(1,077,580)</u>
Depreciable assets - net	<u>1,503,247</u>	<u>109,746</u>	<u>6,965</u>	<u>1,619,958</u>
Total capital assets - net	<u>\$ 2,731,025</u>	<u>\$ 585,897</u>	<u>\$ (149,820)</u>	<u>\$ 3,167,102</u>
	01/01/07	Increases	Decreases	12/31/07
Land	\$ 148,938	\$ 1,059	\$ -	\$ 149,997
Work in progress	740,092	377,819	(40,130)	1,077,781
Total nondepreciable assets	<u>889,030</u>	<u>378,878</u>	<u>(40,130)</u>	<u>1,227,778</u>
Building and land improvements	\$ 1,966,755	\$ 31,897	\$ (2,018)	\$ 1,996,634
Major equipment and vehicles	8,469	-	(28)	8,441
Shop and other equipment	492,300	9,983	(3,698)	498,585
Software development	7,722	176	-	7,898
Total depreciable assets	<u>2,475,246</u>	<u>42,056</u>	<u>(5,744)</u>	<u>2,511,558</u>
Accumulated depreciation and amortization:				
Building and land improvements	(605,557)	(45,129)	201	(650,485)
Major equipment and vehicles	(5,317)	(745)	28	(6,034)
Shop and other equipment	(316,190)	(28,937)	1,181	(343,946)
Software development	(7,718)	(128)	-	(7,846)
Total depreciation and amortization	<u>(934,782)</u>	<u>(74,939)</u>	<u>1,410</u>	<u>(1,008,311)</u>
Depreciable assets - net	<u>1,540,464</u>	<u>(32,883)</u>	<u>(4,334)</u>	<u>1,503,247</u>
Total capital assets - net	<u>\$ 2,429,494</u>	<u>\$ 345,995</u>	<u>\$ (44,464)</u>	<u>\$ 2,731,025</u>

Prior year balances were adjusted to remove certain environmental remediation costs which are deferred costs but are non-capital in nature. (See Note 15 – Prior Period Adjustments)

7. ENVIRONMENTAL REMEDIATION

Water Quality operations are subject to rules and regulations enacted by the Washington State Department of Ecology and the U.S. Environmental Protection Agency for environmental issues. In years prior to 2008, Water Quality evaluated and accrued for environmental remediation based on engineering studies and estimates of future potential costs. Water Quality settled lawsuits related to certain environmentally damaged sites and agreed to pay its portion of remediation and cleanup costs. The initial settlement costs were capitalized as deferred environmental remediation costs and are being amortized over 40 years as offsetting revenues are collected from Water Quality's customers.

In 2008 Water Quality implemented GASB Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*. Liabilities are related to ongoing projects which include the sediment management of aquatic habitats along Elliot Bay and the clean-up of certain sites along the Lower Duwamish Waterway. The implementation of GASB Statement No. 49 has resulted in a prior period restatement of \$27.9 million being added to the estimated remediation liability for December 31, 2007 and carried forward to subsequent years. The significant increase in the liability is attributed to the exclusion of expected grant proceeds which were previously netted with the liability calculated under FASB Statement No. 5, *Accounting for Contingencies*. The comparative 2007 financial statements have been adjusted as explained in Note 15 – Prior Period Adjustments.

The methodology for estimating liabilities continues to be based on Water Quality engineering analysis, program experience and cost projections for the remediation activities scheduled to be undertaken in future years as programmed under the Water Quality's Regional Wastewater Services Plan. The remaining work is well-defined, but continues to be re-measured as succeeding benchmarks are reached or when cost assumptions are modified. Beginning in 2006, all pollution remediation obligations are being deferred under FASB Statement No. 71. (See Note 8 – Regulatory Deferrals.)

8. REGULATORY DEFERRALS

The King County Council has taken various regulatory actions resulting in differences between the recognition of revenues for rate-making purposes and their treatment under generally accepted accounting principles for nonregulated entities. Changes to these balances and their inclusion in rates may occur only at the direction of the Council.

Rate Stabilization—In 2005, pursuant to FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation*, the Council established a Rate Stabilization Reserve. This action created a regulatory liability which deferred \$14.5 million from 2005 operating revenue to be set aside in a reserve and recognized in subsequent years to maintain stable sewer rates. This was increased in 2007 by an additional \$8.3 million. In 2008, the liability was reduced by \$3 million to realize matching revenues against allowable costs in the current year.

Pollution Remediation—In 2006, the Council approved the application of FASB Statement No. 71 to treat pollution remediation obligations as regulatory assets to allow for cost recovery through future rate increases. The amount of the regulatory assets capitalized during 2006 and 2007 were revised in 2008 to account for an increase in the estimated liability with the implementation of GASB Statement No. 49 (See Note 7 – Environmental Remediation). The portion of regulatory asset costs that have been paid out is being amortized over a recovery period of 30 years. Beginning in 2008, the State of Washington Department of Ecology has

issued an annually renewable grant with a 50 percent reimbursement of grant eligible expenditures for the Sediment Management Plan; as grant revenues become realized or realizable, these amounts will be factored into the sewer rate model to help mitigate rate increases.

9. EMPLOYEE BENEFIT PLANS

Defined Benefit Pension Plans—Substantially all full-time and qualifying part-time employees of Water Quality participate in either the Public Employees’ Retirement System (“PERS”) or the Seattle City Employees’ Retirement System (“SCERS”). PERS is a statewide governmental retirement system administered by the State of Washington’s Department of Retirement Systems.

Historical trend and other information regarding PERS are presented in the State of Washington Department of Retirement Systems’ 2008 Comprehensive Annual Financial Report. A copy of this report may be obtained from the Department of Retirement Systems, P.O. Box 48380, Olympia, Washington, 98504-8380.

Historical trend and other information regarding SCERS are presented in the Seattle City Employees’ Retirement System’s 2007 Comprehensive Annual Financial Report. A copy of this report may be obtained from the Seattle City Employees’ Retirement System, 801 Third Avenue, Suite 300, Seattle, Washington, 98104.

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 or at the age of 60 with 5 years of service, or at the age of 55 with 25 years of service. The annual pension is 2 percent of the final average salary per year of service, capped at 60 percent. 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 5 years of service or at 55 with 20 years of service, with an allowance of 2 percent 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 members may retire with 10 years of service or with 5 service years, including one year earned after age 54 and 5 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.

Water Quality's contribution rates expressed as a percentage of covered payrolls as of December 31, 2008, were as follows:

	PERS Plan I 1/1 - 6/30/08	PERS Plan I 07/1 - 12/31/08	PERS Plan II 1/1 - 6/30/08	PERS Plan II 07/1 - 12/31/08	PERS Plan III 1/1 - 6/30/08	PERS Plan III 07/1 - 12/31/08
Employer	6.13 %	6.13%-8.31%	6.13 %	6.12-8.31%	6.13 %	6.13-8.31%
Employee	6.00 %	6.00 %	4.15 %	5.45 %	5% - 15%	5% - 15%

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 percent to 15 percent.

Water Quality's required employer contributions for the years ended December 31 were (in thousands):

	PERS Plan I	PERS Plans II and III
2008	\$ 310	\$ 6,605
2007	269	4,419
2006	99	1,542

Seattle City Employees' Retirement System ("SCERS")—SCERS is a cost-sharing, multiple-employer retirement plan administered in accordance with the Seattle Municipal Code Chapter 4.36. Water Quality employees who are former employees of Seattle Transit are covered by SCERS. SCERS provides retirement, death, and disability benefits.

Employees covered by this plan may retire after 30 years of service regardless of age, after age 52 with 20 years or more of service, after age 57 with 10 or more years of service and after age 62 with 5 or more years of service. Disability retirement is available after 10 years of service. The unmodified monthly retirement allowance is based on a percentage of average salary for every year of service to a maximum of 60 percent. The average salary for this plan is defined as the highest consecutive 24-month average rate of pay. The percentage for each year of service used to compute the retirement benefit depends on the age at retirement and the years of service and ranges from 1.2 percent at age 52 with 20 years of service to a maximum of 2 percent for each year of service. The maximum allowance a member can receive is the unmodified plan, which has no provision for a beneficiary, and under which all payments stop at the member's death. Several optional retirement benefit formulas exist that make provisions for beneficiaries with reduced monthly allowances.

Within SCERS, there were no material changes in benefit provisions in 2008.

The SCERS member contribution rate is 8.03 percent of compensation, except for members qualifying prior to June 1972 for lower rates. Water Quality is required to contribute at an actuarially determined rate. The current rate is 8.03 percent of annual covered payroll. The contribution requirements of plan members and Water Quality are established and may be

amended by the Board of Administration. Both Water Quality and the employees made the required contributions.

10. OPERATING SUBSIDIES AND GRANT REVENUES

Various federal and state government agencies make grants to Water Quality 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 net assets. Capital grants amounted to \$2.3 million and \$1.2 million for the years ended December 31, 2008 and 2007, respectively.

11. OTHER POST-EMPLOYMENT BENEFITS

In 2007, the County implemented GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pension*, which requires the County to accrue other post-employment benefits (OPEB) expenses related to its post-retirement healthcare plan based on a computed annual required contribution (ARC) that includes the current period’s service cost and an amount to amortize unfunded accrued liabilities. The liability is included in noncurrent liabilities on the statements of net assets for Water Quality.

Plan Description: The King County Health Plan (the Health Plan) is a single-employer defined benefit healthcare plan administered by the County. The Health Plan provides medical, prescription drug, vision, and other unreimbursed medical benefits to eligible employees. The Health Plan’s actuary is Healthcare Actuaries and it does not issue a separate stand-alone financial report.

Funding Policy: LEOFF 1 retirees are not required to contribute to the Health Plan. All other retirees are required to pay the COBRA rate associated with the elected plan. During 2008, Water Quality contributed an estimated \$310 thousand to the Health Plan. The contribution was entirely to fund “pay-as-you-go” costs and not to advance fund the cost of benefits.

Annual OPEB and Net OPEB Obligation: Water Quality’s allocated annual OPEB costs, the percentage of annual OPEB cost contributed to the Health Plan, and the net OPEB obligation for 2008 were as follows (in thousands):

	<u>2008</u>	<u>2007</u>
Net OPEB Obligation at January 1	\$ 134	\$ -
Annual OPEB Cost	208	231
Contributions Made	(6)	(97)
Net OPEB Obligation at December 31	<u>\$ 336</u>	<u>\$ 134</u>
Percentage of annual OPEB cost contributed	2.9%	42.0%

Funded Status and Funding Progress: The funded status of the Health Plan as of December 31, 2008 was as follows (in thousands):

	<u>2008</u>	<u>2007</u>
Actuarial Value of Plan Assets	\$ -	\$ -
Actuarial Accrued Liability (AAL)	145,393	141,893
Unfunded Actuarial Accrued Liability (UAAL)	<u>\$ 145,393</u>	<u>\$ 141,893</u>
Funded Ratio (actuarial value assets / AAL)	0%	0%
Covered Payroll (active plan members)	\$ 880,052	\$ 854,800
UAAL as a percentage of covered payroll (AAL less Actuarial Value of Assets / UAAL)	16.5%	16.6%

The December 31, 2008 valuation used the unit credit actuarial cost method. The actuarial assumption included a 4.00 percent investment rate of return (net of administrative expenses) and an initial healthcare cost trend rate of 11.0 percent for KingCare medical, 8.5 percent for KingCare Rx, and 11.0 percent for HMIO medical/Rx, each reduced by decrements to an ultimate rate of 5.0 percent after 12 years. The vision trend rate is 1.0 percent, the miscellaneous trend rate is 7.0 percent, and the Medicare premium trend rate is 8.5 percent, for all years. All trend rates include a 3.0 percent inflation assumption, with the exception of vision trends. The remaining amortization period at December 31, 2008 was 29 years. The UAAL is recalculated each year and amortized as a level dollar amount on an open basis over 30 years.

12. INTERFUND BORROWING AND TRANSFERS

At December 31, 2008, Water Quality had outstanding interfund short-term loans in the amount of \$184.0 million borrowed from the King County Public Transportation Enterprise as authorized by the King County Executive Finance Committee. The loan proceeds were used to 1) reimburse the operating fund which financed the early retirement of certain sewer revenue bonds, and 2) reimburse the construction fund for capital expenses incurred in anticipation of bond issuance in 2009.

The King County Council approves ordinances and/or motions authorizing Water Quality to contribute and receive amounts to and from various County funds. These net amounts are reported as transfers on the statements of revenues, expenses, and changes in net assets. During 2008 and 2007, the net cash transfers to other funds from Water Quality were \$219.0 thousand and \$161.0 thousand, respectively.

13. NET ASSETS DEFICIT

The deficit in unrestricted net assets of \$51.3 million is the result of borrowing by Water Quality from other County funds (See Note 12 – Interfund Borrowing and Transfers). Revenue bonds were issued in 2009 to cover the capital construction loan.

14. 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 Water Quality’s construction plan to meet this requirement, including five treatment plants that are being constructed, 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.

Water Quality is continuing to design, acquire, and construct treatment facilities and conveyance lines within the guidelines of the construction plan. Planned capital spending is about \$525.8 million in 2009 (\$1.5 billion from 2009-2014). 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— Water Quality has received claims from contractors involved in construction projects. The contractors have claimed amounts in excess of the original contract sums. Water Quality intends to defend its case in these actions and cannot assess the likelihood of an adverse outcome; however, management believes any adverse outcomes would not have a material impact on Water Quality.

Water Quality is voluntarily performing remediation activities as described in Note 7 – Environmental Remediation. Cleanup work on an early action site in the Lower Duwamish Waterway is close to completion while currently ongoing is the sediment management plan which addresses potential remediation of identified polluted sites near combined sewer outflows. Currently there is an administrative order from the Environmental Protection Agency (EPA) requiring the County, the City of Seattle, the Boeing Company, and the Port of Seattle to conduct a feasibility study to determine the nature and extent of the contamination in the Lower Duwamish Waterway. Potentially, upon completion of the study, additional administrative or judicial orders may require Water Quality to participate in additional remediation. King County is unable to estimate the likelihood of any further remediation or the amounts for which Water Quality may be liable.

Other outstanding claims or potential claims against Water Quality at the end of December 31, 2008 are listed below. In these cases King County does not have an opinion as to the likelihood of a negative outcome or of the amount for which Water Quality may be liable.

- Claims for unspecified damages were filed by two sewer districts who allege that certain expenditures of King County's Wastewater Treatment Division (WTD) constitute a breach of contract and are in violation of the King County Charter and a local government accounting statute. The County is vigorously defending the claim.
- An appeal is pending on an administrative decision of the Washington State Department of Retirement Systems ruling that settlement payments on two earlier class action lawsuits were properly not reported to the State Retirement System by the County as "compensation earnable." The County is vigorously defending against all claims.
- There is the potential for claims on past and future cleanup costs at the Harbor Island Superfund site. Certain removal costs already incurred by the Port of Seattle are expected to be defrayed by the County and the City of Seattle. The parties have also agreed to share the cost of a supplemental investigation and feasibility study required by the EPA. The agreement states that the WTD has a one-third pro rata share of the study costs but this can still be reallocated among the several potentially responsible parties.

Office Facilities— Water Quality currently rents office space from the Department of Executive Services - Facilities Management Division of King County. Water Quality has not entered into a formalized legal contract for the use of these spaces but is expecting to continue to rent office space for future years. Rent expenses incurred in 2008 and 2007 were approximately \$1.3 million for each year.

15. PRIOR PERIOD ADJUSTMENTS

Certain balances in the comparative presentation of the Statement of Net Assets as of December 31, 2007 and the Statement of Cash Flows for the year ending December 31, 2007 were revised due to 1) the implementation of GASB Statement No. 49, and 2) reclassifications among current, current-restricted, and noncurrent assets and liabilities. The adjustments do not impact the statement of activities and the balance of net assets at December 31, 2007.

Implementation of GASB Statement No. 49 resulted in an adjustment of the beginning liability "Environmental remediation costs". Because environmental remediation costs are deferred as regulatory assets, a corresponding prior year increase was made to "Regulatory assets – environmental remediation". Other prior year environmental remediation costs that were previously capitalized under "Buildings and land improvements" and "Construction work-in-progress" were reclassified as regulatory assets.

Other prior period restatements were made to be consistent with 2008 reclassifications between current and non-current assets and liabilities. Cash and liabilities related to contract retainage that are not scheduled to be released within one year from the statement date were reclassified from current to noncurrent while cash reserved in accordance with management policy were reclassified from noncurrent to current.

Revised balances are shown in the following schedule (in thousands).

STATEMENT/ACCOUNT TITLE	Balances as revised Dec. 31, 2007	Balances as issued Dec. 31, 2007	Net Change
STATEMENT OF NET ASSETS			
Current assets:			
Cash and cash equivalents	\$ 55,319	\$ 34,820	\$ 20,499
Restricted cash and cash equivalents	92,761	83,348	9,413
Non-current assets:			
Revenue fund—cash & cash equivalents	29,087	62,010	(32,923)
Construction fund—cash & cash equivalents	4,530	-	4,530
Bond fund—cash & cash equivalents	68,018	69,537	(1,519)
Capital assets:			
Buildings and land improvements	1,996,634	2,002,194	(5,560)
Construction work-in-progress	1,077,781	1,084,607	(6,826)
Other noncurrent assets:			
Regulatory assets - environmental remediation	40,262	-	40,262
Current liabilities - Accounts payable	(34,784)	(39,314)	4,530
Noncurrent liabilities:			
Retainage payable	(4,530)	-	(4,530)
Environmental remediation costs	(39,669)	(11,793)	(27,876)
Net assets:			
Invested in capital assets - net of related debt	(376,995)	(389,380)	12,385
Restricted for: litigation	(17,477)	(5,092)	(12,385)
NET CHANGE	<u>\$ 2,890,937</u>	<u>\$ 2,890,937</u>	<u>\$ -</u>
STATEMENT OF CASH FLOWS			
Cash Flows From Capital and Related Financing Activities			
Acquisition of capital assets	(337,455)	(343,423)	5,968
Deferred costs	3,628	9,596	(5,968)
NET CHANGE	<u>\$ (333,827)</u>	<u>\$ (333,827)</u>	<u>\$ -</u>

16. SUBSEQUENT EVENTS

Water Quality issued the following bonds in 2009:

- \$300.0 million of Limited Tax General Obligation (LTGO) revenue bonds in April 2009.
- \$250.0 million of sewer revenue bonds in August 2009.
These bonds will be used to finance capital construction and improvements to the sewer system.

KING COUNTY WATER QUALITY ENTERPRISE

SUPPLEMENTAL SCHEDULE OF NET REVENUES AVAILABLE FOR DEBT SERVICE FOR THE YEAR ENDED DECEMBER 31, 2008

Water Quality 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 Water Quality. It is adopted policy of Water Quality to achieve a debt service coverage ratio of 1.25.

Coverage (1.15 required by covenant, adopted policy 1.25) 1.41

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

Coverage (1.15 adopted target) 1.23

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

Coverage (1.00 required by covenant) 1.19

In 2001, Water Quality 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) 7.71



ABOUT THE STATE AUDITOR'S OFFICE

The State Auditor's Office is established in the state's Constitution and is part of the executive branch of state government. The State Auditor is elected by the citizens of Washington and serves four-year terms.

Our mission is to work in cooperation with our audit clients and citizens as an advocate for government accountability. As an elected agency, the State Auditor's Office has the independence necessary to objectively perform audits and investigations. Our audits are designed to comply with professional standards as well as to satisfy the requirements of federal, state, and local laws.

The State Auditor's Office employees are located around the state to deliver our services effectively and efficiently.

Our audits look at financial information and compliance with state, federal and local laws on the part of all local governments, including schools, and all state agencies, including institutions of higher education. In addition, we conduct performance audits of state agencies and local governments and fraud, whistleblower and citizen hotline investigations.

The results of our work are widely distributed through a variety of reports, which are available on our Web site and through our free, electronic subscription service. We continue to refine our reporting efforts to ensure the results of our audits are useful and understandable.

We take our role as partners in accountability seriously. We provide training and technical assistance to governments and have an extensive quality assurance program.

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