



**KING COUNTY WATER QUALITY
ENTERPRISE FUND**
(An Enterprise Fund of King County, Washington)

**Report of Independent Auditors
and Financial Statements with
Required Supplementary Information
and Supplemental Information**

December 31, 2010 and 2009

MOSS ADAMS_{LLP}

Certified Public Accountants | Business Consultants

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REPORT OF INDEPENDENT AUDITORS

To the Metropolitan King County Council
Seattle, Washington

We have audited the accompanying statements of net assets of the King County Water Quality Enterprise Fund (Water Quality) as of December 31, 2010 and 2009, and the related statements of revenues, expenses and changes in net assets, and cash flows for the years then ended. These financial statements are the responsibility of Water Quality's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of Water Quality's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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 Fund as of December 31, 2010 and 2009, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying management's discussion and analysis on pages 2 through 9 and certain information in Note 11, Other Post-Employment Benefits, that is labeled as "required supplementary information" is not a required part of the financial statements but is supplementary information required by the Governmental Accounting Standards Board. This supplementary information is the responsibility of Water Quality's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The Supplemental Schedule of Net Revenues Available for Debt Service is not a required part of the basic financial statements, but is supplemental 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.

Moss Adams LLP

Seattle, Washington
May 10, 2011

**KING COUNTY WATER QUALITY ENTERPRISE FUND
MANAGEMENT'S DISCUSSION AND ANALYSIS
DECEMBER 31, 2010 AND 2009**

The management of King County Water Quality Enterprise Fund (Water Quality) presents to readers of its financial statements this narrative overview and analysis of its activities and financial performance for the fiscal years ended December 31, 2010 and 2009.

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 in Seattle and South Plant in Renton, two smaller secondary treatment plants at Vashon Island and Carnation, 353 miles of interceptors, 42 pump stations, and 38 combined sewer overflow (CSO) control locations. The sewer system collects and treats an average of 206 million gallons per day from approximately 1.5 million residents.

FINANCIAL HIGHLIGHTS

During 2010, Water Quality provided sewage treatment services to 704,391 residential customer equivalents (RCE) compared to 703,795 in 2009 and 706,846 in 2008. 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 7,400 new connections to its customer billing base in 2010. The program added 8,600 and 11,500 new connections in 2009 and 2008, respectively. The average flow of the four treatment plants was 178 million gallons per day (MGD) with a peak daily flow of 639 MGD. Maximum system capacity remained at 767 MGD in 2010. The average daily flow fluctuated between a peak of 178 in 2010, a low of 162 MGD in 2008 and 169 in 2009. The amount of annual precipitation largely determines annual fluctuations in flows, with 2008 considered a low flow year.

In 2010, Water Quality distributed 116,334 wet tons of biosolids to end users engaged in forestry, agriculture and soil enhancement. About 333 million gallons of reclaimed water were used for landscape irrigation, industrial processes, and for heating and cooling. Water Quality sold 1.3 million therms of natural gas to Puget Sound Energy and produced 0.39 million kilowatt hours of electricity that was used on site at South Treatment Plant. Reclaimed water capacity will expand when the Brightwater Treatment Plant begins service in 2012.

The Industrial Pretreatment Program conducted 448 inspections and took 2,347 compliance samples in 2010. The program currently tracks 292 facilities with discharge authorization permits and 126 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 in years 1980-1983 from a baseline of 2.3 billion gallons per year to 815 million gallons currently.

**KING COUNTY WATER QUALITY ENTERPRISE FUND
MANAGEMENT'S DISCUSSION AND ANALYSIS
DECEMBER 31, 2010 AND 2009**

In 1999, the Metropolitan King County Council adopted the Regional Wastewater Services Plan (RWSP) to construct additional capacity, protect public health and provide for future projected population growth in its service area through 2030. Major RWSP projects include the building of the Brightwater Treatment Plant, improvements to the regional conveyance system, construction of 21 combined sewer overflow control projects, and expansion of the South Treatment Plant to 135 million gallons per day capacity by 2029. The RWSP also includes projects to control infiltration and inflow into the conveyance system, process additional biosolids, and produce additional reclaimed water. Total Water Quality capital program expenditures were \$400.8 million for 2010 and \$459.3 million for 2009.

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 \$320.6 million project expenditure in 2010 pushed life to date expenditures to \$1.6 billion. The treatment plant is scheduled for completion and begins operating in 2011 with the conveyance to be completed in 2012.

Water Quality operating revenues decreased by 0.7 percent to \$304.8 million in 2010 from \$306.9 million in 2009. While operating expenses before depreciation increased by 0.6 percent to \$103.7 million in 2010 from \$103.1 million in 2009.

The monthly sewer rate remained stable at \$31.90 per RCE in 2010 and 2009. The capacity charge rate increased to \$49.07 per RCE in 2010 from \$47.64 in 2009. Capacity charge revenues increased 1.3 percent to \$41.4 million in 2010 from \$40.7 million in 2009. The RCE billed for sewer treatment services increased to 704,391 in 2010 from 703,795 in 2009. The rate stabilization reserve increased to \$51.0 million in 2010 from \$35.2 million in 2009. This increase of \$15.8 million in the reserve balance decreases operating revenues for the year and has been excluded from the calculation of debt service coverage for 2010. Future deposits to the rate stabilization reserve will decrease operating revenues and debt service coverage in the year of the deposit. Withdrawals will have the opposite effect of increasing operating revenues and debt service coverage in the year the rate stabilization reserve is reduced.

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 \$100.0 million in multimodal limited tax general obligation variable rate bonds in January 2010 and \$334.4 million in sewer revenue and refunding bonds in July 2010 at an average coupon rate of 4.92 percent. The refunding bonds resulted in an advance refunding and defeasance of \$36.3 million outstanding sewer revenue bonds. Water Quality received \$2.5 million of new, low-rate loans from the State of Washington to help fund the capital program at interest rates between 0.5 percent and 2.7 percent. In addition, the five-year loan of \$100.0 million from other King County funds made in 2008 was reduced from \$80 million to \$60.0 million. For 2009, Water Quality issued \$300.0 million in new limited tax general obligation bonds and \$250.0 million in sewer revenue bonds.

The results of operations for 2010 and 2009 produced a debt service coverage ratio on senior lien debt of 1.40 and 1.44, respectively, exceeding the coverage covenant requirement of 1.15 in both years. The total debt coverage ratio of 1.29 in 2010 and 1.33 in 2009 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. The receipt of monthly sewage treatment charges provides the principal support for Water Quality's activities. Sewage treatment charges of \$253.7 million provided 83.2 percent of operating revenues in 2010 and \$256.2 million provided 83.5 percent in 2009. 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, the 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 2010 and 2009, 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.

**KING COUNTY WATER QUALITY ENTERPRISE FUND
MANAGEMENT'S DISCUSSION AND ANALYSIS
DECEMBER 31, 2010 AND 2009**

FINANCIAL ANALYSIS OF THE STATEMENTS OF NET ASSETS

Comparative data, stated in millions of dollars:

| | Years Ended December 31 | | |
|---------------------------------------|-------------------------|-----------------|-----------------|
| | 2010 | 2009 | 2008 |
| Current assets | \$ 258.7 | \$ 227.9 | \$ 173.0 |
| Noncurrent assets | 191.4 | 172.6 | 142.7 |
| Capital assets | 3,859.0 | 3,483.1 | 3,084.7 |
| Other | 98.3 | 111.3 | 80.7 |
| Total assets | 4,407.4 | 3,994.9 | 3,481.1 |
| Long term liabilities | 3,458.8 | 3,088.7 | 2,530.2 |
| Other liabilities | 386.2 | 362.4 | 431.8 |
| Total liabilities | 3,845.0 | 3,451.1 | 2,962.0 |
| Net assets invested in capital assets | 407.2 | 410.6 | 521.8 |
| Net assets-restricted | 234.4 | 221.2 | 173.7 |
| Net assets-unrestricted | (79.2) | (88.0) | (176.4) |
| Total net assets | \$ 562.4 | \$ 543.8 | \$ 519.1 |

Net assets serve as a useful indicator of Water Quality's financial position. As of December 31, 2010 and 2009, assets exceeded liabilities by \$562.4 million and \$543.8 million, respectively.

Of the total assets of Water Quality, 87.6 percent or \$3,859.0 million were invested in capital assets such as treatment plants, pumping and regulator stations, interceptors, and other equipment at year-end 2010. For the year-end 2009, 87.2 percent or \$3,483.1 million were invested in capital assets. 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 by 3.4 percent or \$18.6 million in 2010 to \$562.4 million from \$543.8 million in 2009. Net assets were reduced over the periods of 2006 to 2008 by a restatement of fixed assets, accumulated depreciation and construction work in progress. The reduction to construction work in progress increased the value of plant in service and depreciation expense and increased the loss on disposal and impairment of capital assets. Restricted assets increased by 6.0 percent or \$13.2 million in 2010 to \$234.4 million from \$221.2 million in 2009. Unrestricted net assets increased by \$8.8 million in 2010 to (\$79.2) million from (\$88.0) million in 2009.

Net assets increased by 4.8 percent or \$24.7 million in 2009 from \$519.1 million in 2008. Restricted assets increased by 27.3 percent or \$47.5 million in 2009 from \$173.7 million in 2008. Unrestricted net assets increased by 50.1 percent or \$88.4 million in 2009 from (\$176.4) million in 2008.

**KING COUNTY WATER QUALITY ENTERPRISE FUND
MANAGEMENT'S DISCUSSION AND ANALYSIS
DECEMBER 31, 2010 AND 2009**

Water Quality reported its investment in capital assets, net of debt related to capital asset acquisition, as \$407.2 million and \$410.6 million at December 31, 2010 and 2009, respectively.

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

Comparative data, stated in millions of dollars:

| | Years Ended December 31 | | |
|------------------------------|-------------------------|-----------------|-----------------|
| | 2010 | 2009 | 2008 |
| Sewage treatment fees | \$ 269.6 | \$ 271.6 | \$ 237.0 |
| Rate stabilization | (15.9) | (15.4) | 3.0 |
| Capacity charge revenue | 41.4 | 40.7 | 34.9 |
| Other revenue | 9.7 | 10.0 | 9.3 |
| Operating revenues | 304.8 | 306.9 | 284.2 |
| Operating expenses | 197.8 | 196.3 | 180.8 |
| Operating income | 107.0 | 110.6 | 103.4 |
| Non operating (expenses) | (90.8) | (87.7) | (71.6) |
| Grant revenues | 2.4 | 1.8 | 2.2 |
| Change in net assets | 18.6 | 24.7 | 34.0 |
| Net assets beginning of year | 543.8 | 519.1 | 485.1 |
| Net assets end of year | <u>\$ 562.4</u> | <u>\$ 543.8</u> | <u>\$ 519.1</u> |

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 2010, operating revenues decreased by 0.7 percent or \$2.1 million to \$304.8 million from \$306.9 million in 2009. Operating expenses increased by 0.8 percent or \$1.5 million to \$197.8 million in 2010 from \$196.3 million in 2009.

In 2009, operating revenues increased by 8.0 percent or \$22.7 million to \$306.9 million from \$284.2 million in 2008. Operating expenses increased by 8.6 percent or \$15.5 million from \$180.8 million in 2008.

The moderation in operating expenses was driven by:

- Chemicals expenses were reduced by 11.5 percent or about \$626.8 thousand in 2010 to \$4.8 million primarily due to price reductions in polymers, caustic soda, sodium hypochlorite and carbon. Chemicals increased by 14.0 percent or \$666.6 thousand to \$5.4 million in 2009 from \$4.8 million in 2008.
- Electricity increased by 7.9 percent or \$777.1 thousand in 2010 to \$10.6 million after increasing 5.7 percent or \$533.9 thousand to \$9.9 million in 2009 from \$9.3 million in 2008.

**KING COUNTY WATER QUALITY ENTERPRISE FUND
MANAGEMENT'S DISCUSSION AND ANALYSIS
DECEMBER 31, 2010 AND 2009**

- Services expenses decreased by 1.9 percent or \$498.0 thousand to \$26.3 million for 2010 from \$26.8 million in 2009. Many of these were one-time costs. Construction services in 2009 were related to emergency preparations in case the Howard Hanson Dam failed and the Green River flooded. Consulting and contracting service expenses dropped reflecting the end of the process to launch Best Maintenance Practices, and legal services were reduced because specific lawsuits were resolved or less active in 2010. Services expenses increased by 20.6 percent or \$4.6 million from \$22.2 million in 2008.
- Intergovernmental expenses decreased by 3.1 percent or \$833.7 thousand in 2010 to \$26.3 million from \$27.2 million in 2009. Local hazardous waste expenses decreased by 8.9 percent or \$200 thousand in 2010 and 9.8 percent in 2009 or \$238.7 thousand due to lower flow. Expenses from Water and Land Resources were reduced by 5.7 percent or \$708.6 thousand in 2010 and by 9.4 percent or \$1.3 million in 2009 due to cost containment efforts. Financial management support services decreased by 10.7 percent or \$209.6 thousand in 2010 and by 5.6 percent or \$116.3 thousand in 2009. General Fund transfers decreased by 12.8 percent or \$296.2 thousand in 2010 and by 16.1 percent or \$2.3 million in 2009 due to countywide budget reductions and cost containment. Intergovernmental expenses decreased by 6.9 percent or \$2.0 million in 2009 from \$29.2 million in 2008.

Water Quality collected a monthly sewage treatment charge of \$31.90 per RCE in 2010 and 2009 and \$27.95 per RCE in 2008. Total sewer disposal revenues before rate stabilization decreased by 0.7 percent or \$2.0 million to \$269.6 million in 2010 from \$271.6 million in 2009. It was increased by 14.6 percent or \$34.6 million in 2009 from \$237.0 in 2008.

- Other operating revenues, including capacity charges for new customers and other treatment charges increased by 0.8 percent or \$0.4 million in 2010 to \$51.1 million from \$50.7 million in 2009. In 2009, it was increased by 14.7 percent or \$6.5 million from \$44.2 million in 2008. Capacity charge early payoff revenues were 18.5 percent or \$7.7 million of total capacity charge revenues in 2010 while in 2009, capacity charge early payoff revenues were 26.5 percent or \$10.8 million of the annual total. Actual new capacity charge connections were 7,400 in 2010 and 8,600 in 2009.
- Net nonoperating revenues and expenses increased by 3.5 percent or (\$3.1) million to (\$90.8) million in 2010 from (\$87.7) million in 2009. Net nonoperating revenues and expenses increased by 22.8 percent or (\$16.3) million from (\$71.4) million in 2008.
- Capital grant revenues received from federal and state agencies increased by \$758.1 thousand to \$2.4 million in 2010 from \$1.8 million in 2009. Capital grant revenues decreased by \$249.0 thousand from \$2.0 million in 2008. Low interest loans have largely replaced grants as the primary method of state agency support in recent years.

CAPITAL ASSETS

At December 31, 2010, Water Quality's investment in capital assets, net of accumulated depreciation, was \$3.9 billion as compared to \$3.5 billion in 2009. These represent increases of 10.8 percent or \$375.9 million in 2010 and 12.9 percent or \$398.4 million in 2009. 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.

**KING COUNTY WATER QUALITY ENTERPRISE FUND
MANAGEMENT'S DISCUSSION AND ANALYSIS
DECEMBER 31, 2010 AND 2009**

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

Large 2010 construction project expenditures include:

- \$4.5 million for Conveyance System Improvements;
- \$4.9 million for the Waste to Energy;
- \$6.4 million for the Bellevue Pump Station Upgrade;
- \$8.5 million for the South Treatment Plant Control System Upgrade;
- \$320.6 million spent toward the Brightwater Treatment Plant and conveyance.

Large 2009 construction project expenditures include:

- \$5.6 million for Pipeline Rehabilitation;
- \$6.7 million for the Brightwater Reclaimed Water Pipeline;
- \$6.8 million for the South Plant Control System Replacement;
- \$12.8 million for the North Creek Pipeline;
- \$360.6 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 \$100 million of multimodal limited tax general obligation bonds in January 2010 and \$334.4 million of sewer revenue and refunding bonds in July 2010 with an average life of 24.6 years at an average coupon rate of 4.92 percent with an effective rate of 4.67 percent.

Water Quality issued \$300 million of limited tax general obligation bonds in April 2009 with an average life of 20.0 years at an average coupon rate of 5.12 percent. An additional \$250.0 million in revenue bonds were issued in August 2009, with an average life of 26.8 years at an average coupon rate of 5.09 percent.

Water Quality received \$2.5 million in low-interest loans from the state of Washington in 2010 and \$19.2 million in 2009. The loans carry below-market rates between 0.5 percent and 3.1 percent with repayment terms up to 20 years.

Water Quality has \$2.4 billion of sewer revenue bonds and variable rate revenue bonds outstanding at the end of 2010 and \$2.2 billion outstanding at the end of 2009. 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.

**KING COUNTY WATER QUALITY ENTERPRISE FUND
MANAGEMENT'S DISCUSSION AND ANALYSIS
DECEMBER 31, 2010 AND 2009**

At the end of 2010, Water Quality has \$830.5 million of general obligation bonds and variable rate general obligation bonds outstanding and \$733.0 million of general obligation bonds outstanding at the end of 2009. 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 long-term ratings of AAA from Standard and Poor's for the multimodal limited tax general obligation bond issue in January 2010 and "Aa1" from Moody's Investor's with short-term ratings of "VMIG 1" and "A-1+". At the time of the issuance of the sewer revenue bonds in July 2010, Water Quality's bond ratings were:

| | |
|-----------------------------------|------------------------------|
| Moody's Investor's Service | Standard & Poor's |
| Aa2 | 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, 2010, the cash balance in the reserve account was \$130.5 million and \$113.1 million at the end of 2009. In addition to bond covenant reserves, Water Quality also maintains financial policy reserves. At December 31, 2010 and 2009, respectively, the rate stabilization, liquidity, and asset management financial policy reserves totaled \$81.4 million and \$65.5 million.

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

DEBT SERVICE COVERAGE RATIOS

| | <u>FY 2010</u> | <u>FY 2009</u> |
|-------------|-----------------------|-----------------------|
| Parity Debt | 1.40 | 1.44 |
| Total Debt | 1.29 | 1.33 |

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. Since 2001, Water Quality established a minimum coverage policy of 1.15 on total debt to further strengthen coverage performance.

REQUESTS FOR INFORMATION

This financial report is designed to provide an overview of Water Quality's financial condition as of the years ended December 31, 2010 and 2009. 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, WA 98104.

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KING COUNTY WATER QUALITY ENTERPRISE FUND
STATEMENTS OF NET ASSETS
DECEMBER 31, 2010 AND 2009
(in thousands)

| | ASSETS | |
|---|---------------------|---------------------|
| | 2010 | 2009 |
| CURRENT ASSETS | | |
| Cash and cash equivalents | \$ 24,018 | \$ 21,625 |
| Restricted cash and cash equivalents | 185,942 | 169,998 |
| Accounts receivable, net | 27,529 | 25,639 |
| Inventory of supplies | 5,758 | 5,384 |
| Due from other funds | 5,845 | 5,118 |
| Due from other governments | 9,550 | - |
| Prepayments | 77 | 152 |
| | 258,719 | 227,916 |
| NONCURRENT ASSETS | | |
| Revenue fund | | |
| Cash and cash equivalents | 59,275 | 43,586 |
| Accounts receivable, net | 354 | 384 |
| Construction fund—cash and cash equivalents | 1,219 | 15,560 |
| Bond fund—cash and cash equivalents | 130,542 | 113,051 |
| | 191,390 | 172,581 |
| Capital assets | | |
| Building and land improvements | 1,219,155 | 1,193,870 |
| Infrastructure | 1,064,898 | 1,023,221 |
| Plant in service and other equipment | 661,130 | 659,131 |
| Less accumulated depreciation | (1,230,078) | (1,151,861) |
| | 1,715,105 | 1,724,361 |
| Land and easements | 151,427 | 151,201 |
| Construction work in progress | 1,992,454 | 1,607,537 |
| | 3,858,986 | 3,483,099 |
| Other noncurrent | | |
| Regulatory assets - environmental remediation | 47,079 | 51,946 |
| Other utility assets, net of amortization | 22,703 | 24,360 |
| Deferred environmental remediation costs | 5,150 | 12,393 |
| Other deferred charges | 23,375 | 22,561 |
| | 98,307 | 111,260 |
| TOTAL ASSETS | \$ 4,407,402 | \$ 3,994,856 |

KING COUNTY WATER QUALITY ENTERPRISE FUND
STATEMENTS OF NET ASSETS (CONTINUED)
DECEMBER 31, 2010 AND 2009
(in thousands)

| | 2010 | 2009 |
|---|---------------------|---------------------|
| LIABILITIES AND NET ASSETS | | |
| CURRENT LIABILITIES | | |
| Accounts payable | \$ 57,626 | \$ 57,105 |
| Interest payable | 76,146 | 70,098 |
| Wages and benefits payable | 3,690 | 3,154 |
| Compensated absences | 393 | 387 |
| Environmental remediation costs | 5,599 | 3,126 |
| Notes payable | 100,000 | 100,000 |
| State loans payable | 7,896 | 7,771 |
| Due to other funds | 2,068 | 3,502 |
| Interfund loans payable | 96,313 | 82,633 |
| General obligation bonds payable | 2,630 | 2,530 |
| Revenue bonds payable | 33,860 | 32,090 |
| | <u>386,221</u> | <u>362,396</u> |
| NONCURRENT LIABILITIES | | |
| Retainage payable | 1,340 | 15,756 |
| Compensated absences | 10,681 | 9,906 |
| Other post-employment benefits | 673 | 503 |
| General obligation bonds payable | 827,885 | 730,515 |
| Revenue bonds payable | 2,399,490 | 2,135,275 |
| Deferred bond premium, discount, and refunding losses | 7,462 | (13,298) |
| Rate stabilization | 51,000 | 35,150 |
| Environmental remediation costs | 32,157 | 41,486 |
| State loans payable | 128,099 | 133,394 |
| | <u>3,458,787</u> | <u>3,088,687</u> |
| Total liabilities | <u>3,845,008</u> | <u>3,451,083</u> |
| NET ASSETS | | |
| Invested in capital assets—net of related debt | 407,161 | 410,649 |
| Restricted for | | |
| Debt service | 204,126 | 185,242 |
| Regulatory assets and environmental liabilities | 30,302 | 35,870 |
| Unrestricted | (79,195) | (87,988) |
| | <u>562,394</u> | <u>543,773</u> |
| Total net assets | <u>562,394</u> | <u>543,773</u> |
| TOTAL | <u>\$ 4,407,402</u> | <u>\$ 3,994,856</u> |

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KING COUNTY WATER QUALITY ENTERPRISE FUND
STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
YEARS ENDED DECEMBER 31, 2010 AND 2009
(in thousands)

| | <u>2010</u> | <u>2009</u> |
|---|-------------------|-------------------|
| OPERATING REVENUES | | |
| Sewage disposal fees | \$ 253,684 | \$ 256,160 |
| Other operating revenues | <u>51,141</u> | <u>50,696</u> |
| Total operating revenues | <u>304,825</u> | <u>306,856</u> |
| OPERATING EXPENSES | | |
| Sewage treatment, disposal, and transmission | 74,194 | 73,046 |
| General and administrative | 29,488 | 30,072 |
| Environmental related amortization | 1,535 | 1,565 |
| Depreciation and amortization | <u>92,627</u> | <u>91,595</u> |
| Total operating expenses | <u>197,844</u> | <u>196,278</u> |
| OPERATING INCOME | <u>106,981</u> | <u>110,578</u> |
| NONOPERATING REVENUES (EXPENSES) | | |
| Investment earnings | 3,220 | 4,776 |
| Interest | (81,099) | (69,893) |
| Amortization of debt related accounts | (2,937) | (3,196) |
| Loss on disposal and impairment of capital assets | (10,171) | (19,996) |
| Other | <u>196</u> | <u>534</u> |
| Total nonoperating expenses | <u>(90,791)</u> | <u>(87,775)</u> |
| INCOME BEFORE GRANTS AND CONTRIBUTIONS | <u>16,190</u> | <u>22,803</u> |
| CAPITAL GRANT REVENUES | <u>2,431</u> | <u>1,843</u> |
| CHANGE IN NET ASSETS | 18,621 | 24,646 |
| NET ASSETS | | |
| Beginning of year | <u>543,773</u> | <u>519,127</u> |
| End of year | <u>\$ 562,394</u> | <u>\$ 543,773</u> |

KING COUNTY WATER QUALITY ENTERPRISE FUND
STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 31, 2010 AND 2009
(in thousands)

| | <u>2010</u> | <u>2009</u> |
|---|-------------------|-------------------|
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Cash received from customers | \$ 308,538 | \$ 316,985 |
| Cash payments to suppliers for goods and services | (77,713) | (47,458) |
| Cash payments for employee services | <u>(40,110)</u> | <u>(37,816)</u> |
| Net cash provided by operating activities | <u>190,715</u> | <u>231,711</u> |
| CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES | | |
| Transfers out | (632) | (140) |
| Interfund loan principal received | 96,313 | 82,633 |
| Interfund loan principal paid | (82,633) | (184,041) |
| Interest paid on short-term loans | <u>(762)</u> | <u>(2,242)</u> |
| Net cash from noncapital financing activities | <u>12,286</u> | <u>(103,790)</u> |
| CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES | | |
| Acquisition of capital assets | (409,691) | (450,268) |
| Recoveries on (financing of) environmental remediation | 3,719 | (10,603) |
| Principal paid on general obligation bonds | (2,530) | (3,905) |
| Interest paid on general obligation bonds | (37,188) | (25,342) |
| Proceeds of new bond issuance | 434,365 | 550,000 |
| Principal paid on bonds for advance refunding | (36,290) | - |
| Principal paid on revenue bonds | (32,090) | (30,540) |
| Interest paid on revenue bonds | (102,629) | (90,789) |
| Interest paid on notes payable | (475) | (853) |
| Principal paid on state loans | (7,715) | (7,228) |
| Proceeds of state loans | 2,544 | 19,208 |
| Interest paid on state loans | (2,162) | (2,123) |
| Capital grants received | 2,431 | 1,843 |
| Receipts (payments made) on other noncurrent assets | <u>18,666</u> | <u>(2,462)</u> |
| Net cash used in capital and related financing activities | <u>(169,045)</u> | <u>(53,062)</u> |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Interest and realized gains | <u>3,220</u> | <u>4,776</u> |
| NET INCREASE IN CASH AND CASH EQUIVALENTS | 37,176 | 79,635 |
| CASH AND CASH EQUIVALENTS | | |
| Beginning of year | <u>363,820</u> | <u>284,185</u> |
| End of year | <u>\$ 400,996</u> | <u>\$ 363,820</u> |

KING COUNTY WATER QUALITY ENTERPRISE FUND
STATEMENTS OF CASH FLOWS (CONTINUED)
YEARS ENDED DECEMBER 31, 2010 AND 2009
(in thousands)

| | <u>2010</u> | <u>2009</u> |
|--|-------------------|-------------------|
| RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES | | |
| Operating income | \$ 106,981 | \$ 110,578 |
| Adjustments to reconcile operating income to net cash provided by operating activities | | |
| Depreciation and amortization | 94,162 | 93,160 |
| Changes in assets | | |
| Accounts receivable | (1,860) | (4,053) |
| Due from other funds | (727) | (1,218) |
| Due from other governments | (9,550) | - |
| Inventory of supplies | (374) | 188 |
| Prepayments | 75 | (35) |
| Changes in liabilities | | |
| Accounts payable | 521 | 12,735 |
| Due to other funds | (1,434) | 741 |
| Retainage payable | (14,416) | 2,713 |
| Rate stabilization | 15,850 | 15,400 |
| Wages and benefits payable | 536 | 413 |
| Compensated absences | 781 | 922 |
| Other post-employment benefits | 170 | 167 |
| Total adjustments | <u>83,734</u> | <u>121,133</u> |
| NET CASH PROVIDED BY OPERATING ACTIVITIES | <u>\$ 190,715</u> | <u>\$ 231,711</u> |
| SUPPLEMENTAL DISCLOSURE OF NONCASH CAPITAL AND RELATED FINANCING ACTIVITIES | | |
| Contribution of capital assets from government | <u>\$ 1,239</u> | <u>\$ 632</u> |

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KING COUNTY WATER QUALITY ENTERPRISE FUND
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2010 AND 2009

Note 1 - Operations and Accounting Policies

Summary of Operations - The King County Water Quality Enterprise Fund (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), represents approximately 40 percent of total sewage disposal fees in 2010 and in 2009.

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 \$26.3 million and \$27.2 million in 2010 and 2009, 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 (GAAP) 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 Opinions and Accounting Research Bulletins 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.

KING COUNTY WATER QUALITY ENTERPRISE FUND
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2010 AND 2009

Note 1 - Operations and Accounting Policies (Continued)

- 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* - Capital assets are stated at cost, less accumulated depreciation and amortization. Water Quality's capitalization threshold is: equipment at \$5 thousand; software at \$25 thousand, and buildings and improvements at \$50 thousand. Provision for depreciation and amortization are made on a straight-line basis over the estimated useful lives of Water Quality's capital assets, which ranges from 3 to 75 years.

| Description | Estimated Useful Life |
|---------------------------|-----------------------|
| Buildings | 10 - 75 years |
| Cars, vans, and trucks | 5 - 8 years |
| Data processing equipment | 3 - 10 years |
| Heavy equipment | 7 - 15 years |
| Sewer lines | 50 years |
| Shop equipment | 5 - 20 years |

Water Quality capitalizes certain interest income and expense related to borrowings until the assets are ready for their intended use. The amount capitalized is the difference between the interest revenue and interest expense associated with the applicable tax free borrowings. Total interest incurred was \$150.5 million and \$135.2 million during the years ended December 31, 2010 and 2009, respectively, of which \$69.4 million and \$65.3 million, respectively, was capitalized.

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

KING COUNTY WATER QUALITY ENTERPRISE FUND
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2010 AND 2009

Note 1 - Operations and Accounting Policies (Continued)

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. The fuel cell demonstration project was deemed impaired in 2009 due to the failure of a vital component and technological obsolescence of the installed model. A charge of \$12.6 million was incurred as a loss on the abandonment of the impaired asset.

- g. *Compensated Absences* - Employees earn vacation based upon their date of hire and years of service. They may accumulate a maximum of 480 hours or as bargained for by represented employees. 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.

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. *Debt-related Amortization* - Bond premiums and discounts, refunding losses, as well as issuance costs, are deferred and amortized over the life of the bonds using the outstanding principal balance method. Bonds payable are reported net of the applicable bond premium or discount. Issuance costs are reported as deferred charges and amortized over the term of the related debt.
- 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 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.

KING COUNTY WATER QUALITY ENTERPRISE FUND
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2010 AND 2009

Note 1 - Operations and Accounting Policies (Continued)

- l. *Reclassifications* - Certain reclassifications have been made to the prior year statements to conform to the current year presentation.
- 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 \$2.4 million and \$1.8 million for the years ended December 31, 2010 and 2009, 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 Standards - In June 2007, GASB issued Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*. This statement establishes accounting and financial reporting requirements for recognition, initial measurement and amortization of intangible assets. The statement is effective for financial statements for periods beginning after June 15, 2009 and was adopted by Water Quality in 2010 without a material impact on its financial position or results of operations.

GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, provides guidance for the recognition, measurement and disclosure of activity related to derivative instruments held by state and local governments. This Statement is effective for reporting periods beginning after June 15, 2009. This statement has no impact on Water Quality's financial statements.

In April 2009, GASB issued Statement No. 55, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*, to ensure integration of the GAAP hierarchy for state and local governments into GASB literature. The statement became effective immediately. This statement has no impact on Water Quality's financial statements.

GASB Statement No. 56, *Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards*, was issued in April 2009, which incorporates into the GASB's authoritative literature certain accounting and financial reporting guidance presented in the American Institute of Certified Public Accountants' Statements on Auditing Standards. This statement addresses three issues not included in the authoritative literature that establishes accounting principles: related party transactions, going concern considerations and subsequent events. The statement was effective immediately upon its issuance. It has no impact on Water Quality's financial statements.

In June 2010, the GASB issued Statement No. 59, *Financial Instruments Omnibus*, which clarifies guidance in existing standards on the financial reporting of the following four areas, 2a7 -like external investment pools; interest rate risk disclosures for debt investment pools; unallocated insurance contracts; and certain amendments to GASB Statement No. 53 on derivatives. This statement is effective for periods beginning after June 15, 2010. Water Quality is currently evaluating the impact of the adoption of this standard on its financial statements.

KING COUNTY WATER QUALITY ENTERPRISE FUND
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2010 AND 2009

Note 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 are 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 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 100 percent covered by the Public Deposit Protection Commission of the State of Washington (PDPC), a statutory authority established under chapter 39.58 RCW. Beginning in July 2009, PDPC requires all banks and thrifts that operate as public depositories to collateralize their uninsured public deposits at 100 percent. 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, Water Quality's cash and cash equivalents balance of \$401.0 million and \$363.8 million were fully insured and collateralized as of December 31, 2010 and December 31, 2009, respectively.

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, 2010.

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. The County completed the restructuring of three of the four securities in 2008 and completed the restructuring of the fourth security in 2009. 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 \$1.5 million at December 31, 2010 and \$2.0 million at December 31, 2009. Losses from impaired investments are offset against other investment earnings.

KING COUNTY WATER QUALITY ENTERPRISE FUND
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2010 AND 2009

Note 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 \$377.3 million in 2010 and \$342.6 million in 2009 to pay for debt service and to comply with bond reserve requirements. Current restricted assets consist of cash reserved to fund the current portion of long-term debt, prefunded interest payments, the retainage on impaired investments, the current portion of the retainage held on contractual payments and the balance of cash held in trust, totaling \$185.9 million in 2010 and \$170 million in 2009. The non-current restricted assets consist primarily of cash reserved to fund construction, \$1.2 million in 2010 and \$15.6 million in 2009, and bond reserves of \$130.5 million in 2010 and \$113.1 million in 2009.

Note 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.

During 2010 and 2009, Water Quality claims paid by the Insurance Fund of King County were \$217 thousand and \$135 thousand, respectively. There was no occurrence that resulted in payment in excess of the self-insured retention level of \$3.5 million.

Claims settlements and loss expenses are accrued in the three internal service funds for the estimated settlement value of both reported and unreported claims. These funds are responsible for collecting interfund premiums from insured funds and departments, for paying claim settlements, and for purchasing certain policies. 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.

Note 5 - Long-Term Liabilities and Notes Payable

Sewer Revenue Bonds - As of December 31, 2010, bonds outstanding include \$855.5 million of serial bonds maturing from January 1, 2011 through 2034, bearing interest at stated rates of 2.00 percent to 5.50 percent per annum, and \$1,577.9 million of term bonds maturing on January 1 in the years 2024 through 2050, bearing interest at stated rates of 4.25 percent to 5.75 percent per annum.

KING COUNTY WATER QUALITY ENTERPRISE FUND
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2010 AND 2009

Note 5 - Long-Term Liabilities and Notes Payable (Continued)

In 2010, Water Quality issued \$334.4 million of Sewer Revenue Refunding Bonds maturing from January 1, 2011 to 2050. The new refunding issues include \$125.1 million of serial bonds maturing from January 1, 2011 through 2032, bearing interest at stated rates between 2.00 percent and 5.00 percent, and \$209.2 million of term bonds, maturing in the years 2036 through 2050, bearing interest at stated rates between 4.25 percent and 5.00 percent. This issue resulted in an advance refunding of \$36.3 million of the 2001 Sewer Revenue Refunding Bonds.

The economic gain resulting from the refunding transaction was \$3.1 million. The difference between the cash flows required to service the outstanding bonds and the cash flows required to service the new debt was a gain of \$4.0 million.

In 2009, Water Quality issued \$250.0 million of Sewer Revenue Bonds maturing from January 1, 2013 to 2048. The new issues include \$48.0 million of serial bonds maturing from January 1, 2017 through 2034, bearing interest at stated rate between 4.00 percent and 5.00 percent, and \$202.0 million of term bonds, maturing in the years 2039 through 2042, bearing interest at stated rates between 5.00 percent and 5.25 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, 2010, Water Quality restricted cash balances in the amount of \$91.0 million to pay principal and interest due on revenue bonds on January 1, 2011. Principal and interest incurred in the current year and total customer net revenues were \$174.4 million and \$201.1 million, respectively.

Additional amounts of \$130.5 million and \$113.1 million held in the bond fund as bond reserves, as of December 31, 2010 and 2009, 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 2010, by depositing \$16.6 million to the bond reserve account for this issue. 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, 2010, Water Quality is in compliance with the combined amount required for the reserve and surety policies.

KING COUNTY WATER QUALITY ENTERPRISE FUND
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2010 AND 2009

Note 5 - Long-Term Liabilities and Notes Payable (Continued)

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 December 31, 2010</u> |
|-----------------------------|---------------------------|---------------------------|--------------------------------------|---|
| 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 | 183,555 |
| 2002A | 1/1/35 | 5.00-5.50% | 100,000 | 94,960 |
| 2002B Refunding | 1/1/33 | 4.00-5.50% | 346,130 | 226,670 |
| 2003A Refunding | 1/1/35 | 3.00-5.50% | 96,470 | 90,905 |
| 2004A | 1/1/35 | 4.50-4.75% | 185,000 | 185,000 |
| 2004B Refunding | 1/1/35 | 3.00-5.00% | 61,760 | 57,015 |
| 2006 Refunding | 1/1/36 | 5.00% | 124,070 | 124,070 |
| 2006 (2nd Series) Refunding | 1/1/36 | 3.50-5.00% | 193,435 | 186,810 |
| 2007 | 1/1/47 | 5.00% | 250,000 | 250,000 |
| 2008 | 1/1/48 | 5.00-5.75% | 350,000 | 350,000 |
| 2009 | 1/1/42 | 4.00-5.25% | 250,000 | 250,000 |
| 2010 | 1/1/50 | 2.00-5.00% | 334,365 | 334,365 |
| | | | <u>\$ 2,661,290</u> | <u>\$ 2,433,350</u> |

General Obligation Bonds - As of December 31, 2010, bonds outstanding include \$535.7 million of serial bonds maturing January 1, 2011 through 2031, bearing interest at stated rates of 3.25 percent to 5.25 percent per annum. General Obligation Bonds outstanding also include \$294.8 million of term bonds maturing on January 1, 2033 through 2039, bearing interest at stated rates of 4.75 percent to 5.25 percent.

In 2010, Water Quality issued \$100.0 million of Multi-Modal Limited Tax General Obligation (LTGO) variable rate bonds maturing January 1, 2040. The bond initially will bear interest at Weekly Rates for Weekly Rate Periods, subject to conversion to other Interest Rate Modes.

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.

In 2009, Water Quality issued \$300.0 million of Limited Tax General Obligation (Sewer Revenue) Bonds maturing from 2014 to 2039. The new issues included \$150.1 million of serial bonds maturing from January 1, 2014 through 2030, bearing interest at stated rates of 5.00 percent, and \$149.9 million of term bonds, maturing in the years of 2033 through 2039, bearing interest at stated rates between 5.13 percent and 5.25 percent.

KING COUNTY WATER QUALITY ENTERPRISE FUND
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2010 AND 2009

Note 5 - Long-Term Liabilities and Notes Payable (Continued)

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

| | Final Maturity | Interest Rates | Original Issue Amount | Outstanding at December 31, 2010 |
|--------------------------|-------------------|-------------------|-----------------------------|--|
| 2005 LTGO | 1/1/35 | 4.50-5.00% | \$ 200,000 | \$ 200,000 |
| 2008 LTGO | 1/1/34 | 3.25-5.25% | 236,950 | 230,515 |
| 2009B LTGO | 7/1/39 | 5.00-5.25% | 300,000 | 300,000 |
| 2010A-B Multi-Modal LTGO | 1/1/40 | (variable) | 100,000 | 100,000 |
| | | | <u>\$ 836,950</u> | <u>\$ 830,515</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 2011 through 2031 and bear interest at stated rates from 0.00 percent to 3.10 percent. As of December 31, 2010, the balance due on all state loans is \$136.0 million. Water Quality maintains separate cash reserves of \$8.3 million. These reserves are treated as restricted, being required under the Revolving Fund Loan Program.

At December 31, 2010, the required principal and interest payments for all classes of long-term debt are as follows (in thousands):

| Year(s) Beginning | Revenue Bonds | | General Obligation Bonds | | Variable Rate General Obligation Bonds, Revenue Bonds, and Commercial Paper Note | | State Loans | | Total |
|----------------------|---------------------|---------------------|--------------------------|-------------------|---|-------------------|-------------------|------------------|---------------------|
| | Principal | Interest | Principal | Interest | Principal | Interest | Principal | Interest | |
| January 1, 2011 | \$ 33,860 | \$ 108,423 | \$ 2,630 | \$ 36,416 | \$ - | \$ 15,651 | \$ 7,896 | \$ 2,096 | \$ 206,972 |
| January 1, 2012 | 35,395 | 115,179 | 2,730 | 36,284 | - | 15,525 | 8,596 | 1,978 | 215,687 |
| January 1, 2013 | 38,190 | 113,737 | 2,795 | 36,195 | - | 15,525 | 8,759 | 1,852 | 217,053 |
| January 1, 2014 | 43,270 | 111,826 | 8,750 | 36,104 | - | 15,525 | 8,879 | 1,724 | 226,078 |
| January 1, 2015 | 45,480 | 109,622 | 9,000 | 35,667 | - | 15,525 | 9,002 | 1,593 | 225,889 |
| January 1, 2016—2020 | 214,580 | 514,907 | 101,330 | 167,767 | 100,000 | 62,100 | 46,154 | 5,931 | 1,212,769 |
| January 1, 2021—2025 | 260,250 | 458,640 | 142,755 | 137,267 | - | 51,750 | 36,887 | 2,626 | 1,090,175 |
| January 1, 2026—2030 | 333,440 | 387,367 | 181,420 | 97,788 | - | 51,750 | 9,701 | 478 | 1,061,944 |
| January 1, 2031—2035 | 428,225 | 296,267 | 203,860 | 48,998 | 100,000 | 36,225 | 121 | 1 | 1,113,697 |
| January 1, 2036—2040 | 349,300 | 197,695 | 75,245 | 10,112 | 100,000 | 25,875 | - | - | 758,227 |
| January 1, 2041—2045 | 340,110 | 103,516 | - | - | - | - | - | - | 443,626 |
| January 1, 2046—2050 | 211,250 | 24,897 | - | - | - | - | - | - | 236,147 |
| | <u>\$ 2,333,350</u> | <u>\$ 2,542,076</u> | <u>\$ 730,515</u> | <u>\$ 642,598</u> | <u>\$ 300,000</u> | <u>\$ 305,451</u> | <u>\$ 135,995</u> | <u>\$ 18,279</u> | <u>\$ 7,008,264</u> |

The future annualized interest payments for the variable rate revenue bonds are based on an interest rate of 5.175 percent, which represents 90 percent of the Revenue Bond Index assumed by the County for financial planning purposes.

KING COUNTY WATER QUALITY ENTERPRISE FUND
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DECEMBER 31, 2010 AND 2009

Note 5 - Long-Term Liabilities and Notes Payable (Continued)

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, 2010, \$100.0 million was issued and outstanding under this program. The commercial paper has maturities ranging between 62 and 94 days and is classified as a current liability of Water Quality's operating fund. Changes in short-term note payables for the year ended December 31, 2010 and 2009 was as follows (in thousands):

| | Balance January 1, 2010 | Additions | Reductions | Balance December 31, 2010 |
|------------------|-------------------------------|---------------------|-----------------------|---------------------------------|
| Commercial paper | <u>\$ 100,000</u> | <u>\$ 953,409</u> | <u>\$ (953,409)</u> | <u>\$ 100,000</u> |
| | Balance January 1, 2009 | Additions | Reductions | Balance December 31, 2009 |
| Commercial paper | <u>\$ 100,000</u> | <u>\$ 1,130,295</u> | <u>\$ (1,130,295)</u> | <u>\$ 100,000</u> |

Variable Rate General Obligation and Revenue Bonds - The variable rate bonds, 2001 Series A and Series B revenue bonds are supported by a periodically renewable letter of credit that expires December 31, 2015. The variable rate bonds, 2010 Series A and Series B general obligation bonds are supported by a Standby Bond Purchase Agreement that expires January 21, 2013.

Financial Policy Reserves - In addition to bond reserves related to Sewer Revenue Bonds, Water Quality maintains liquidity and asset management reserves totaling \$30.4 million at December 31, 2010.

Compliance with Bond Resolutions - With respect to the year ended December 31, 2010, Water Quality complied with all financial covenants stipulated by its bond resolutions.

KING COUNTY WATER QUALITY ENTERPRISE FUND
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2010 AND 2009

Note 5 - Long-Term Liabilities and Notes Payable (Continued)

Changes in Long-Term Liabilities - Long-term liability activity for the years ended December 31, 2010 and 2009 was as follows (in thousands):

| | Balance January 1, 2010 | Additions | Reductions | Balance December 31, 2010 | Due Within One Year |
|--------------------------------|-------------------------------|-------------------|--------------------|---------------------------------|------------------------|
| Bonds payable | \$ 2,900,410 | \$ 434,365 | \$ (70,910) | \$ 3,263,865 | \$ 36,490 |
| Bond premiums and discounts | 46,496 | 21,847 | (3,709) | 64,634 | 4,093 |
| Refunding losses | <u>(59,793)</u> | <u>(2,635)</u> | <u>5,256</u> | <u>(57,172)</u> | <u>(4,895)</u> |
| Total bonds payable | 2,887,113 | 453,577 | (69,363) | 3,271,327 | 35,688 |
| Retainage payable | 21,223 | 525 | (2,302) | 19,446 | 18,106 |
| State loans | 141,165 | 2,545 | (7,715) | 135,995 | 7,896 |
| Compensated absences | 10,293 | 1,215 | (434) | 11,074 | 393 |
| Other post-employment benefits | 503 | 252 | (82) | 673 | - |
| Environmental remediation | 44,612 | 3,914 | (10,770) | 37,756 | 5,599 |
| Rate stabilization | <u>35,150</u> | <u>15,850</u> | <u>-</u> | <u>51,000</u> | <u>-</u> |
| Total long-term liabilities | <u>\$ 3,140,059</u> | <u>\$ 477,878</u> | <u>\$ (90,666)</u> | <u>\$ 3,527,271</u> | <u>\$ 67,682</u> |

The current portion of retainage payable in the amount of \$18.1 million and \$5.5 million for 2010 and 2009, respectively, is classified in Accounts Payable.

| | Balance January 1, 2009 | Additions | Reductions | Balance December 31, 2009 | Due Within One Year |
|--------------------------------|-------------------------------|-------------------|--------------------|---------------------------------|------------------------|
| Bonds payable | \$ 2,384,855 | \$ 550,000 | \$ (34,445) | \$ 2,900,410 | \$ 34,620 |
| Bond premiums and discounts | 46,626 | 3,344 | (3,474) | 46,496 | 3,345 |
| Refunding losses | <u>(65,100)</u> | <u>-</u> | <u>5,307</u> | <u>(59,793)</u> | <u>(5,223)</u> |
| Total bonds payable | 2,366,381 | 553,344 | (32,612) | 2,887,113 | 32,742 |
| Retainage payable | 17,027 | 4,336 | (140) | 21,223 | 5,467 |
| State loans | 129,186 | 19,207 | (7,228) | 141,165 | 7,771 |
| Compensated absences | 9,371 | 922 | - | 10,293 | 387 |
| Other post-employment benefits | 336 | 167 | - | 503 | - |
| Environmental remediation | 34,141 | 14,152 | (3,681) | 44,612 | 3,126 |
| Rate stabilization | <u>19,750</u> | <u>15,400</u> | <u>-</u> | <u>35,150</u> | <u>-</u> |
| Total long-term liabilities | <u>\$ 2,576,192</u> | <u>\$ 607,528</u> | <u>\$ (43,661)</u> | <u>\$ 3,140,059</u> | <u>\$ 49,493</u> |

KING COUNTY WATER QUALITY ENTERPRISE FUND
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2010 AND 2009

Note 6 - Changes in Capital Assets

Changes in capital assets for the years ended December 31, 2010 and 2009 are shown in the following table (in thousands):

| | Balance January 1, 2010 | Increases | Decreases | Balance December 31, 2010 |
|---|-------------------------------|-------------------|--------------------|---------------------------------|
| Land | \$ 129,786 | \$ 166 | \$ - | \$ 129,952 |
| Easements | 21,415 | 60 | - | 21,475 |
| Construction work in progress | 1,607,537 | 474,406 | (89,489) | 1,992,454 |
| Total nondepreciable assets | <u>1,758,738</u> | <u>474,632</u> | <u>(89,489)</u> | <u>2,143,881</u> |
| Buildings | 1,170,132 | 25,362 | (1,026) | 1,194,468 |
| Land improvements | 23,738 | 949 | - | 24,687 |
| Infrastructure | 1,023,221 | 41,677 | - | 1,064,898 |
| Major equipment and vehicles | 9,149 | 817 | (30) | 9,936 |
| Shop and other equipment | 637,500 | 15,308 | (14,096) | 638,712 |
| Software development | 12,482 | - | - | 12,482 |
| Total depreciable assets | <u>2,876,222</u> | <u>84,113</u> | <u>(15,152)</u> | <u>2,945,183</u> |
| Accumulated depreciation and amortization: | | | | |
| Building | (412,505) | (27,836) | 935 | (439,406) |
| Land improvements | (13,125) | (1,822) | - | (14,947) |
| Infrastructure | (314,227) | (22,397) | - | (336,624) |
| Major equipment and vehicles | (7,076) | (825) | 29 | (7,872) |
| Shop and other equipment | (393,214) | (39,416) | 13,730 | (418,900) |
| Software development | (11,714) | (615) | - | (12,329) |
| Total depreciation and amortization | <u>(1,151,861)</u> | <u>(92,911)</u> | <u>14,694</u> | <u>(1,230,078)</u> |
| Depreciable assets - net | <u>1,724,361</u> | <u>(8,798)</u> | <u>(458)</u> | <u>1,715,105</u> |
| Total capital assets - net | <u>\$ 3,483,099</u> | <u>\$ 465,834</u> | <u>\$ (89,947)</u> | <u>\$ 3,858,986</u> |

KING COUNTY WATER QUALITY ENTERPRISE FUND
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2010 AND 2009

Note 6 - Changes in Capital Assets (Continued)

| | Balance January 1, 2009 | Increases | Decreases | Balance December 31, 2009 |
|---|-------------------------------|-------------------|---------------------|---------------------------------|
| Land | \$ 129,786 | \$ - | \$ - | \$ 129,786 |
| Easements | 21,155 | 260 | - | 21,415 |
| Construction work in progress | 1,245,615 | 533,779 | (171,857) | 1,607,537 |
| Total nondepreciable assets | <u>1,396,556</u> | <u>534,039</u> | <u>(171,857)</u> | <u>1,758,738</u> |
| Building | 1,131,325 | 54,411 | (15,604) | 1,170,132 |
| Land improvements | 21,344 | 2,394 | - | 23,738 |
| Infrastructure | 990,325 | 32,896 | - | 1,023,221 |
| Major equipment and vehicles | 8,758 | 601 | (210) | 9,149 |
| Shop and other equipment | 601,538 | 47,134 | (11,172) | 637,500 |
| Software development | 16,829 | 377 | (4,724) | 12,482 |
| Total depreciable assets | <u>2,770,119</u> | <u>137,813</u> | <u>(31,710)</u> | <u>2,876,222</u> |
| Accumulated depreciation and amortization: | | | | |
| Building | (381,444) | (34,813) | 3,752 | (412,505) |
| Land improvements | (11,801) | (1,324) | - | (13,125) |
| Infrastructure | (300,800) | (13,427) | - | (314,227) |
| Major equipment and vehicles | (6,415) | (849) | 188 | (7,076) |
| Shop and other equipment | (365,531) | (38,381) | 10,698 | (393,214) |
| Software development | (16,011) | (427) | 4,724 | (11,714) |
| Total depreciation and amortization | <u>(1,082,002)</u> | <u>(89,221)</u> | <u>19,362</u> | <u>(1,151,861)</u> |
| Depreciable assets - net | <u>1,688,117</u> | <u>48,592</u> | <u>(12,348)</u> | <u>1,724,361</u> |
| Total capital assets - net | <u>\$ 3,084,673</u> | <u>\$ 582,631</u> | <u>\$ (184,205)</u> | <u>\$ 3,483,099</u> |

During the current year, Water Quality implemented GASB Statement 51, *Accounting and Financial Reporting for Intangible Assets*, which requires retroactive reporting for intangible assets except for those considered to have an indefinite useful life. Capital assets for Water Quality were reclassified for the years 2010 and 2009 in the above schedules to reflect both the implementation of GASB Statement 51 and a segregation of infrastructure from the building and land improvement assets and accumulated depreciation.

Note 7 - Environmental Remediation

Water Quality operations are subject to rules and regulations enacted by the Washington State Department of Ecology (DOE) and the U.S. Environmental Protection Agency (EPA). 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.

Note 7 - Environmental Remediation (Continued)

Water Quality follows GASB Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations* (GASB 49), which mandates the disclosure of "obligations to address current or potential detrimental effects of existing pollution by participating in pollution remediation activities." GASB 49 establishes five events, any one of which obligates Water Quality to record a liability for pollution remediation expenditures. 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 Sediment Management Project has been approved by the Metropolitan King County Council as a self obligated pollution remediation program. The Lower Duwamish Waterway project became a Water Quality obligation when King County entered into an Administrative Order on Consent (AOC) with the DOE and EPA. This AOC also includes The Boeing Company, the City of Seattle and the Port of Seattle as parties to the cleanup. Each party has agreed to pay one fourth of the cleanup costs.

Both projects may result in additional cleanup efforts as a result of additional regulatory orders. Additionally, the U.S. EPA has announced its intention to negotiate an agreement with local governments, including King County, and other Potentially Responsible Parties (PRP) for the remediation of Combined Sewer Overflows which may result in Water Quality recording additional pollution remediation liabilities in the future. These potential cleanup liabilities cannot be currently estimated. Ongoing, regulatory action may identify other PRP's for the Lower Duwamish Waterway cleanup.

There are no estimated recoveries at this time that will reduce the amount of Water Quality's pollution remediation obligations. However, the State of Washington has indicated that it intends to fund grants in support of Water Quality's Lower Duwamish Waterway cleanup. These amounts are forecast at \$1.2 million over the period 2011 to 2016. The total environmental remediation liability at December 31, 2010 stands at \$37.8 million and \$44.6 million in 2009.

The pollution remediation obligation is an estimate and subject to changes resulting from price increases or reductions, technology, or changes in applicable laws or regulations.

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 Water Quality's Regional Wastewater Services Plan. Certain costs were developed by consulting engineers. Costs were estimated using the expected cash flow method set out by GASB 49. For the Lower Duwamish Waterway project a weighted average method is used to calculate the liability. The Sediment Management Plan does not employ a weighted average cost estimate because the remaining work is well-defined and negates the utility of multiple estimates. The cost estimates continue to be re-measured as succeeding benchmarks are reached or when cost assumptions are modified. All pollution remediation obligations are being deferred as permitted by regulatory accounting standards (see Note 8 - Regulatory Deferrals.)

Note 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, the Council established a Rate Stabilization Reserve. This action created a regulatory liability which deferred operating revenue to be set aside in a reserve and recognized in subsequent years to maintain stable sewer rates. The reserve was \$35.2 million in 2009 increased by \$15.8 million to \$51.0 million in 2010.

Pollution Remediation - In 2006, the Council approved the application of regulatory accounting 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 accrued is being amortized over a recovery period of 30 years.

Note 9 - Employee Benefit Plans

Defined Benefit Pension Plans - All full-time and qualifying part-time employees of Water Quality participate in the Public Employees' Retirement System (PERS). PERS is a statewide governmental retirement system administered by the State of Washington's Department of Retirement Systems.

The Department of Retirement Systems (DRS), a department within the primary government of the State of Washington, issues a publicly available Comprehensive Annual Financial Report (CAFR) that includes financial statements and required supplementary information for each plan. The DRS CAFR may be obtained by writing to: Department of Retirement Systems, Communications Unit, PO Box 48380, Olympia, WA 98504-8380; or it may be downloaded from the DRS website at www.drs.wa.gov.

Public Employees Retirement System - The Washington State Legislature established PERS in 1947 under RCW Chapter 41.40. PERS is a cost-sharing, multiple-employer retirement system comprised of three separate plans for membership purposes: Plans 1 and 2 are defined benefit plans and Plan 3 is a combination defined benefit/defined contribution plan. PERS participants who joined the system by September 30, 1977, are Plan 1 members. Those who joined on or after October 1, 1977, and by August 31, 2002 (for local government employees), are Plan 2 members unless they exercise an option to transfer their membership to Plan 3. PERS participants joining the system on or after September 1, 2002 (for local government employees), have the irrevocable option of choosing membership in either PERS Plan 2 or PERS Plan 3. The option must be exercised within 90 days of employment. Employees who fail to choose within 90 days default to PERS Plan 3.

PERS Plan 1 and Plan 2 defined benefit retirement benefits are financed from a combination of investment earnings and employer and employee contributions. PERS retirement benefit provisions are established in state statute and may be amended only by the State Legislature.

Note 9 - Employee Benefit Plans (Continued)

PERS Plan 1 members are vested after the completion of five years of eligible service. Plan 1 members are eligible for retirement after 30 years of service, or at the age of 60 with five years of service, or at the age of 55 with 25 years of service. The annual benefit is two percent of the average final compensation (AFC) per year of service, capped at 60 percent. (The AFC is based on the greatest compensation during any 24 eligible consecutive compensation months.) This annual benefit is subject to a minimum for PERS Plan 1 retirees who have 25 years of service and have been retired 20 years, or who have 20 years of service and have been retired 25 years. Plan 1 members who retire from inactive status prior to the age of 65 may receive actuarially reduced benefits. If a survivor option is chosen, the benefit is further reduced. A cost-of living allowance (COLA) is granted at age 66 based upon years of service times the COLA amount, which is increased three percent annually. Plan 1 members may also elect to receive an optional COLA that provides an automatic annual adjustment based on the Consumer Price Index. The adjustment is capped at three percent annually. The benefit is reduced to offset the cost of this annual adjustment.

PERS Plan 2 members are vested after the completion of five years of eligible service. Plan 2 members may retire at the age of 65 with five years of service with an allowance of two percent of the AFC per year of service. (The AFC is based on the greatest compensation during any eligible consecutive 60-month period.)

Plan 2 members who have at least 20 years of service credit and are 55 years of age or older are eligible for early retirement with a reduced benefit. The benefit is reduced by an early retirement factor (ERF) that varies according to age for each year before age 65. PERS plan 2 members who have 30 or more years of service credit and are at least 55 years old can retire under one of two provisions: with a benefit that is reduced by 3 percent for each year before age 65; with a benefit that has a smaller (or no) reduction (depending on age) that imposes stricter return-to-work rules.

The benefit is also actuarially reduced to reflect the choice of a survivor option. There is no cap on years of service credit and a cost-of-living allowance is granted (based on the Consumer Price Index), capped at three percent annually.

PERS Plan 3 has a dual benefit structure. Employer contributions finance a defined benefit component, and member contributions finance a defined contribution component. The defined benefit portion provides a benefit calculated at one percent of the AFC per year of service. (The AFC is based on the greatest compensation during any eligible consecutive 60-month period.) Effective June 7, 2006, PERS Plan 3 members are vested in the defined benefit portion of their plan after ten years of service; or after five years of service, if twelve months of that service are earned after age 44; or after five service credit years earned in PERS Plan 2 prior to June 1, 2003. Plan 3 members are immediately vested in the defined contribution portion of their plan.

Vested Plan 3 members are eligible for normal retirement at age 65 or they may retire early with the following conditions and benefits: If they have at least ten service credit years and are 55 years old, the benefit is reduced by an ERF that varies with age for each year before age 65; if they have 30 service credit years and at least 55 years old, they have the choice of a benefit that is reduced by 3 percent for each year before age 65 or a benefit with a smaller (or no) reduction factor (depending on age) that imposes stricter return-to-work rules.

KING COUNTY WATER QUALITY ENTERPRISE FUND
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2010 AND 2009

Note 9 - Employee Benefit Plans (Continued)

PERS Plan 3 defined benefit retirement benefits are also actuarially reduced to reflect the choice, if made, of a survivor option. There is no cap on years of service credit and Plan 3 provides the same cost-of-living allowance as Plan 2.

PERS Plan 3 defined contribution retirement benefits are solely dependent upon the results of investment activities. The defined contribution portion can be distributed in accordance with an option selected by the member, either as a lump sum or pursuant to other options authorized by the Director of the Department of Retirement Systems.

Each biennium, the state Pension Funding Council adopts Plan 1 employer contribution rates, Plan 2 employer and employee contribution rates, and Plan 3 employer contribution rates. Employee contribution rates for Plan 1 are established by statute at six percent for state agencies and local government unit employees, and at 7.5 percent for state government elected officials. The employer and employee contribution rates for Plan 2 and the employer contribution rate for Plan 3 are developed by the Office of the State Actuary to fully fund Plan 2 and the defined benefit portion of Plan 3. All employers are required to contribute at the level established by the Legislature. Under PERS Plan 3, employer contributions finance the defined benefit portion of the plan, and member contributions finance the defined contribution portion. The Employee Retirement Benefits Board sets Plan 3 employee contribution rates. Six rate options are available ranging from 5 to 15 percent; two of the options are graduated rates dependent on the employee's age.

Water Quality's contribution rates expressed as a percentage of covered payrolls as of December 31, 2010 were as follows:

| | PERS | | |
|----------|--------------------------------------|--------------------------------------|--------------------------------------|
| | Plan I | Plan II | Plan III |
| | January 1 to December 31, 2010 | January 1 to December 31, 2010 | January 1 to December 31, 2010 |
| Employer | 5.31% | 5.31% | 5.31% |
| Employee | 6.00% | 3.90% | 5.00%-15.00% |

The employer rates include the employer administrative expense fee currently set at 0.16 percent. The employee rates for PERS Plan 3 may vary from 5 percent to 15 percent based on the rate selected by the PERS 3 member.

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

| | PERS | |
|------|--------|------------------|
| | Plan I | Plans II and III |
| 2010 | \$ 119 | \$ 3,107 |
| 2009 | \$ 157 | \$ 3,628 |
| 2008 | \$ 169 | \$ 3,824 |

Note 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 \$2.4 million and \$1.8 million for the years ended December 31, 2010 and 2009, respectively.

Note 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 - Law Enforcement Officers' and Fire Fighters' Retirement System Plan (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. Water Quality contributed an estimated \$82 thousand to the Health Plan during 2010 and \$80 thousand during 2009. The contribution was entirely to fund "pay-as-you-go" costs under the Health Plan and not to advance fund the cost of benefits.

Annual OPEB and Net OPEB Obligation - The basis of the County's annual OPEB cost (expense) is the ARC. The ARC represents a level of funding that, if paid on an ongoing basis, the actuary projects will cover normal costs each year and amortize any unfunded actuarial liabilities (or funding excess) over a period not to exceed thirty years.

KING COUNTY WATER QUALITY ENTERPRISE FUND
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2010 AND 2009

Note 11 - Other Post-Employment Benefits (Continued)

Water Quality's allocated annual OPEB costs, the percentage of annual OPEB cost contributed to the Health Plan, and the net OPEB obligation for the years ended December 31, 2010 and 2009 were as follows (in thousands):

| | 2010 | 2009 |
|--|--------|--------|
| Normal cost - Unit Credit Method | \$ 196 | \$ 193 |
| Amortization of unfunded actuarial accrued liability (UAAL) | 3 | 2 |
| Amortization of unfunded actuarial accrued liability (UAAL) at transition | 55 | 54 |
| Annual Required Contribution (ARC) | 254 | 249 |
| Interest on net OPEB obligation | 4 | 4 |
| Adjustment to annual required contribution | (6) | (6) |
| Annual OPEB cost (expense) | 252 | 247 |
| Contributions made | (82) | (80) |
| Increase in net OPEB obligation | 170 | 167 |
| Net OPEB obligation - beginning of year | 503 | 336 |
| Net OPEB obligation - end of year | \$ 673 | \$ 503 |

| Year Ended | Annual OPEB Cost | Percentage of Annual OPEB Cost Contributed | Net OPEB Obligation |
|------------|---------------------|--|------------------------|
| 12/31/2010 | \$ 252 | 32.5% | \$ 673 |
| 12/31/2009 | \$ 247 | 32.4% | \$ 503 |
| 12/31/2008 | \$ 208 | 2.9% | \$ 336 |

Required Supplementary Information:

Funded Status and Funding Progress - The funded status of the Health Plan as of December 31, 2010 and 2009 was as follows (in thousands):

| | 2010 | 2009 | 2008 |
|---|------------|------------|------------|
| Actuarial Value of Plan Assets | \$ - | \$ - | \$ - |
| Actuarial Accrued Liability (AAL) | 149,390 | 149,390 | 145,393 |
| Unfunded Actuarial Accrued Liability (UAAL) | \$ 149,390 | \$ 149,390 | \$ 145,393 |
| Funded Ratio (actuarial value assets / AAL) | 0% | 0% | 0% |
| Covered Payroll (active plan members) | \$ 969,082 | \$ 947,530 | \$ 890,310 |
| UAAL as a percentage of covered payroll | 15.4% | 15.8% | 16.3% |

Note 11 - Other Post-Employment Benefits (Continued)

Actuarial Methods and Assumptions - The basis of projections of benefits for financial reporting purposes is the substantive plan (the Health Plan as understood by the County and members of the Health Plan) and include the types of benefits provided at the time of each valuation and the historical pattern of sharing of benefit costs between the County and Members of the Health Plan members to that point. The actuarial methods and assumptions used include techniques that are designed to reduce the effects of short-term volatility in actuarial accrued liabilities and the actuarial value of assets, consistent with the long-term perspective of the calculations.

The December 31, 2009 valuation used the projected unit credit actuarial cost method. The actuarial assumptions 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 pharmacy, and 11.0 percent for HMO medical/pharmacy, each reduced by decrements to an ultimate rate of 5.2 percent after 71 years and 12 years for medical and pharmacy, respectively. 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 amortization of UAAL at transition uses a level dollar amount on a closed basis. The remaining amortization period at December 31, 2009 was 27 years. The UAAL is recalculated each year and amortized as a level dollar amount on an open basis over 30 years.

Note 12 - Interfund Borrowing and Transfers

At December 31, 2010, Water Quality had outstanding interfund short-term loans in the amount of \$96.3 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 that 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 2011.

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 2010 and 2009, the net cash transfers to other funds from Water Quality were \$632 thousand and \$140 thousand, respectively.

Note 13 - Net Assets Deficit

The deficits in unrestricted net assets of \$79.2 and \$88.0 million in 2010 and 2009, respectively, are the result of short-term borrowings by Water Quality from other County funds (see Note 12 - Interfund Borrowing and Transfers). Water Quality revenue bonds were issued in the subsequent fiscal years to cover the capital construction loans.

Note 14 - Commitments and Contingencies

Contingencies and Claims - There is no litigation or claim currently pending against the King County Water Quality Enterprise Fund in which, to our knowledge, the likelihood of an unfavorable outcome with material damages assessed against the enterprise is considered "probable."

The following litigation, or potential litigation, may involve claims for material damages against the King County Water Quality Enterprise Fund for which the Water Quality is unable to provide an opinion as to the ultimate outcome or the amount of damages that may be found:

- An administrative order from the EPA that requires 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. Final draft of report and public comments are being reviewed by the EPA. Due to the high level of regulatory review, the County is unable to determine the particular remediation alternative, the schedule and cost of any required remediation, or the extent of County responsibility.
- A potential requirement for more cleanup in the area contaminated when the Denny Way combined sewer outflow was replaced in 2005. The King County Wastewater Treatment Division (WTD) has already performed interim cleanup costing \$3.6 million to comply with a formal agreement with the Washington State Department of Ecology, who reserves its rights to require additional remediation.
- Potential claims for 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 only a one-third pro rata share of the study costs and that portion is still potentially allocable among the several potentially responsible parties. Further remediation costs cannot be reasonably estimated until the study is completed.
- At the end of 2010, there was a pending lawsuit filed by two sewer districts who allege that certain expenditures of the WTD constitute a breach of contract and a violation of the King County Charter and a local government accounting statute. During litigation, various claims were dismissed by the court by summary judgment. In March 2011, a ruling came down in favor of the County with one issue left unresolved. Although still in dispute, the remaining claim is expected to be approximately \$2 million. Plaintiffs had indicated their intention to appeal the court's rulings.
- A series of requests for change orders and claims for damages from the prime contractor for the Brightwater Treatment Plant central conveyance system alleging differing site conditions and defective specifications. The County is vigorously defending against the claims and has filed suit alleging contract default by the contractor for failure to complete the contract work within time limits. Contractor is asserting damages of approximately \$75 million. The County has updated its estimated damages amount to \$132 million.

Note 14 - Commitments and Contingencies (Continued)

- In March 2011, a contractor initiated a suit against the County related to its outstanding claim at the end of 2010 in the amount of \$3.7 million for the Juanita Bay Pump Station Replacement project alleging defective specifications. The County has issued counterclaims for defective work and breach of contract and is defending against all claims, pursuing damages, and negotiating insurance recoveries.
- A claim by a vendor for additional compensation of approximately \$427 thousand to cover unexpected tariff increases on imported construction materials. The dispute is still being handled through contract administration.

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 2010 and 2009 were approximately \$1.3 million for each year.

Note 15 - Subsequent Event

Water Quality issued \$175.0 million of sewer revenue bonds in January 2011. These bonds will be used to finance capital construction and improvements to the sewer system.

**KING COUNTY WATER QUALITY ENTERPRISE FUND
SUPPLEMENTAL INFORMATION
SUPPLEMENTAL SCHEDULE OF NET REVENUES AVAILABLE FOR DEBT SERVICE (UNAUDITED)
YEAR ENDED DECEMBER 31, 2010**

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 an 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) 1.40

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) 1.29

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) 1.22

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. In 2010, Water Quality issued Multi-Modal Limited Tax General Obligation Sewer Revenue Bonds, series 2010A and 2010B which incorporate the identical requirement as Junior Lien obligations.

Coverage (1.10 required by covenant) 39.50