



**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, 2011 and 2010**

**MOSS ADAMS<sub>LLP</sub>**

Certified Public Accountants | Business Consultants

*Acumen. Agility. Answers.*

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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, 2011 and 2010, 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 Water Quality as of December 31, 2011 and 2010, 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.

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 3 through 10 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Our audits were conducted for the purpose of forming an opinion on Water Quality's financial statements. The Supplemental Schedule of Net Revenues Available for Debt Service is presented for purposes of additional analysis and is not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The supplemental schedule has not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

*Moss Adams LLP*

Seattle, Washington  
May 15, 2012

**KING COUNTY WATER QUALITY ENTERPRISE FUND  
MANAGEMENT'S DISCUSSION AND ANALYSIS  
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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, 2011 and 2010.

**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, the Brightwater tertiary treatment plant located near Woodinville and two smaller secondary treatment plants at Vashon Island and Carnation, 353 miles of interceptors, 42 pump stations, 19 regulator stations and 38 combined sewer overflow (CSO) control locations. The sewer system collects and treats an average of 175 million gallons per day from approximately 1.5 million residents.

**FINANCIAL HIGHLIGHTS**

During 2011, Water Quality provided sewage treatment services to 707,278 residential customer equivalents (RCE) compared to 704,391 in 2010 and 703,795 in 2009. 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 6,900 new connections to its customer billing base in 2011. The program added 7,400 and 8,600 new connections in 2010 and 2009, respectively. The average flow of the four treatment plants was 173 million gallons per day (MGD) with a peak daily flow of 472 MGD. Maximum system capacity remained at 767 MGD in 2010 and increased to 897 MGD in 2011 with full implementation of the Brightwater Treatment Plant. The average daily flow fluctuated between a peak of 178 MGD in 2010 and a low of 169 MGD in 2009. The annual fluctuation in flows largely depends on the amount of annual precipitation.

In 2011, Water Quality distributed 119,026 wet tons of biosolids to end users engaged in forestry, agriculture and soil enhancement. About 307.6 million gallons of reclaimed water were used for landscape irrigation, industrial processes, and for heating and cooling. Water Quality sold 1.9 million therms of natural gas to Puget Sound Energy and produced 2.0 million kilowatt hours of electricity that was used on site at South Treatment Plant. Reclaimed water capacity will expand when the Brightwater Treatment Plant operates at full capacity in 2012.

The Industrial Pretreatment Program conducted 415 inspections and took 2099 compliance samples in 2011. The program currently tracks 306 facilities with discharge authorization permits and 122 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.

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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 CSO 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 \$274.2 million for 2011 and \$400.8 million for 2010.

Construction continued on the new Brightwater Treatment Plant located in southern Snohomish County and the associated conveyance system. The plant was placed in service on September 6, 2011 with initial flows conveyed to the West Point Treatment Plant or the South Treatment Plant for final treatment and discharge. An average of 8.1 MGD was treated in that manner during 2011. The \$147.7 million project expenditure in 2011 pushed life to date expenditures to \$1.9 billion. The Brightwater conveyance pipelines and outfall will be completed in July 2012. At that point the new treatment plant will enter full operation with a peak capacity of 130 MGD.

Water Quality operating revenues increased by 10.7 percent to \$337.4 million in 2011 from \$304.8 million in 2010. While operating expenses before depreciation increased by 1.0 percent to \$106.3 million in 2011 from \$105.2 million in 2010.

The monthly sewer rate increased to \$36.10 per RCE in 2011 from \$31.90 in 2010. The capacity charge rate increased to \$50.45 per RCE's in 2011 from \$49.07 in 2010. Capacity charge revenues increased 17.7 percent to \$48.7 million in 2011 from \$41.4 million in 2010. The RCE's billed for sewer treatment services increased to 707,278 in 2011 from 704,391 in 2010. The rate stabilization reserve increased to \$76.5 million in 2011 from \$51.0 million in 2010. This increase of \$25.5 million in the reserve balance decreases operating revenues for the year and has been excluded from the calculation of debt service coverage for 2011. 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 \$701.7 million in sewer revenue and refunding bonds in 2011 and \$100.0 million of variable rate junior lien bonds. Series 2011 was issued in January at an average coupon rate of 5.19 percent. Series 2011B was issued in August at an average coupon of 4.99 percent and refunded \$458.0 million of outstanding revenue bonds with \$424.0 million of new revenue bonds. The issue included \$70.0 million in new revenue bonds. Series 2011C was issued in October at an average coupon rate of 4.88 percent and refunded \$33.5 million of outstanding revenue bonds with \$32.5 million of new revenue bonds. Water Quality received \$1.2 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 \$60.0 million to \$40.0 million. In January 2010, Water Quality issued \$100.0 million in multimodal limited tax general obligation variable rate bonds and \$334.4 million in sewer revenue and refunding bonds in July 2010 at an average coupon rate of 4.92 percent.

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The results of operations for 2011 and 2010 produced a debt service coverage ratio on senior lien debt of 1.42 and 1.40, respectively, exceeding the coverage covenant requirement of 1.15 in both years. The total debt coverage ratio of 1.32 in 2011 and 1.29 in 2010 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 \$280.9 million provided 83.2 percent of operating revenues in 2011 and \$253.7 million provided 83.2 percent in 2010. Water Quality is a wholesale provider of sewage treatment services to thirty-four 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 2011 and 2010, 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  
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**FINANCIAL ANALYSIS OF THE STATEMENTS OF NET ASSETS**

Comparative data, stated in millions of dollars:

	Years Ended December 31,		
	2011	2010	2009
Current assets	\$ 281.6	\$ 258.7	\$ 227.9
Noncurrent assets	231.2	191.4	172.6
Capital assets	4,062.1	3,859.0	3,483.1
Other	109.0	98.3	111.3
<b>Total assets</b>	<b>4,683.9</b>	<b>4,407.4</b>	<b>3,994.9</b>
Current liabilities	307.8	386.2	362.4
Long term liabilities	3,788.0	3,458.8	3,088.7
<b>Total liabilities</b>	<b>4,095.8</b>	<b>3,845.0</b>	<b>3,451.1</b>
Net assets invested in capital assets	298.0	407.2	410.6
Net assets-restricted	297.3	234.4	221.2
Net assets-unrestricted	(7.2)	(79.2)	(88.0)
<b>Total net assets</b>	<b>\$ 588.1</b>	<b>\$ 562.4</b>	<b>\$ 543.8</b>

Net assets serve as a useful indicator of Water Quality's financial position. As of December 31, 2011 and 2010, assets exceeded liabilities by \$588.1 million and \$562.4 million, respectively.

Of the total assets of Water Quality, 86.7 percent or \$4,062.1 million were invested in capital assets such as treatment plants, pumping and regulator stations, interceptors, and other equipment at year-end 2011. For the year-end 2010, 87.6 percent or \$3,859.0 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 4.6 percent or \$25.7 million in 2011 to \$588.1 million from \$562.4 million in 2010. 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 26.8 percent or \$62.9 million in 2011 to \$297.3 million from \$234.4 million in 2010. The unrestricted net deficit decreased by \$72.0 million in 2011 to \$(7.2) million from \$(79.2) million in 2010.

Net assets increased by 3.4 percent or \$18.6 million in 2010 from \$543.8 million in 2009. Restricted assets increased by 6.0 percent or \$13.2 million in 2010 from \$221.2 million in 2009. The unrestricted net deficit decreased by 10.0 percent or \$8.8 million in 2010 from \$(88.0) million in 2009.

Water Quality reported its investment in capital assets, net of debt related to capital asset acquisition, as \$298.0 million and \$407.2 million at December 31, 2011 and 2010, respectively.

**KING COUNTY WATER QUALITY ENTERPRISE FUND  
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**FINANCIAL ANALYSIS OF THE STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS**

Comparative data, stated in millions of dollars:

	Years Ended December 31,		
	2011	2010	2009
Sewage treatment fees	\$ 306.4	\$ 269.6	\$ 271.6
Rate stabilization	(25.5)	(15.9)	(15.4)
Capacity charge revenue	48.7	41.4	40.7
Other revenue	7.8	9.7	10.0
Operating revenues	337.4	304.8	306.9
Operating expenses	214.7	197.8	196.3
Operating income	122.7	107.0	110.6
Non operating (expenses)	(104.3)	(90.8)	(87.7)
Grant revenues	7.3	2.4	1.8
Change in net assets	25.7	18.6	24.7
Net assets beginning of year	562.4	543.8	519.1
Net assets end of year	<u>\$ 588.1</u>	<u>\$ 562.4</u>	<u>\$ 543.8</u>

While the statements of net assets show changes in assets, liabilities and net assets, the statements of revenues, expenses and changes in net assets provide insight into the source of these changes.

During 2011, operating revenues increased by 10.7 percent or \$32.6 million to \$337.4 million from \$304.8 million in 2010. Operating expenses increased by 8.5 percent or \$16.9 million to \$214.7 million in 2011 from \$197.8 million in 2010.

In 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 from \$196.3 million in 2009.

The operating expenses and revenues were driven by:

- Chemicals expenses increased by 3.6 percent or about \$171 thousand in 2011 to \$5.0 million primarily due to price increases in polymers, caustic soda, sodium hypochlorite and carbon. Chemicals expenses decreased by 11.5 percent or \$627 thousand to \$4.8 million in 2010 from \$5.4 million in 2009.
- Electricity expenses increased by 1.0 percent or \$102 thousand in 2011 to \$10.7 million after increasing 7.9 percent or \$777 thousand to \$10.6 million in 2010 from \$9.9 million in 2009.
- Services expenses increased by 3.5 percent or \$923 thousand to \$27.2 million for 2011 from \$26.3 million in 2010. Services expenses decreased by 1.9 percent or \$498 thousand from \$26.8 million in 2009.

**KING COUNTY WATER QUALITY ENTERPRISE FUND  
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- Intergovernmental expenses decreased by 7.3 percent or \$1.9 million in 2011 to \$24.4 million from \$26.3 million in 2010. Expenses from Water and Land Resources were reduced by 18.2 percent or \$2.1 million in 2011 and by 5.7 percent or \$708.6 thousand in 2010 due to cost containment efforts. Financial management support services decreased by 4.8 percent or \$85 thousand in 2011 and by 10.7 percent or \$210 thousand in 2010. General Fund transfers decreased by 2.6 percent or \$53 thousand in 2011 and by 12.8 percent or \$296.2 thousand in 2010 due to countywide budget reductions and cost containment. Intergovernmental expenses decreased by 3.1 percent or \$.08 million in 2010 from \$27.2 million in 2009.
- Water Quality collected a monthly sewage treatment charge of \$36.10 per RCE in 2011, and \$31.90 in 2010 and 2009. Total sewer disposal revenues before rate stabilization increased by 13.7 percent or \$37.0 million to \$306.4 million in 2011 from \$269.6 million in 2010. It decreased by 0.7 percent or \$2.0 million in 2010 from \$271.6 in 2009.
- Other operating revenues, including capacity charges for new customers and other treatment charges, increased by 10.6 percent or \$5.4 million in 2011 to \$56.5 million from \$51.1 million in 2010. In 2010, these revenues increased by 0.8 percent or \$.4 million from \$50.7 million in 2009. Capacity charge early payoff revenues were 24.3 percent or \$11.8 million of total capacity charge revenues in 2011, while in 2010, capacity charge early payoff revenues were 18.5 percent or \$7.7 million of the annual total. Actual new capacity charge connections were 6,900 in 2011 and 7,600 in 2010.
- Net nonoperating revenues and expenses decreased by 14.9 percent or \$13.5 million to \$(104.3) million in 2011 from \$(90.8) million in 2010. Net nonoperating revenues and expenses decreased by 3.5 percent or \$(3.1) million from \$(87.7) million in 2009.
- Capital grant revenues received from federal and state agencies increased by \$4.9 million to \$7.3 million in 2011 from \$2.4 million in 2010. Capital grant revenues increased by \$758 thousand from \$1.8 million in 2009. This was primarily due to the waste to energy grant for co-generation at the West Point Treatment plant. Low interest loans have largely replaced grants as the primary method of state agency support in recent years.

#### **CAPITAL ASSETS**

At December 31, 2011, Water Quality's investment in capital assets, net of accumulated depreciation, was \$4.1 billion as compared to \$3.9 billion in 2010. These represent increases of 5.3 percent or \$203.1 million in 2011 and 10.8 percent or \$375.9 million in 2010. The changes are a result of the Brightwater Treatment Plant and Conveyance project, 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.

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

Large 2011 construction project expenditures include:

- \$5.3 million for the Ballard Siphon;
- \$5.6 million for the South Treatment Plant Control System;
- \$11.5 million for the Interbay Pumping Station;
- \$12.5 million for West Point Treatment Plant Waste to Energy;
- \$174.7 million spent toward the Brightwater Treatment Plant and conveyance.

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.

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

### **DEBT ADMINISTRATION**

Water Quality issued \$175 million of revenue bonds in January 2011 with an average life of 19.5 years at an average rate of 5.19 percent and an effective rate of 4.90 percent, \$494.3 million of revenue and refunding bonds in August with an average life of 12.8 years at an average rate of 4.99 percent and effective rate of 3.79 percent, and \$32.4 million of revenue refunding bonds in October 2011 with an average life of 20 years at an average rate of 4.88 percent and an effective rate of 4.24 percent. In October 2011, Water Quality issued \$100 million in variable rate revenue bonds.

Water Quality issued \$100 million of multi-modal limited tax general obligations 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 received \$1.2 million in low-interest loans from the state of Washington in 2011 and \$2.5 million in 2010. The loans carry below-market rates between 0.5 percent and 3.1 percent with repayment terms up to 20 years.

Water Quality has \$2.7 billion of sewer revenue bonds and variable rate revenue bonds outstanding at the end of 2011 and \$2.4 billion outstanding at the end of 2010. 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.

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At the end of 2011, Water Quality has \$828 million of general obligation bonds and variable rate general obligation bonds outstanding and \$830.5 million of general obligation bonds and variable rate general obligation bonds outstanding at the end of 2010. 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 issued 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 2011 and 2010, Water Quality's bond ratings were:

<b>Moody's Investor's Service</b>	<b>Standard &amp; Poor's</b>
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, 2011, the cash balance in the reserve account was \$144.7 million and \$130.5 million at the end of 2010. In addition to bond covenant reserves, Water Quality also maintains financial policy reserves. At December 31, 2011 and 2010, respectively, the rate stabilization, liquidity, and asset management financial policy reserves totaled \$107.5 million and \$81.4 million.

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

**DEBT SERVICE COVERAGE RATIOS**

	<u>FY 2011</u>	<u>FY 2010</u>
Parity Debt	1.42	1.40
Total Debt	1.32	1.29

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, 2011 and 2010. 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, 2011 AND 2010**  
**(in thousands)**

	<b>ASSETS</b>	
	2011	2010
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$ 4,052	\$ 24,018
Restricted cash and cash equivalents	234,673	185,942
Accounts receivable, net	33,274	27,529
Inventory of supplies	6,332	5,758
Due from other funds	3,175	5,845
Due from other governments	-	9,550
Prepayments	77	77
	281,583	258,719
<b>NONCURRENT ASSETS</b>		
Revenue fund		
Cash and cash equivalents	76,523	59,275
Accounts receivable, net	325	354
Construction fund—cash and cash equivalents	1,167	1,219
Bond fund—cash and cash equivalents	153,204	130,542
	231,219	191,390
Capital assets		
Building and land improvements	1,819,716	1,219,155
Infrastructure and right of way	1,314,211	1,064,898
Plant in service and other equipment	925,097	661,130
Less accumulated depreciation	(1,299,758)	(1,230,078)
	2,759,266	1,715,105
Land and easements	229,930	151,427
Construction work in progress	1,072,858	1,992,454
	4,062,054	3,858,986
Other noncurrent		
Regulatory assets - environmental remediation	48,536	47,079
Other utility assets, net of amortization	28,634	22,703
Deferred environmental remediation costs	4,912	5,150
Other deferred charges	26,966	23,375
	109,048	98,307
<b>TOTAL ASSETS</b>	<b>\$ 4,683,904</b>	<b>\$ 4,407,402</b>

**KING COUNTY WATER QUALITY ENTERPRISE FUND**  
**STATEMENTS OF NET ASSETS (CONTINUED)**  
**DECEMBER 31, 2011 AND 2010**  
**(in thousands)**

**LIABILITIES AND NET ASSETS**

	2011	2010
<b>CURRENT LIABILITIES</b>		
Accounts payable	\$ 33,043	\$ 57,626
Interest payable	74,399	76,146
Wages and benefits payable	3,643	3,690
Compensated absences	405	393
Environmental remediation costs	5,104	5,599
Notes payable	100,000	100,000
State loans payable	8,599	7,896
Due to other funds	1,347	2,068
Interfund loans payable	39,583	96,313
General obligation bonds payable	2,730	2,630
Revenue bonds payable	39,005	33,860
	307,858	386,221
<b>NONCURRENT LIABILITIES</b>		
Retainage payable	18	1,340
Compensated absences	10,799	10,681
Other post-employment benefits	856	673
General obligation bonds payable	825,155	827,885
Revenue bonds payable	2,670,710	2,399,490
Deferred bond premium, discount, and refunding losses	50,954	7,462
Rate stabilization	76,500	51,000
Environmental remediation costs	32,318	32,157
State loans payable	120,677	128,099
	3,787,987	3,458,787
Total liabilities	4,095,845	3,845,008
<b>NET ASSETS</b>		
Invested in capital assets—net of related debt	298,014	407,161
Restricted for		
Debt service	265,305	204,126
Regulatory assets and environmental liabilities	32,017	30,302
Unrestricted	(7,277)	(79,195)
	588,059	562,394
Total net assets	588,059	562,394
<b>TOTAL</b>	<b>\$ 4,683,904</b>	<b>\$ 4,407,402</b>

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**KING COUNTY WATER QUALITY ENTERPRISE FUND**  
**STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS**  
**YEARS ENDED DECEMBER 31, 2011 AND 2010**  
**(in thousands)**

	<u>2011</u>	<u>2010</u>
<b>OPERATING REVENUES</b>		
Sewage disposal fees	\$ 280,907	\$ 253,684
Other operating revenues	<u>56,523</u>	<u>51,141</u>
Total operating revenues	<u>337,430</u>	<u>304,825</u>
 <b>OPERATING EXPENSES</b>		
Sewage treatment, disposal, and transmission	77,019	74,194
General and administrative	26,976	29,488
Environmental related amortization	2,376	1,535
Depreciation and amortization	<u>108,384</u>	<u>92,627</u>
Total operating expenses	<u>214,755</u>	<u>197,844</u>
 <b>OPERATING INCOME</b>	 <u>122,675</u>	 <u>106,981</u>
 <b>NONOPERATING REVENUES (EXPENSES)</b>		
Investment earnings	2,824	3,220
Interest	(103,807)	(81,099)
Amortization of debt related accounts	(144)	(2,937)
Loss on disposal and impairment of capital assets	(3,900)	(10,171)
Other	<u>706</u>	<u>196</u>
Total nonoperating expenses	<u>(104,321)</u>	<u>(90,791)</u>
 <b>INCOME BEFORE GRANTS AND CONTRIBUTIONS</b>	 18,354	 16,190
 <b>CAPITAL GRANT REVENUES</b>	 <u>7,311</u>	 <u>2,431</u>
 <b>CHANGE IN NET ASSETS</b>	 25,665	 18,621
 <b>NET ASSETS</b>		
Beginning of year	<u>562,394</u>	<u>543,773</u>
End of year	<u>\$ 588,059</u>	<u>\$ 562,394</u>

**KING COUNTY WATER QUALITY ENTERPRISE FUND**  
**STATEMENTS OF CASH FLOWS**  
**YEARS ENDED DECEMBER 31, 2011 AND 2010**  
**(in thousands)**

	<u>2011</u>	<u>2010</u>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Cash received from customers	\$ 369,436	\$ 308,538
Cash payments to suppliers for goods and services	(89,356)	(77,713)
Cash payments for employee services	<u>(41,573)</u>	<u>(40,110)</u>
Net cash provided by operating activities	<u>238,507</u>	<u>190,715</u>
 <b>CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES</b>		
Transfers out	(11)	(632)
Interfund loan principal received	39,583	96,313
Interfund loan principal paid	(96,313)	(82,633)
Interest paid on short-term loans	<u>(1,581)</u>	<u>(762)</u>
Net cash (used in) provided by noncapital financing activities	<u>(58,322)</u>	<u>12,286</u>
 <b>CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES</b>		
Acquisition of capital and other utility assets	(270,797)	(405,535)
Recoveries on (financing of) environmental remediation	(3,930)	3,719
Principal paid on general obligation bonds	(2,630)	(2,530)
Interest paid on general obligation bonds	(37,721)	(35,764)
Proceeds of new bond issuance	801,715	434,365
Principal paid on bonds for advance refunding	(491,490)	(36,290)
Principal paid on revenue bonds	(33,860)	(32,090)
Interest paid on revenue bonds	(74,342)	(91,173)
Interest paid on notes payable	(485)	(475)
Principal paid on state loans	(7,896)	(7,715)
Proceeds of state loans	1,177	2,544
Interest paid on state loans	(2,144)	(2,162)
Capital grants received	7,311	2,431
Other receipts	706	1,630
Net cash used in capital and related financing activities	<u>(114,386)</u>	<u>(169,045)</u>
 <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Interest and realized gains	<u>2,824</u>	<u>3,220</u>
 <b>NET INCREASE IN CASH AND CASH EQUIVALENTS</b>	 68,623	 37,176
 <b>CASH AND CASH EQUIVALENTS</b>		
Beginning of year	<u>400,996</u>	<u>363,820</u>
End of year	<u><u>\$ 469,619</u></u>	<u><u>\$ 400,996</u></u>

**KING COUNTY WATER QUALITY ENTERPRISE FUND**  
**STATEMENTS OF CASH FLOWS (CONTINUED)**  
**YEARS ENDED DECEMBER 31, 2011 AND 2010**  
**(in thousands)**

	<u>2011</u>	<u>2010</u>
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES		
Operating income	<u>\$ 122,675</u>	<u>\$ 106,981</u>
Adjustments to reconcile operating income to net cash provided by operating activities		
Depreciation and amortization	110,760	94,162
Changes in assets		
Accounts receivable	(5,714)	(1,860)
Due from other funds	2,670	(727)
Due from other governments	9,550	(9,550)
Inventory of supplies	(574)	(374)
Prepayments	-	75
Changes in liabilities		
Accounts payable	(24,583)	521
Due to other funds	(721)	(1,434)
Retainage payable	(1,322)	(14,416)
Rate stabilization	25,500	15,850
Wages and benefits payable	(47)	536
Compensated absences	130	781
Other post-employment benefits	183	170
Total adjustments	<u>115,832</u>	<u>83,734</u>
NET CASH PROVIDED BY OPERATING ACTIVITIES	<u>\$ 238,507</u>	<u>\$ 190,715</u>
SUPPLEMENTAL DISCLOSURE OF NONCASH CAPITAL AND RELATED FINANCING ACTIVITIES		
Contribution of capital assets from government	<u>\$ 1,066</u>	<u>\$ 1,239</u>

**KING COUNTY WATER QUALITY ENTERPRISE FUND**  
**NOTES TO FINANCIAL STATEMENTS**  
**DECEMBER 31, 2011 AND 2010**

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**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), represent approximately 40 percent of total sewage disposal fees in 2011 and in 2010.

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 \$24.4 million and \$26.3 million in 2011 and 2010, 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.
- 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.

**KING COUNTY WATER QUALITY ENTERPRISE FUND**  
**NOTES TO FINANCIAL STATEMENTS**  
**DECEMBER 31, 2011 AND 2010**

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**Note 1 - Operations and Accounting Policies (Continued)**

- 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 \$159.6 million and \$150.5 million during the years ended December 31, 2011 and 2010, respectively, of which \$55.8 million and \$69.4 million, respectively, was capitalized.

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

Water Quality annually reviews long-lived assets for impairment to determine whether any events or circumstances indicate the carrying value of the assets may not be recoverable.

**KING COUNTY WATER QUALITY ENTERPRISE FUND**  
**NOTES TO FINANCIAL STATEMENTS**  
**DECEMBER 31, 2011 AND 2010**

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**Note 1 - Operations and Accounting Policies (Continued)**

- 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.
- 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 \$7.3 million and \$2.4 million for the years ended December 31, 2011 and 2010, respectively.

**KING COUNTY WATER QUALITY ENTERPRISE FUND**  
**NOTES TO FINANCIAL STATEMENTS**  
**DECEMBER 31, 2011 AND 2010**

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**Note 1 - Operations and Accounting Policies (Continued)**

- 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 had 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. This statement did not have an impact on Water Quality’s financial statements.

GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncement*, was issued in December 2010, which incorporates into the GASB’s authoritative literature certain accounting and financial reporting guidance included in the FASB and American Institute of Certified Public Accountants (AICPA) pronouncements. This statement also supersedes Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*. The statement is effective for reporting periods beginning after December 15, 2011. It will have no impact on Water Quality’s financial statements.

In June 2011, GASB issued Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*, which provides financial reporting guidance for deferred outflows and inflows of resources. The statement amends the net asset reporting requirements in Statement No. 34, *Basic Financial Statements and Management’s Discussion and Analysis for State and Local Governments*. This statement is effective for reporting periods beginning after December 15, 2011. 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, 2011 AND 2010**

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**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 administered by the King County Treasury Operations Section and is not registered with the Securities and Exchange Commission (SEC) as an investment company. Oversight is provided by the King County Executive Finance Committee (EFC) pursuant to RCW 36.29.020. The EFC consists of the Chair of the County Council, the County Executive, the Director of Office of Performance, Strategy and Budget, and the Director of the Finance and Business Operations Division, or their designees. All investments are subject to written policies 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 insured by the Federal Depository Insurance Corporation (FDIC) are collateralized by the Public Deposit Protection Commission of the State of Washington (PDPC), a statutory authority established under chapter 39.58 RCW. It constitutes a multiple financial institution collateral pool that can make pro rata assessments to all public depositories within the state for their public deposits. PDPC protection is of the nature of collateral, not of insurance, in accordance with GASB Codification of Governmental Accounting and Financial Reporting Standards, Section 150.110. 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 \$469.6 million and \$401.0 million were fully insured and collateralized as of December 31, 2011 and 2010, respectively.

**Credit Risk - Investments:** Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligation. As of December 31, 2011, the Pool was not rated by a Nationally Recognized Statistical Rating Organization (NRSRO). In compliance with state statutes, Pool policies authorize investments in U.S. Treasury securities, U.S. agency securities and mortgage-backed securities, municipal securities (rated at least "A" by two NRSROs), commercial paper (rated at least the equivalent of "A-1" by two NRSROs), certificates of deposit issued by qualified public depositories, repurchase agreements, and the Local Government Investment Pool managed by the Washington State Treasurer's office. The Pool's policies limit the maximum amount that can be invested in various securities. At 2011 and 2010 year-end the Pool was in compliance. The Pool's actual composition, as of December 31, 2011, consisted of U.S. Treasury Notes, 20.7 percent; U.S. Agency Notes, 61.8 percent; U.S. Agency Mortgage Backed, 0.5 percent; and the State Treasurer's Investment Pool, 17.0 percent. The December 31, 2010 composition of the Pool comprised repurchase agreements, 7.4 percent; US Treasury Bills, 20.4 percent; US Treasury Notes, 23.0 percent; U.S. Agency Securities, 37.7 percent; U.S. Agency Mortgage Backed Securities, 0.7 percent; the State Treasurer's Investment Pool, 10.5 percent; and Municipal Notes, 0.3 percent.

**Note 2 - Deposits and Investments (Continued)**

**Custodial Credit Risk - Investments:** Custodial credit risk is the risk that in the event of the failure of the counterparty, the County will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party. County policy mandates that all security transactions, including repurchase agreements, are settled “delivery versus payment.” This means that payment is made simultaneously with the receipt of the security. These securities are delivered to the County’s safekeeping bank or its tri-party custodian banks.

**Concentration of Credit Risk - Investments:** Concentration of credit risk is the risk of loss attributed to the magnitude of a government’s investment in a single issue. At 2011 year-end the Pool had concentrations greater than 5 percent of the total investment pool portfolio in the following issues: Federal Home Loan Mortgage Corporation-15 percent, Federal National Mortgage Association-24 percent, Federal Home Loan Bank-15 percent, and Federal Farm Credit Bank-8 percent. The issues with concentrations greater than 5 percent of the pool portfolio at 2010 year-end were as follows: Federal Home Loan Mortgage Corporation-6 percent, Federal National Mortgage Association-21 percent, Federal Home Loan Bank-6 percent, and Federal Farm Credit Bank-6 percent.

**Interest Rate Risk - Investments:** Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. Through its investment policy, the County manages its exposure to fair value losses arising from increasing interest rates by setting maturity and effective duration limits for the Pool. The policy limit for the Pool’s maximum effective duration is 1.5 years, and 40 percent of the Pool’s total value in securities must have a maturity of 12 months or fewer. Securities in the portfolio cannot have an average life greater than five years at purchase. The combined effective duration of the liquidity and core portfolios was 0.724 years and 0.711 years, respectively, at December 31, 2011 and 2010.

As of December 31, 2011, the Pool has four impaired commercial paper investments which have completed enforcement events. 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 \$926 thousand at December 31, 2011 and \$1.5 million at December 31, 2010. Losses from impaired investments are offset against other investment earnings.

**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 \$465.9 million in 2011 and \$377.3 million in 2010 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 \$234.7 million in 2011 and \$185.9 million in 2010. The non-current restricted assets consist primarily of cash reserved to fund construction, \$1.2 million in 2011 and \$1.2 million in 2010, and bond reserves of \$144.7 million in 2011 and \$130.5 million in 2010.

**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 2011 and 2010, Water Quality claims paid by the Insurance Fund of King County were \$33 thousand and \$217 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, 2011, bonds outstanding include \$1,189.1 million of serial bonds maturing from January 1, 2012 through 2034, bearing interest at stated rates of 1.00 percent to 5.50 percent per annum, and \$1,520.6 million of term bonds maturing on January 1 in the years 2034 through 2050, bearing interest at stated rates of 3.00 percent to 5.75 percent per annum.

In 2011, Water Quality issued \$701.7 million of Sewer Revenue and Refunding Bonds maturing from January 1, 2012 to 2041. The new bond issues include \$470.6 million of serial bonds maturing from January 1, 2012 through 2032, bearing interest at stated rates between 1.00 percent and 5.25 percent, and \$231.1 million of term bonds, maturing in the years 2022 through 2041, bearing interest at stated rates between 3.00 percent and 5.00 percent. These issues resulted in an advance refunding of \$175.9 million of the 2001 Sewer Revenue Refunding Bonds; \$95.0 million of the 2002A Sewer Revenue Bonds; \$177.6 million of the 2002B Sewer Revenue Refunding Bonds; and \$43.0 million of the 2004A Sewer Revenue Bonds.

**KING COUNTY WATER QUALITY ENTERPRISE FUND**  
**NOTES TO FINANCIAL STATEMENTS**  
**DECEMBER 31, 2011 AND 2010**

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

The economic gain resulting from the refunding transactions was \$54.7 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 \$73.6 million.

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.

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, 2011, Water Quality restricted cash balances in the amount of \$94.5 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 \$193.6 million and \$233.4 million, respectively.

Additional amounts of \$144.7 million and \$130.5 million held in the bond fund as bond reserves, as of December 31, 2011 and 2010, 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 2011 and 2011B, by depositing \$12.9 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, 2011, 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, 2011 AND 2010**

**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, 2011</u>
2001A-B Jr Lien Variable	1/1/32	(variable)	\$ 100,000	\$ 100,000
2001 Refunding	1/1/35	5.00-5.25%	270,060	3,915
2002B Refunding	1/1/33	4.00-5.50%	346,130	25,185
2003A Refunding	1/1/35	3.00-5.50%	96,470	90,155
2004A	1/1/35	4.50-4.75%	185,000	141,975
2004B Refunding	1/1/35	3.00-5.00%	61,760	55,080
2006 Refunding	1/1/36	5.00%	124,070	124,070
2006 (2nd Series) Refunding	1/1/36	3.50-5.00%	193,435	183,405
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	334,215
2011	1/1/41	5.00-5.25%	175,000	175,000
2011 Series B	1/1/41	1.00-5.25%	494,270	494,270
2011 Series C	1/1/35	3.00-5.00%	32,445	32,445
2011 Sewer Jr Lien Variable	1/1/42	(variable)	100,000	100,000
			<u>\$ 3,363,005</u>	<u>\$ 2,709,715</u>

**General Obligation Bonds** - As of December 31, 2011, bonds outstanding include \$533.1 million of serial bonds maturing January 1, 2012 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.

**KING COUNTY WATER QUALITY ENTERPRISE FUND**  
**NOTES TO FINANCIAL STATEMENTS**  
**DECEMBER 31, 2011 AND 2010**

**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, 2011
2005 LTGO	1/1/35	4.50-5.00%	\$ 200,000	\$ 200,000
2008 LTGO	1/1/34	3.25-5.25%	236,950	227,885
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>\$ 827,885</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 2012 through 2033 and bear interest at stated rates from 0.00 percent to 3.10 percent. As of December 31, 2011, the balance due on all state loans is \$129.3 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, 2011, 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 Notes		State Loans		Total
	Principal	Interest	Principal	Interest	Principal	Interest	Principal	Interest	
January 1, 2012	\$ 39,005	\$ 116,958	\$ 2,730	\$ 36,284	\$ -	\$ 15,757	\$ 8,599	\$ 2,009	\$ 221,342
January 1, 2013	39,290	123,210	2,795	36,195	-	17,897	8,766	1,883	230,036
January 1, 2014	47,320	121,562	8,750	36,104	-	17,871	8,906	1,755	242,268
January 1, 2015	49,485	119,335	9,000	35,667	-	17,871	9,050	1,623	242,031
January 1, 2016—2020	51,845	116,957	9,420	35,217	-	17,877	9,177	1,489	241,982
January 1, 2017—2021	232,510	550,723	117,775	162,746	100,000	68,699	46,126	5,368	1,283,947
January 1, 2022—2026	298,110	487,626	149,800	130,077	-	63,518	31,209	2,137	1,162,477
January 1, 2027—2031	381,525	405,822	190,225	88,788	-	63,524	7,340	318	1,137,542
January 1, 2032—2036	461,370	301,163	179,540	38,920	100,000	42,824	103	3	1,123,923
January 1, 2037—2041	438,740	191,489	57,880	6,184	100,000	32,474	-	-	826,767
January 1, 2042—2046	323,275	85,695	-	-	100,000	2,546	-	-	511,516
January 1, 2047—2051	147,240	14,111	-	-	-	-	-	-	161,351
	<u>\$ 2,509,715</u>	<u>\$ 2,634,651</u>	<u>\$ 727,915</u>	<u>\$ 606,182</u>	<u>\$ 400,000</u>	<u>\$ 360,858</u>	<u>\$ 129,276</u>	<u>\$ 16,585</u>	<u>\$ 7,385,182</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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**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, 2011, \$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, 2011 and 2010 was as follows (in thousands):

	Balance January 1, 2011	Additions	Reductions	Balance December 31, 2011
Commercial paper	<u>\$ 100,000</u>	<u>\$ 909,110</u>	<u>\$ (909,110)</u>	<u>\$ 100,000</u>
	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>

**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. The variable rate bonds, 2011 Sewer Jr Lien VRDM bonds, do not have a liquidity facility.

**Financial Policy Reserves** - In addition to bond reserves related to Sewer Revenue Bonds, Water Quality maintains liquidity and asset management reserves totaling \$31.1 million at December 31, 2011.

**Compliance with Bond Resolutions** - With respect to the year ended December 31, 2011, Water Quality complied with all financial covenants stipulated by its bond resolutions.

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

**Changes in Long-Term Liabilities** - Long-term liability activity for the years ended December 31, 2011 and 2010 was as follows (in thousands):

	Balance January 1, 2011	Additions	Reductions	Balance December 31, 2011	Due Within One Year
Bonds payable	\$ 3,263,865	\$ 801,715	\$ (527,980)	\$ 3,537,600	\$ 41,735
Bond premiums and discounts	64,634	65,087	(7,356)	122,365	-
Refunding losses	(57,172)	(18,546)	4,307	(71,411)	-
Total bonds payable	3,271,327	848,256	(531,029)	3,588,554	41,735
Retainage payable	19,446	89	(18,368)	1,167	1,149
State loans	135,995	1,177	(7,896)	129,276	8,599
Compensated absences	11,074	690	(560)	11,204	405
Other post-employment benefits	673	245	(62)	856	-
Environmental remediation	37,756	3,595	(3,929)	37,422	5,104
Rate stabilization	51,000	25,500	-	76,500	-
Total long-term liabilities	<u>\$ 3,527,271</u>	<u>\$ 879,552</u>	<u>\$ (561,844)</u>	<u>\$ 3,844,979</u>	<u>\$ 56,992</u>

The current portion of retainage payable in the amount of \$1.1 million and \$18.1 million for 2011 and 2010, respectively, is classified in Accounts Payable.

	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	-
Refunding losses	(59,793)	(2,635)	5,256	(57,172)	-
Total bonds payable	2,887,113	453,577	(69,363)	3,271,327	36,490
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	35,150	15,850	-	51,000	-
Total long-term liabilities	<u>\$ 3,140,059</u>	<u>\$ 477,878</u>	<u>\$ (90,666)</u>	<u>\$ 3,527,271</u>	<u>\$ 68,484</u>

**KING COUNTY WATER QUALITY ENTERPRISE FUND**  
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**Note 6 - Changes in Capital Assets**

Changes in capital assets for the years ended December 31, 2011 and 2010 are shown in the following table (in thousands):

	Balance January 1, 2011	Increases	Decreases	Balance December 31, 2011
Land	\$ 129,952	\$ 88,509	\$ -	\$ 218,461
Easements	21,475	27	(10,033)	11,469
Construction work in progress	1,992,454	273,735	(1,193,331)	1,072,858
Total nondepreciable assets	<u>2,143,881</u>	<u>362,271</u>	<u>(1,203,364)</u>	<u>1,302,788</u>
Buildings	1,194,468	584,253	(17,865)	1,760,856
Land improvements	24,687	34,173	-	58,860
Right of way	-	7,635	-	7,635
Infrastructure	1,064,898	242,092	(414)	1,306,576
Major equipment and vehicles	9,936	1	(33)	9,904
Shop and other equipment	638,712	271,169	(27,356)	882,525
Software development	12,482	20,186	-	32,668
Total depreciable assets	<u>2,945,183</u>	<u>1,159,509</u>	<u>(45,668)</u>	<u>4,059,024</u>
Accumulated depreciation and amortization:				
Building	(439,406)	(32,021)	6,919	(464,508)
Land improvements	(14,947)	(1,121)	-	(16,068)
Right of way	-	(55)	-	(55)
Infrastructure	(336,624)	(26,927)	2,795	(360,756)
Major equipment and vehicles	(7,872)	(231)	28	(8,075)
Shop and other equipment	(418,900)	(46,130)	32,602	(432,428)
Software development	(12,329)	(5,551)	12	(17,868)
Total depreciation and amortization	<u>(1,230,078)</u>	<u>(112,036)</u>	<u>42,356</u>	<u>(1,299,758)</u>
Depreciable assets - net	<u>1,715,105</u>	<u>1,047,473</u>	<u>(3,312)</u>	<u>2,759,266</u>
Total capital assets - net	<u>\$ 3,858,986</u>	<u>\$ 1,409,744</u>	<u>\$ (1,206,676)</u>	<u>\$ 4,062,054</u>

**KING COUNTY WATER QUALITY ENTERPRISE FUND**  
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**Note 6 - Changes in Capital Assets (Continued)**

	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>
Building	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>

In 2010, 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 2011 and 2010 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 2012 to 2016. The total environmental remediation liability at December 31, 2011 stands at \$37.4 million and \$37.8 million in 2010.

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 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 \$51.0 million in 2010 and increased by \$25.5 million to \$76.5 million in 2011.

**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 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](http://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; or 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.

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**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 6.0 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, 2011 were as follows:

	PERS Plan 1	PERS Plan 2	PERS Plan 3
Employer	7.25%	7.25%	7.25%
Employee	6.00%	4.64%	5.00%-15.00%

The employer rates include the employer administrative expense fee currently set at 0.16 percent. PERS Plan 3 is the defined benefit portion only. 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
2011	\$ 244	\$ 6,495
2010	\$ 119	\$ 3,107
2009	\$ 157	\$ 3,628

**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 \$7.3 million and \$2.4 million for the years ended December 31, 2011 and 2010, 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 \$62 thousand to the Health Plan during 2011 and \$82 thousand during 2010. 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.

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**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, 2011 and 2010 were as follows (in thousands):

	<u>2011</u>	<u>2010</u>
Normal cost - Unit Credit Method	\$ 215	\$ 196
Amortization of unfunded actuarial accrued liability (UAAL)	33	3
Amortization of unfunded actuarial accrued liability (UAAL) at transition	-	55
Annual Required Contribution (ARC)	<u>248</u>	<u>254</u>
Interest on net OPEB obligation	3	4
Adjustment to annual required contribution	<u>(6)</u>	<u>(6)</u>
Annual OPEB cost (expense)	245	252
Contributions made	<u>(62)</u>	<u>(82)</u>
Increase in net OPEB obligation	183	170
Net OPEB obligation - beginning of year	<u>673</u>	<u>503</u>
Net OPEB obligation - end of year	<u>\$ 856</u>	<u>\$ 673</u>

<u>Year Ended</u>	<u>Annual OPEB Cost</u>	<u>Percentage of Annual OPEB Cost Contributed</u>	<u>Net OPEB Obligation</u>
12/31/2011	\$ 245	25.3%	\$ 856
12/31/2010	\$ 252	32.5%	\$ 673
12/31/2009	\$ 247	32.4%	\$ 503

**Required Supplementary Information: Funded Status and Funding Progress** - The funded status of the Health Plan as of December 31, 2011 and 2010 was as follows (in thousands):

	<u>2011</u>	<u>2010</u>	<u>2009</u>
Actuarial Value of Plan Assets	\$ -	\$ -	\$ -
Actuarial Accrued Liability (AAL)	<u>178,502</u>	<u>149,390</u>	<u>149,390</u>
Unfunded Actuarial Accrued Liability (UAAL)	<u>\$ 178,502</u>	<u>\$ 149,390</u>	<u>\$ 149,390</u>
Funded Ratio (actuarial value assets/AAL)	0%	0%	0%
Covered Payroll (active plan members)	\$ 956,750	\$ 969,082	\$ 947,530
UAAL as a percentage of covered payroll (AAL less actuarial value of assets/UAAL)	18.7%	15.4%	15.8%

**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, 2011 valuation used the projected unit credit actuarial cost method. The actuarial assumption included a 2.8 percent investment rate of return (net of administrative expenses) and an initial healthcare cost trend rate of 10.0 percent for KingCare medical, 8.0 percent for KingCare pharmacy, and 10.0 percent for HMO medical/pharmacy, each reduced by decrements to an ultimate rate of 4.2 percent after 71 years and 12 years for medical and pharmacy, respectively. The vision trend rate is 4.0 percent, the miscellaneous trend rate is 7.0 percent, and the Medicare premium trend rate is 7.0 percent, for all years. All trend rates include a 3.0 percent inflation assumption, with the exception of vision trends. The amortization of the UAAL at transition uses a level dollar amount on an open basis. 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, 2011 and 2010, Water Quality had outstanding interfund short-term loans in the amount of \$39.6 and \$96.3 million, respectively, 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 2012 and 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 2011 and 2010, the net cash transfers to other funds from Water Quality were \$11 thousand and \$632 thousand, respectively.

**Note 13 - Net Assets Deficit**

The deficits in unrestricted net assets of \$7.3 and \$79.2 million in 2011 and 2010, 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 management's 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 2011 and 2010 were approximately \$1.3 million for each year.

**Note 15 - Subsequent Event**

Water Quality issued \$172.8 million of sewer revenue and LTGO refunding bonds in April 2012. 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, 2011**

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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) 1.42

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) 1.32

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) 1.25

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) 25.33