Washington State Auditor's Office

Financial Statement Audit Report

King County Water Quality Enterprise

Audit Period
January 1, 2006 through December 31, 2006

Report No. 72902

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June 29, 2007

Washington
State Auditor
Brian Sonntag

Washington State Auditor
Brian Sonntag

June 29, 2007

King County Council and Executive
King County
Seattle, Washington

Report on Financial Statements

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

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

Sincerely,

BRIAN SONNTAG, CGFM
STATE AUDITOR

Table of Contents

King County Water Quality Enterprise
January 1, 2006 through December 31, 2006

Independent Auditor's Report

King County Water Quality Enterprise
January 1, 2006 through December 31, 2006

County Council and Executive
King County
Seattle, Washington

We have audited the accompanying basic financial statements of the King County Water Quality Enterprise, an enterprise fund of King County, Washington, as of and for the year ended December 31, 2006, as listed on page 3. These financial statements are the responsibility of the County's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of the King County Water Quality Enterprise as of December 31, 2005, were audited by other auditors whose report dated June 26, 2006, expressed an unqualified opinion on those statements.

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

As discussed in Note 1, the financial statements present only the King County Water Quality Enterprise and do not purport to, and do not, present fairly the financial position of King County, Washington, as of December 31, 2006, the changes in its financial position, or, where applicable, its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the 2006 basic financial statements referred to above present fairly, in all material respects, the financial position of the King County Water Quality Enterprise, as of December 31, 2006, and the changes in financial position and cash flows thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

We also audited the adjustments described in Note 10 that were applied to restate the 2005 financial statements. In our opinion, such adjustments are appropriate and have been properly applied.

Our audit was performed for the purpose of forming opinions on the financial statements that collectively comprise the King County Water Quality Enterprise's basic financial statements. The accompanying Schedule of Net Revenues Available for Debt Service on page 33 is presented for purposes of additional analysis as required by bond covenants. This schedule is not part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.

The accompanying information listed as management's discussion and analysis on pages 4 through 15 is not a required part of the basic financial statements but is supplementary information presented for the purposes of additional analysis. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on it.

BRIAN SONNTAG, CGFM
STATE AUDITOR

June 29, 2007

Financial Section

King County Water Quality Enterprise
January 1, 2006 through December 31, 2006

SUPPLEMENTAL INFORMATION

Management's Discussion and Analysis – 2006 and 2005

BASIC FINANCIAL STATEMENTS

Statements of Net Assets – 2006 and 2005
Statements of Revenues, Expenses and Changes in Net Assets – 2006 and 2005
Statements of Cash Flows – 2006 and 2005
Notes to Financial Statements – 2006 and 2005

SUPPLEMENTAL INFORMATION

Supplemental Schedule of Net Revenues Available for Debt Service

KING COUNTY WATER QUALITY ENTERPRISE

The Management's Discussion and Analysis ("MD&A") is presented in two sections. The first section presents an analysis of comparative results for 2006 and 2005. The second section presents an analysis of comparative results for 2005 and 2004.

I. MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED)
December 31, 2006 and 2005

The following Management's Discussion and Analysis ("MD&A") of the King County Water Quality Enterprise's ("Water Quality") activities and financial performance provides an introduction and overview to the financial statements for the fiscal years ending December 31, 2006 and 2005.

The information in this MD&A has been prepared by Water Quality's management and should be used in combination with the accompanying financial statements and notes as well as supplemental information in order to provide a complete understanding of the data contained in the financial statements.

FINANCIAL HIGHLIGHTS

Total Water Quality Capital program expenditures for 2006 were $266.9 million. During the year, Water Quality continued implementation of the Regional Wastewater Services Plan (RWSP) and replacement of existing assets. The RWSP is intended to build additional capacity for Water Quality to meet future projected population growth in its service area through 2030. Construction continued on the new Brightwater treatment plant located in southern Snohomish County and the associated conveyance system. Total cost estimates for the Brightwater project currently are $1.8 billion. In 2006, actual expenditures were $170.3 million, and cumulatively are $434.0 million life-to-date. The North Mitigation area was over 95% complete at year end and site preparation construction was ongoing. Brightwater conveyance progressed with the East Tunnel under construction and the West Tunnel design 90% complete. The Central Tunnel and Outfall Design Build contracts were in the bidding stage. Work continued on replacing the Juanita Bay Pump Station and constructing the new Hidden Lake Pump Station with $8.8 million and $10.1 million spent respectively during 2006 and 2005. The upgrade to the Vashon Island Treatment Plant was completed in December at a total cost of $20.9 million.

Water Quality remained focused on controlling operating costs during 2006 with operating expenses net of depreciation increasing $7.5 million between 2005 and 2006 to a total of $91.1 million.

The monthly sewer rate remained at $25.60 in 2006 and the associated Residential Customer Equivalents (RCE) customer base grew from 689,817 to 690,934. Total operating revenues increased to $241.3 million reflecting an overall 9.1% increase or a 2.4% increase in revenues if ignoring the 2005 contribution to the Rate Stabilization Reserve. In 2006, Water Quality maintained its rate stabilization reserve at $14.5 million. A rate stabilization reserve is used to maintain a level sewer rate across current and future years. When the reserve is created, associated operating revenues are excluded from the calculation of debt service coverage for that year. When the reserve is used, the associated operating revenue is used in the calculation of debt service coverage for that year. Capacity Charges for new sewer connections remained stable at $34.05 per month. Capacity charge revenues increased $5.2 million reflecting the addition of 10,896 new sewer connections and an increase in the number of accounts paying off early.

Water Quality issued $147.1 million in new revenue bonds and $170.4 million of refunding bonds in support of its capital program in 2006 at an average interest rate of 4.53%. This activity resulted in refunding of $85.3 million of limited tax general obligation ("LTGO") bonds and $85.1 million of revenue bonds with a combined net present value savings of $13.8 million. Water Quality issued $100 million of Junior Lien Multi-modal Sewer Revenue Bonds and used a portion of the proceeds to retire $50 million of commercial paper. Debt from state loans increased during 2006 as new, low-rate loans were received from the state of Washington to help fund the capital program at interest rates between 1.0% and 1.5%.

The results of operations for 2006 produced a debt service coverage ratio on senior lien debt of 1.43 in excess of the coverage covenant requirement of 1.15 and a coverage ratio of 1.28 on total debt.

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 comprise the financial statements and the notes to the financial statements, which explain certain elements of the financial statements in greater detail.

REQUIRED FINANCIAL STATEMENTS

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

The comparative statements of net assets present 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 statements of net assets provide information about the nature and amount of investments in resources (assets) and obligations to creditors (liabilities).

The two most recent years' operating and non-operating revenues and expenses of Water Quality are accounted for in the statements of revenues, expenses and changes in net assets. The statements illustrate the current and prior period results of operations and recovery of costs by receipt of fees and are instrumental in demonstrating continued creditworthiness. All changes in net assets are reported as soon as the underlying event occurs, irrespective of the timing of related cash flows. Readers should note that the principal support for Water Quality's activities (87.9% of operating revenues in 2006 and 89.4% in 2005) is receipt of monthly sewage disposal charges. Water Quality is a wholesale provider of sewage treatment services to thirty-three municipal and four non-municipal participants in King 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 2006 and 2005, reasons for differences between operating cash flows and operating income, and the effect on the statements of net assets from investing, capital and financing activities.

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

FINANCIAL ANALYSIS OF THE STATEMENTS OF NET ASSETS

Comparative data, stated in millions of dollars:

	2006	2005	Difference 2006-2005	Difference 2005-2004	Percent Change 2006-2005	Percent Change 2005-2004
Current assets	$40.0	$41.8	$(1.8)	$13.9	(4.2)%	50.0 %
Capital assets	2,435.9	2,221.7	214.2	174.5	9.6 %	8.5 %
Total assets	2,716.1	2,536.6	179.5	258.7	7.1 %	11.4 %
Total liabilities	2,206.6	2,037.5	169.1	253.7	8.3 %	14.2 %
Net assets:						
Invested in capital assets (net of related debt)	384.9	372.2	12.6	6.0	3.4 %	1.6 %
Restricted	85.0	98.9	(13.8)	3.4	(14.0)%	3.6 %
Unrestricted	39.6	28.0	11.6	(4.4)	41.4 %	(13.7)%
Total net assets	509.5	499.1	10.4	5.0	2.1 %	1.0 %

The table above includes a reclassification of capital assets from Plant in Service and Other Equipment to Buildings and Land Improvements. Accumulated depreciation associated with this reclassification has been adjusted to reflect the appropriate remaining useful life. See note 10 to the financial statements.

Net assets serve as a useful indicator of Water Quality's financial position. As of December 31, 2006 and 2005, assets exceeded liabilities by $509.5 million and $499.1 million, respectively.

Of the total assets of Water Quality, at year-end 2006 and 2005, 89.7% and 87.6% respectively, are invested in capital assets such as treatment plants, pumping and regulator stations, interceptors and other equipment. Water Quality uses its capital assets to provide wholesale wastewater collection and treatment services in King and Snohomish Counties. Current operating and debt service requirements are met by operating and nonoperating revenues composed of monthly sewage disposal charges, a capacity charge for new customers, other special-handling charges, miscellaneous operating revenues and investment earnings.

Net assets increased $10.4 million in 2006 and $5.0 million in 2005 or an increase of 2.1% and 1.0% respectively. This relative stability in change of net assets was attributable to stable operating results and increased revenues. Restricted net assets decreased by $13.8 million in 2006 or 14.0% after increasing by $3.4 million in 2005 or 3.6%. Unrestricted net assets increased in 2006 by $11.6 million or 41.4% reflecting reduced reserve requirements for state loans after decreasing by $4.4 million or 13.7% in 2005.

Water Quality reported its investment in capital assets, net of debt related to capital asset acquisition, as $384.9 million and $372.2 million at year-end 2006 and 2005 or an annual increase of 3.4% and 1.6% respectively.

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

Comparative data, stated in millions of dollars:

	2006	2005	Difference 2006-2005	Difference 2005-2004	Percent Change 2006-2005	Percent Change 2005-2004
Operating revenues	$241.3	$221.1	$20.2	$3.8	9.1 %	1.8 %
Operating expenses	166.9	154.6	12.3	0.6	8.0 %	0.4 %
Operating income	74.4	66.5	7.9	3.2	11.8 %	5.1 %
Nonoperating expenses (net of revenues)	66.3	64.5	1.8	4.9	2.9 %	8.2 %
Grant revenues	2.3	3.2	(1.0)	(12.7)	(29.5)%	(79.8)%
Change in net assets	10.4	5.0	5.3	(14.4)	106.4 %	(74.2)%

- 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 2006 and 2005, the statements report that operating revenues increased by $20.2 million and $3.8 million or 9.1% and 1.8% respectively, while operating expenses increased by $12.3 million and $0.6 million or 8.0% and 0.4% respectively. These changes were influenced by several factors: Underlying the 2005 operating revenues is $14.5 million removed from monthly sewage disposal charge revenue and placed in a rate stabilization reserve for use in future years in compliance with Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 71 (FAS 71). During 2005 the statements report that operating revenues increased by $3.8 million (after the Rate Stabilization Reserve deposit) or 1.8%. For comparative purposes if the $14.5 million had not been deferred in 2005 the increase in operating revenues increase would have been 2.4% and 8.4% respectively for 2006 and 2005.

- Water Quality collected a monthly sewage disposal charge of $25.60 in 2006 and 2005. Total sewage disposal revenues were level between 2006 and 2005 (before the Rate Stabilization Reserve deposit). Customer equivalents increased by 1,117 or 0.2% in 2006 and 1,908 or 0.3% in 2005. An increase in sewer rate from $23.40 in 2004 to $25.60 in 2005 produced an increase of $19.2 million (before the Rate Stabilization Reserve deposit) or 9.9% over 2004 for sewage disposal charges.

- Other operating revenues increased $5.7 million in 2006 or 24.1% following a decrease of $0.8 million or 4.3% in 2005. The majority of these changes were related to capacity charge revenues. The capacity charge rate for new connections was $34.05 in both 2005 & 2006 with new capacity charge connections of 10,896 and 9,628 respectively. In addition to new connections, 2006 saw an increase in early payoff revenues climbing to $4.8 million or 21.5% of the year's total capacity charge revenues. Non-depreciation-related operating expenses increased $7.5 million or 8.9% in 2006 following a modest $0.9 million increase or 1.1% in 2005. While most expenses were impacted by inflation between 2005 and 2006, several rose faster than inflation. The following is several of the larger amounts. Total salaries and benefits increased by $2.4 million or 7.3%, lead by overall increases to regular salaries and retirement expenses. Electricity expense rose by $1.1 million or 14.9% due to a price increase of 13.2% at the South Treatment Plant. Non-employee benefit related insurance rose $0.5 million or 27.0% reflecting an increase in overall premium costs.

- Non-operating expenses (net of revenues) were $66.3 million and $64.5 million in 2006 and 2005, increases of $1.8 million and $4.9 million or 2.9% and 8.2%, respectively.

The statements also report comparative amounts of capital grant revenues for 2006 and 2005:

- Capital grant revenues derived from federal and state agencies were $2.3 million and $3.2 million in 2006 and 2005 or a decrease of $1.0 million and $12.7 million respectively. Low interest loans have largely replaced grants as the primary method of state agency support in recent years.

CAPITAL ASSETS

At December 31, 2006 and 2005, Water Quality's investment in capital assets, net of accumulated depreciation, was $2.4 billion and $2.2 billion, respectively. These are increases of $214.2 million and $174.5 million or 9.6% and 8.5% respectively, over the previous year-end investment in capital assets, net of accumulated depreciation. The change is a result of replacement and additions to the interceptor and siphon systems, purchases of land, additional storage capacity, extensions of sewer trunk lines and continued efforts to control odor and improve sewage-handling technology.

The increase is directly related to continued implementation of Water Quality's RWSP. Large 2006 construction project expenditures include:

- $5.9 million for completion of New Facilities at the Vashon Island Treatment Plant;

- $5.9 million for the Fairwood Interceptor construction;

- $8.8 million for Juanita Bay Pump Station construction;

- $10.1 million for construction of the Hidden Lake Pump Station;

- $170.3 million spent toward the Brightwater Treatment Plant and conveyance.

Large 2005 construction project expenditures include:

- $6.5 million for New Facilities at the Vashon Island Treatment Plant;

- $7.4 million for Conveyance System Improvements;

- $7.4 million for the Mathews Park Pump Station Improvements;

- $14.6 million for construction of Cogeneration Facility at South Treatment Plant;

- $101.6 million spent toward the Brightwater Treatment Plant and conveyance.

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

DEBT ADMINISTRATION

During 2006, Water Quality benefited from a moderate interest rate environment. In May 2006, proceeds from issuance of the $124.1 million Sewer Revenue Bonds Series 2006, were used to fund construction activities of Water Quality and to refund $24.2 million of revenue bonds. The average interest rate on this bond issue was 4.72%. In October, proceeds of the $100 million junior lien multi-modal sewer revenue bonds were used to retire $50 million of commercial paper bond anticipation notes and for Water Quality construction activities. In November, proceeds from the $193.4 million of Sewer Revenue Bonds, 2006 (Second Series) were used to fund construction activities of Water Quality and to refund $85.3 million of LTGO bonds and $60.8 million of revenue bonds. These bonds have an average interest rate of 4.41%.

During 2006, Water Quality received loan proceeds from agencies of the state of Washington totaling $6.1 million. The loans carry below-market interest rates of 1.0% to 1.5% and repayment terms up to 20 years. Water Quality received $20.3 million in low interest loans from the state of Washington in 2005.

Water Quality has $1.5 billion and $1.2 billion of sewer revenue bonds outstanding at the end of 2006 and 2005 respectively. Revenue bonds are repaid from and secured by a pledge of revenues and money received by Water Quality from or on account of operation of the sewer system, to include receipts from sewage disposal fees and other income of Water Quality. Revenue bonds are not guaranteed by the full faith and credit of King County.

At the end of 2006 and 2005, Water Quality had $456.5 million and $548.1 million of general obligation bonds outstanding respectively. Although repaid from a portion of receipts from sewage disposal fees and other income, the full faith and credit of King County guarantees repayment of principal and interest on general obligation bonds. At time of the issuance of the general obligation bonds (double-barrel payable from sewer revenues) in 2006, Water Quality's bond ratings, as conditioned upon the delivery of an accompanying municipal bond insurance policy, were:

Moody's Investors Service	**Standard & Poor's**
Aaa	AAA

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

Underlying ratings for Water Quality's LTGO issue in 2005 were "Aa1" for Moody's Investors Service and "AA+" for Standard & Poor's.

As required by bond covenant, Water Quality maintains a bond reserve account, which is funded by cash balances and surety policies. At December 31, 2006 and 2005, the cash balance in the reserve account was $68.0 million and $68.9 million respectively. In addition to bond covenant reserves, Water Quality also maintains financial policy reserves. At December 31, 2006 and 2005, the rate stabilization, liquidity and asset management financial policy reserves totaled $44.5 million and $39.3 million, respectively.

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

DEBT SERVICE COVERAGE RATIOS

	2006	**2005**
Parity Debt	1.43	1.33
Total Debt	1.28	1.22

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 set sewer rates at a level adequate to provide net revenue equal to at least 1.15 times the annual debt service requirement on parity debt. Water Quality has an adopted policy to achieve a ratio of at least 1.25 on parity debt or 0.10 above the ratio required by bond ordinance. To further strengthen coverage performance, Water Quality has been targeting coverage of 1.15 on total debt since 2001. For 2006 and 2005 Water Quality has produced ratios on parity debt of 1.43 and 1.33 respectively, both comfortably in excess of the bond requirement of 1.15 and policy of 1.25. The ratios for 2005 are computed with the exclusion of $14.5 million in operating revenue which has been placed in a rate stabilization reserve for use in a future year in compliance with FAS 71.

II. MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED)
December 31, 2005 and 2004

The following Management's Discussion and Analysis ("MD&A") of the King County Water Quality Enterprise's ("Water Quality") activities and financial performance provides an introduction and overview to the financial statements for the fiscal years ending December 31, 2005 and 2004.

The information in this MD&A has been prepared by Water Quality's management and should be used in combination with the accompanying financial statements and notes to provide a complete understanding of the data contained in the financial statements.

FINANCIAL HIGHLIGHTS

During 2005, Water Quality made significant investments in its continued implementation of the Regional Wastewater Services Plan ("RWSP") and replacement of existing assets. The RWSP is intended to build additional capacity for Water Quality to meet future projected population growth in its service area through 2030. As part of RWSP, a new treatment plant known as Brightwater is being constructed in southern Snohomish County. It is currently estimated that the total cost of the Brightwater project will be $1.6 billion (in 2005 constant dollars). In 2005 actual expenditures were $101.6 million, and cumulatively, $263.9 million. In 2005, work on the Brightwater project continued on schedule with completion of property acquisition for the treatment plant and 95% of the conveyance system parcels/easements. Nearly all major permits required for construction of the Brightwater system have been secured. In addition, Water Quality completed two major construction projects designed to control combined sewer overflows: Denny Way and Henderson/Martin Luther King Way CSO ("Combined Sewer Overflow"). The completion of the Henderson/Martin Luther King Way CSO project brought the last uncontrolled county CSO into Lake Washington and into compliance with state environmental requirements.

Water Quality remained focused on controlling operating costs during 2005 with operating expenses net of depreciation increasing $0.9 million between 2004 and 2005 to a total of $83.7 million. The monthly sewer rate increased from $23.40 in 2004 to $25.60 in 2005 and the associated Residential Customer Equivalents (RCE) customer base grew from 687,909 to 689,817 despite concerns of drought conditions in early 2005. Total sewer rate revenues increased by $19.2 million reflecting an overall 9.9% increase attributable to increases in both the sewer rate customer base and sewer rate. (Ignoring the $14.5 million contribution to the Rate Stabilization Reserve in 2005) Capacity Charges for new sewer connections increased from $18.00 per residential equivalent per month to $34.05 per month for fifteen years. Capacity charge revenues decreased $ 0.5 million despite a higher rate of $34.05, a $16.05 increase over 2004 for new connections. This was due to the reduction in early payoffs of capacity charge because of a decrease in the discount for early payoff from 8.0% to 5.5% in January 2005. Water Quality added 9,628 new sewer connections in 2005. The intent of King County Council is to keep the capacity charge rate at $34.05 for new connections through 2007. In 2005, Water Quality created a rate stabilization reserve of $14.5 million from current year operating revenues. A rate stabilization reserve is used to maintain a level sewer rate across current and future years. When the reserve was created, associated operating revenues were excluded from the calculation of debt service coverage for 2005. When the reserve is used in future years, the associated operating revenue will be used in the calculation of debt service coverage for that year.

Water Quality issued $200.0 million of limited tax general obligation ("LTGO") bonds in support of its capital program in 2005 at an average interest rate of 4.74%. Debt from state loans increased during 2005 as new, low-rate loans were received from the state of Washington to help fund the capital program at interest rates between 0.5% and 1.5%.

The results of operations for 2005 produced a debt service coverage ratio on senior lien debt of 1.33 which is in excess of the coverage covenant requirement of 1.15 and Water Quality's financial policy target of 1.25. Additionally a debt service coverage ratio of 1.22 was achieved on total debt.

Water Quality operations were stable during 2004, with operating expenses net of depreciation declining $0.1 million between 2003 and 2004 to a total of $82.8 million. The monthly sewer rate was unchanged from 2003 at $23.40. 2004 was the third year of a planned three-year level rate for monthly sewer charges. Total sewer rate revenues increased $1 million, reflecting an overall 0.4% increase in the sewer rate customer base. Capacity charge revenues increased $1.2 million, reflecting a higher rate of $18.00, a 40-cent increase over 2003, and the addition of 11,136 new sewer connections. Debt from state loans increased during 2004 as new, low-rate loans were received from the State of Washington to help fund the Water Quality's capital program.

The results of operations for 2004 produced a debt service coverage ratio on senior lien debt of 1.39, which is in excess of the coverage covenant requirement of 1.15 and Water Quality's financial policy target of 1.25.

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 change in net assets; statement 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 and use 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 statements of net assets present 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 statements of net assets provide information about the nature and amount of investments in resources (assets) and obligations to creditors (liabilities). Over time, the statements demonstrate a measure of Water Quality's financial health by providing a basis for the reader to evaluate capital structure, liquidity, and financial flexibility.

The two most recent years' operating and non-operating revenues and expenses of Water Quality are accounted for in the statements of revenues, expenses and changes in net assets. The statements illustrate the current and prior period results of operations and recovery of costs by receipt of fees and are instrumental in demonstrating continued creditworthiness. All changes in net assets are reported as soon as the underlying event occurs, irrespective of the timing of related cash flows. Readers should note that the principal support for Water Quality's activities (89.4% of operating revenues in 2005 and 88.8% in 2004) is receipt of monthly sewage disposal charges. Water Quality is a wholesale provider of sewage treatment services to thirty-three municipal and three non-municipal participants in King 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 for the periods ended December 31, 2005 and 2004, respectively, 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 2005 and 2004, reasons for differences between operating cash flows and operating income, and the effect on the statements of net assets from investing, capital and financing activities.

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

FINANCIAL ANALYSIS OF THE STATEMENTS OF NET ASSETS

Comparative data, stated in millions of dollars:

	2005	2004	Difference 2005-2004	Difference 2004-2003	Percent Change 2005-2004	Percent Change 2004-2003
Current assets	$41.8	$27.9	$13.9	$(0.4)	49.7 %	(1.4)%
Capital assets	2,221.7	2,047.2	174.5	127.4	8.5 %	6.6 %
Total assets	2,536.6	2,277.9	258.7	140.5	11.4 %	6.6 %
Total liabilities	2,037.5	1,783.8	253.7	121.0	14.2 %	7.3 %
Net assets:						
Invested in capital assets (net of related debt)	372.2	366.3	6.0	0.8	1.6 %	0.2 %
Restricted	98.9	95.4	3.4	17.1	3.6 %	21.8 %
Unrestricted	28.0	32.4	(4.4)	1.6	(13.7)%	5.1 %
Total net assets	499.1	494.1	5.0	19.5	1.0 %	4.1 %

The table above includes a reclassification of capital assets from Plant in Service and Other Equipment to Buildings and Land Improvements. Accumulated depreciation associated with this reclassification has been adjusted to reflect the appropriate remaining useful life. See note 10 to the financial statements.

Net assets serve as a useful indicator of Water Quality's financial position. As of December 31, 2005 and 2004, assets exceeded liabilities by $499.1 million and $494.1 million, respectively.

Of the total assets of Water Quality, at year-end 2005 and 2004, 87.6% and 89.9% respectively, are invested in capital assets such as treatment plants, pumping and regulator stations, interceptors and other equipment. Water Quality uses its capital assets to provide wholesale wastewater collection and treatment services in King and Snohomish Counties. Current operating and debt service requirements are met by operating and non-operating revenues composed of monthly sewage disposal charges, a capacity charge for new customers, other special-handling charges, miscellaneous operating revenues and investment earnings.

Net assets increased $5.0 million in 2005 and increased $19.5 million in 2004 or an increase of 1.0% and 4.1%, respectively. Restricted net assets increased in 2005 by $3.4 million or 3.6% and increased in 2004 by $17.1 million or 21.8% and unrestricted net assets decreased in 2005 by $4.4 million or 13.7% and increased in 2004 by $1.6 million or 5.1%.

Water Quality reported its investment in capital assets, net of debt related to capital asset acquisitions, as $372.2 million and $366.3 million at year-end 2005 and 2004 or an annual increase of 1.6% and 0.2%, respectively.

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

Comparative data, stated in millions of dollars:

	2005	2004	Difference 2005-2004	Difference 2004-2003	Percent Change 2005-2004	Percent Change 2004-2003
Operating revenues	$221.1	$217.3	$3.8	$2.9	1.8 %	1.4 %
Operating expenses	154.6	154.0	0.6	0.6	0.4 %	0.4 %
Operating income	66.5	63.3	3.2	2.5	5.1 %	4.2 %
Nonoperating expenses (net of revenues)	64.5	59.6	4.9	7.3	8.2 %	14.0 %
Grant revenues	3.2	15.9	(12.7)	4.5	(79.8)%	39.2 %
Change in net assets	5.0	19.5	(14.4)	1.8	(74.2)%	10.1%

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. Underlying the 2005 operating revenues is $14.5 million removed from monthly sewage disposal charge revenue and placed in a rate stabilization reserve for use in future years in compliance with Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 71 (FAS 71). During 2005 and 2004, the statements report that operating revenues increased by $3.8 million (after the Rate Stabilization Reserve deposit) and $2.9 million or 1.8% and 1.4% respectively, while operating expenses increased by $0.6 million each year, or 0.4% each year. These changes were influenced by several factors:

- Water Quality collected a monthly sewage disposal charge of $25.60 in 2005 and $23.40 in 2004. The 2005 9.4% increase of $2.20 from 2004 to 2005 is the first year of an intended two year rate. Total sewage disposal fees increased by $4.7 million (after the Rate Stabilization Reserve deposit) or 2.4% in 2005 due to this rate increase and an accompanying increase of 0.3% in the total number of customers from 2004 to 2005. Growth in the number of customers of 0.4% between 2003 and 2004 produced an increase of $1.0 million or 0.5% over 2003 for sewage disposal fees as the monthly sewer rate remained unchanged from 2003 to 2004.

- Other operating revenues, including capacity charges for new customers and other treatment charges, fell $0.9 million in 2005 or 4.3% following an increase of $2.0 million or 8.6% in 2004. On January 1, 2005, two changes affected capacity charge revenues. First, the monthly capacity charge rate was increased from $18.00 to $34.05 or 89.2% and secondly, the discount rate used to compute the early payoff of the capacity charge was changed from 8.0% to 5.5%. These two changes lead to a change in payment patterns of the capacity charge in 2004 and 2005. In 2004, early payoff revenues were $5.5 million or 31.6% of the year's total capacity charge revenues. In 2005, early payoff revenues were $3.3 million or 19.5% of the year's total capacity charge revenues. Actual new capacity charge connections increased by 9,628 in 2005 and 11,136 in 2004. More customers are now opting to pay over 15 years as opposed to paying early and taking the discount.

- Non-depreciation-related operating expenses increased $0.9 million or 1.1% in 2005 following a $0.1 million decrease or 0.1% in 2004. While most operating expenses of Water Quality remained stable throughout 2003-2005, the costs of petroleum based chemical products have risen sharply. Between 2004 and 2005 chemical related expenses increased from $3.0 million to $4.1 million or an increase of 37.5%. These increases have been offset by lower electrical costs and efforts of Water Quality to lower overall operating expenses.

- Non-operating expenses (net of revenues) were $64.5 million and $59.6 million in 2005 and 2004, increases of $4.9 million and $7.3 million or 8.2% and 14.0%, respectively.

The statements also report comparative amounts of capital grant revenues for 2005 and 2004:

- Capital grant revenues derived from federal and state agencies were $3.2 million and $15.9 million in 2005 and 2004, or a decrease of $12.7 million and an increase of $4.5 million for 2004 respectively. This essentially completes the grants for the Denny Way CSO and Renton projects.

CAPITAL ASSETS

At December 31, 2005 and 2004, Water Quality's investment in capital assets, net of accumulated depreciation, was $2.2 billion and $2.0 billion, respectively. These are increases of $174.5 million and $127.4 million or 8.5% and 6.6% respectively, over the previous year-end investment in capital assets, net of accumulated depreciation. The change is a result of replacement and additions to the interceptor and siphon systems, purchases of land, additional storage capacity, extensions of sewer trunk lines and continued efforts to control odor and improve sewage-handling technology.

The 2005 increase is directly related to continued implementation of Water Quality's RWSP. Large 2005 construction project expenditures include:

- $6.5 million for New Facilities at the Vashon Island Treatment Plant;
- $7.4 million for Conveyance System Improvements;
- $7.4 million for the Mathews Park Pump Station Improvements;
- $14.6 million for construction of Cogeneration Facility at South Treatment Plant;
- $101.6 million spent toward the Brightwater Treatment Plant and conveyance.

The 2004 increase is directly related to continued implementation of Water Quality's RWSP. Large 2004 construction project expenditures include:

- $18.3 million added to the Denny Way Combined Sewer Overflow project, a joint venture with Seattle Public Utilities, also partially funded by federal grants;
- $7.3 million to replace dewatering equipment at the South Treatment Plant;
- $11 million for the Henderson/Martin Luther King Way Combined Sewer Overflow project;
- $9.4 million for construction of Cogeneration Facility at South Treatment Plant;
- $82.7 million spent toward the Brightwater Treatment Plant and conveyance.

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

DEBT ADMINISTRATION

During 2005, Water Quality benefited from a moderate interest rate environment. In May 2005, proceeds from issuance of $200 million in LTGO bonds (payable from sewer revenues), were used to fund construction activities of Water Quality. The average interest rate on this bond issue was 4.74%.

During 2004, Water Quality benefited from declining interest rates. Rates paid on commercial paper and variable rate debt were substantially below amounts projected in setting the 2004 sewer rate. In March 2004, proceeds from issuance of Sewer Revenue Bonds, Series 2004B, were used for advance refunding of existing debt. The transaction reduced aggregate debt service payments by $7.2 million over the life of the bonds. The present value of the reduction of aggregate Water Quality debt service was $4.1 million. In March 2004, Water Quality also issued $185 million in Sewer Revenue Bonds, Series 2004A, proceeds of which were used to repay construction-related short-term debt and to fund construction activities. The average interest rate on this bond issue was 4.60%.

During 2005, Water Quality received loan proceeds from agencies of the state of Washington totaling $20.3 million. The loans carry below-market interest rates of 0.5% to 1.5% and repayment terms up to 20 years. During 2004, loan amounts totaling $9.1 million were received.

Water Quality has $1.2 billion of sewer revenue bonds outstanding at the end of 2005 and 2004. 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 disposal fees and other income of Water Quality. Revenue bonds are not guaranteed by the full faith and credit of King County.

At the end of 2005, Water Quality had $548.1 million of general obligation bonds outstanding. At the end of 2004 the amount totaled $356.1 million. Although repaid from a portion of receipts from sewage disposal fees and other income, the full faith and credit of King County guarantees repayment of principal and interest on general obligation bonds. At time of the issuance of the general obligation bonds (double-barrel payable from sewer revenues) in 2005, Water Quality's bond ratings, as conditioned upon the delivery of an accompanying municipal bond insurance policy, were:

Moody's Investors Service	**Standard & Poor's**
Aaa	AAA

Underlying ratings (those assigned by the ratings services without benefit of an accompanying municipal bond insurance policy) are "Aa1" for Moody's Investors Service and "AA+" for Standard & Poor's. These ratings are based on general obligation bonds for King County as a whole.

Underlying ratings for Water Quality's revenue bond issue in 2004 were "A1" for Moody's Investors Service and "AA-" for Standard & Poor's. In Water Quality's most recent bond rating for its May 1, 2006 revenue bond issue, Moody's Investor Service has confirmed its rating of "A1" and Standard & Poor's has raised its rating to "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, 2005 and 2004, the cash balances in the reserve account were $68.9 million and $67.1 million, respectively. In addition to bond covenant reserves, Water Quality also maintains financial policy reserves. At December 31, 2005 and 2004, the rate stabilization, liquidity and asset management financial policy reserves totaled $39.3 million and $21.6 million, respectively.

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

DEBT SERVICE COVERAGE RATIOS

	2005	**2004**
Parity Debt	1.33	1.39
Total Debt	1.22	1.30

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 set sewer rates at a level adequate to provide net revenue equal to at least 1.15 times the annual debt service requirement on parity debt. Water Quality has an adopted policy to achieve a ratio of at least 1.25 on parity debt or 0.10 above the ratio required by bond ordinance. To further strengthen coverage performance, Water Quality has been targeting coverage of 1.15 on total debt since 2001. For 2005, 2004, and 2003 Water Quality has produced ratios on parity debt of 1.33 and 1.39 and 1.46 respectively, all comfortably in excess of the bond requirement of 1.15 and policy of 1.25.

REQUESTS FOR INFORMATION

This financial report is designed to provide an overview of Water Quality's financial condition as of years ending December 31, 2006 and 2005. Questions concerning this report or requests for additional information should be addressed to Pete Anthony, Chief Accountant for King County, 500 Fourth Avenue, Room 653, Seattle, Washington 98104.

KING COUNTY WATER QUALITY ENTERPRISE

STATEMENTS OF NET ASSETS
DECEMBER 31, 2006 AND 2005
(IN THOUSANDS)

	2006	2005
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 12,780	$ 20,577
Accounts receivable	22,174	16,441
Inventory of supplies	4,991	4,687
Prepaid insurance	94	102
	40,039	41,807
NONCURRENT ASSETS:		
Revenue fund:		
Cash and cash equivalents	52,355	52,314
Accounts receivable	443	472
Construction fund:		
Cash and cash equivalents	19,850	39,850
Grants receivable	-	3,178
Due from other governments	-	985
Bond fund—cash and cash equivalents	148,733	158,499
	221,381	255,298
Capital assets:		
Building and land improvements	1,970,219	1,938,297
Plant in service and other equipment	508,491	506,398
Less accumulated depreciation	(934,782)	(859,231)
	1,543,928	1,585,464
Land	148,938	110,370
Construction work in progress	743,045	525,865
	2,435,911	2,221,699
Other noncurrent:		
Deferred environmental remediation costs	6,099	6,337
Other deferred charges	12,633	11,447
	18,732	17,784
TOTAL ASSETS	2,716,063	2,536,588

(Continued)

KING COUNTY WATER QUALITY ENTERPRISE

STATEMENTS OF NET ASSETS
DECEMBER 31, 2006 AND 2005
(IN THOUSANDS)

	2006	2005
LIABILITIES		
CURRENT LIABILITIES:		
Accounts payable	$ 31,346	$ 29,849
Interest payable	44,494	43,530
Wages and benefits payable	2,772	2,557
Compensated absences	605	706
Notes payable	50,000	100,000
Obligations under reverse repurchase agreements	9,827	30,003
State loans payable	5,850	4,395
Due to other funds	3,568	2,754
Rate stabilization—current portion	-	2,000
Due to other governments	-	715
General obligation bonds payable—current portion	6,005	6,215
Revenue bonds payable—current portion	24,885	23,115
Environmental remediation costs	-	1,803
	179,352	247,642
NONCURRENT LIABILITIES:		
Compensated absences	8,165	7,676
General obligation bonds payable	450,540	541,875
Revenue bonds payable	1,474,220	1,166,640
Deferred bond premium, discount, and refunding losses	(43,326)	(51,125)
Rate stabilization	14,500	12,500
Environmental remediation costs	10,356	5,161
State loans payable	112,772	107,088
	2,027,227	1,789,815
Total liabilities	2,206,579	2,037,457
NET ASSETS		
Invested in capital assets—net of related debt	384,874	372,264
Restricted for:		
Capital Assets	51,965	66,672
Debt Service	28,419	28,113
Litigation	4,670	4,104
Unrestricted	39,556	27,978
Total net assets	$ 509,484	$ 499,131

See notes to financial statements. (Concluded)

KING COUNTY WATER QUALITY ENTERPRISE

STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
YEARS ENDED DECEMBER 31, 2006 AND 2005
(IN THOUSANDS)

	2006	2005
OPERATING REVENUES:		
Sewage disposal fees	$ 212,117	$ 197,570
Other operating revenues	29,200	23,534
Total operating revenues	241,317	221,104
OPERATING EXPENSES:		
Sewage treatment, disposal, and transmission	77,081	70,603
General and administrative	14,040	13,049
Depreciation and amortization	75,796	70,933
Total operating expenses	166,917	154,585
OPERATING INCOME	74,400	66,519
NONOPERATING REVENUES (EXPENSES):		
Investment earnings	10,104	5,868
Interest	(68,276)	(63,372)
Amortization of bond premium, discount, and issuance costs	(4,411)	(5,485)
Loss on disposal of capital assets and environmental	(5,159)	(3,641)
Other	1,435	2,171
Total nonoperating expenses	(66,307)	(64,459)
INCOME BEFORE GRANTS, CONTRIBUTIONS, AND TRANSFERS	8,093	2,060
CAPITAL GRANT REVENUES	2,271	3,223
TRANSFERS	(11)	(268)
CHANGE IN NET ASSETS	10,353	5,015
NET ASSETS—Beginning of year (restated)	499,131	494,116 [(a)]
NET ASSETS—End of year	$ 509,484	$ 499,131

(a) See Note 10, restatement of beginning balance

See notes to financial statements.

KING COUNTY WATER QUALITY ENTERPRISE

STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 31, 2006 AND 2005
(IN THOUSANDS)

	2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Cash received from customers	$ 236,600	$ 233,466
Cash payments to suppliers for goods and services	(54,397)	(46,303)
Cash payments for employee services	(34,115)	(31,534)
Net cash provided by operating activities	148,088	155,629
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:		
Transfers out	(11)	(268)
Interest paid on short-term loans	(43)	(239)
Net cash used in noncapital financing activities	(54)	(507)
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:		
Acquisition of capital assets	(269,875)	(220,121)
Principal paid on general obligation bonds	(6,215)	(7,970)
Interest paid on general obligation bonds	(28,279)	(19,956)
Proceeds of new bond issuance	417,505	200,000
Principal paid on bonds by refunding	(170,370)	-
Principal paid on revenue bonds	(23,115)	(20,585)
Interest paid on revenue bonds	(57,591)	(57,657)
Principal paid on notes payable	(50,000)	-
Interest paid on notes payable	(3,533)	(2,409)
Principal paid on state loans	(3,479)	(2,260)
Proceeds of state loans	10,618	20,278
Interest paid on state loans	(2,273)	(1,245)
Capital grants received	5,449	5,822
Deferred costs	5,673	5,532
Net cash used in capital and related financing activities	(175,485)	(100,571)
CASH FLOWS FROM INVESTING ACTIVITIES—		
Interest and changes in reverse repurchase obligations	(10,071)	29,746
Net cash provided by investing activities	(10,071)	29,746

(Continued)

KING COUNTY WATER QUALITY ENTERPRISE

STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 31, 2006 AND 2005
(IN THOUSANDS)

	2006	2005
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	$ (37,522)	$ 84,297
CASH AND CASH EQUIVALENTS—Beginning of year	271,240	186,943
CASH AND CASH EQUIVALENTS—End of year	$ 233,718	$ 271,240
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Operating income	$ 74,400	$ 66,519
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation and amortization	75,796	70,933
Changes in assets:		
Accounts receivable	(5,704)	(1,194)
Inventory of supplies	(304)	(11)
Due from other governments	985	(944)
Changes in liabilities:		
Accounts payable	1,497	2,584
Wages and benefits payable	604	857
Rate stabilization	-	14,500
Due to other funds	814	2,385
Total adjustments	73,688	89,110
NET CASH PROVIDED BY OPERATING ACTIVITIES	$ 148,088	$ 155,629
SUPPLEMENTAL DISCLOSURE OF NONCASH CAPITAL AND RELATED FINANCING ACTIVITIES—Contribution of capital assets from government	$ 279	$ 393
SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING ACTIVITIES—Changes in fair value of investments (held in investment pool)	$ (19,202)	$ 23,130

See notes to financial statements. (Concluded)

1. OPERATIONS AND ACCOUNTING POLICIES

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

Water Quality is an integral part of the County reporting entity and is included, as an enterprise fund, in the County's comprehensive annual financial report. As an enterprise fund, Water Quality is funded and operated separately from other operations of the County. Revenues, bond proceeds, and grants-in-aid are restricted by purpose. Accordingly, Water Quality has separate accounting records and 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 largest customer, the City of Seattle (Seattle Public Utilities), represent approximately 41.7% of total sewage disposal fees in 2006 and 42.5% in 2005.

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 $27.4 million and $26.1 million in 2006 and 2005, respectively.

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

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

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

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

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

e. *Capital Assets*—The capitalization threshold in Water Quality is $1,000. The provision for depreciation is made on a straight-line basis over the estimated useful lives of Water Quality's capital assets, which range from 2 to 50 years.

Water Quality capitalizes certain interest and income expense related to tax-free borrowings until the assets are ready for their intended use. The amount capitalized is the difference between the interest revenue and interest expense associated the applicable tax free borrowings. Total interest incurred was $92.7 million and $86.7 million during the years ended December 31, 2006 and 2005, respectively, of which $24.4 million and $23.3 million, respectively, was capitalized.

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

Water Quality periodically reviews long-lived assets for impairment to determine whether any events or circumstances indicate the carrying value of the assets may not be recoverable. No impairment was identified in 2006 or 2005.

f. *Environmental and Property Remediation Costs*—Water Quality evaluates and accrues for environmental remediation based on engineering studies and estimates of future potential costs. In prior years, Water Quality settled lawsuits related to certain environmentally damaged sites. In these settlements, Water Quality agreed to pay its portion of remediation and cleanup costs.

During the early years, Water Quality funded the majority of its environmental expenditures with debt proceeds. Water Quality also received grant funding to offset a portion of these costs. The initial settlement costs, net of the partial grant funding and other recoveries, are deferred and are being amortized over 40 years as revenues are collected from Water Quality's customers. Also see Note 6 relating to regulatory deferrals under FAS 71.

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

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

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

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

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

i. *Operating and Nonoperating Revenues and Expenses*— Operating revenues result from exchange transactions of Water Quality's activities. Nonoperating revenues result from nonexchange transactions such as operating subsidies and investment earnings. Expenses associated with providing wastewater treatment services and operating Water Quality's treatment facilities are considered operating.

j. *Deferred Compensation*—The County offers a consolidated deferred compensation plan that complies with Internal Revenue Code Section (IRC) 457. The plan permits employees to defer a portion of annual compensation until future years. Participation in the plan is voluntary. The assets are not the property of Water Quality and not recorded in the financial statements.

k. *Use of Estimates*—The preparation of the financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements. Specific estimates have been made in the areas of allowance for uncollectible accounts, environmental remediation costs, useful lives of capital assets, and future interest rates. Actual results could differ from these estimates.

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

m. *Capital Grant Revenues*—Pursuant to GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, grant revenues are reported separately from operating and nonoperating revenues as capital grant revenues. Water Quality received capital grant revenues of $2.3 million and $3.2 million for the years ended December 31, 2006 and 2005, respectively.

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

New Accounting Standards Adopted**—**In 2003, the GASB issued Statement No. 40, *Deposit and Investment Risk Disclosures*. This statement establishes and modifies disclosure requirements related to investment risks: credit risk (including custodial credit risk and concentrations of credit risk), interest rate risk, and foreign currency risk. This statement also establishes and modifies disclosure requirements for deposit risks: custodial credit risk and foreign currency risk. GASB Statement No. 40 is effective for fiscal periods beginning after June 15, 2004 and was adopted by Water Quality in 2005 without a material impact on its financial position or results of operations in 2006.

In 2003, the GASB issued Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries.* This statement establishes accounting and financial reporting standards for impairment of capital assets. A capital asset is considered impaired when its service utility has declined significantly and unexpectedly. This statement also clarifies and establishes accounting requirements for insurance recoveries. Water Quality adopted this statement effective January 1, 2005 without a material impact on its financial position or results of operations in 2006.

In June 2004, the GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. Statement No. 45 establishes accounting and financial reporting standards for benefits that are earned during an employee's active service, but will not be paid until after the employee retires. GASB Statement No. 45 is effective for Water Quality beginning in fiscal year 2007. Water Quality management is currently evaluating the potential impact that GASB Statement No. 45 may have on its financial position and results of operations.

2. DEPOSITS AND REVERSE REPURCHASE AGREEMENTS

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

The County has deposit and investment policies addressing risks that have the potential to result in losses of deposits and investments. All deposits not covered by the Federal Depository Insurance Corporation (FDIC) are covered by the Public Deposit Protection Commission of the State of Washington (PDPC), a statutory authority established under chapter 39.58 RCW. To the extent that uninsured public deposits of a financial institution exceed the PDPC's total value, equivalent proportions of the County's deposits in those institutions are exposed to custodial credit risk because they are uninsured and uncollateralized. 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, $5.8 million and $8.8 million of Water Quality's bank balance of $224.4 million and $242.7 million (as of December 31, 2006 and December 31, 2005, respectively) was exposed to custodial credit risk as uninsured and uncollateralized.

Statutes permit the Pool to enter into reverse repurchase agreements. Water Quality has been allocated a proportionate share of the pooled investments and liabilities associated with reverse repurchase agreements based on total equity in the Pool. Reverse repurchase agreements are recorded as an increase to assets and an offsetting increase to liabilities. Water Quality's share of the reverse repurchase agreements was $9.8 million and $30.0 million as of December 31, 2006 and 2005, respectively. The proceeds from the repurchase agreements are reinvested in other instruments with the same maturity as the collateral securities, resulting in a matched position.

The amount of cash received in reverse repurchase agreements is normally less than the market value of the underlying security. Should a third-party default on their obligations to resell these securities to the County, the County would be faced with an economic loss equal to the difference between the market value of the underlying securities and the agreement obligation. During the fiscal years ended December 31, 2006 and 2005, no losses were incurred as a result of default.

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

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

Water Quality retains all risk associated with environmental claims.

4. LONG-TERM LIABILITIES AND NOTES PAYABLE

Sewer Revenue Bonds—As of December 31, 2006, bonds outstanding include $746.4 million of serial bonds maturing from January 1, 2007 through 2031, bearing interest at stated rates of 3% to 5.5% per annum, and $752.7 million of term bonds maturing on January 1 in the years 2020 through 2036, bearing interest at stated rates of 4.38% to 5% per annum.

In 2006, Water Quality issued $317.5 million of sewer revenue bonds maturing from January 1, 2008 to 2036, and $100 million of variable rate debt. The new issues includes $157.2 million of serial bonds maturing from January 1, 2008 through 2030, bearing interest at stated rates of 3.5% to 5%, and $260.3 million of term bonds, maturing in the years 2031 through 2036, bearing interest at the stated rates of 4.38% to 5%.

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.

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, 2006 Water Quality designated restricted cash balances of $54.8 million as amounts to repay principal and interest due on revenue bonds on January 1, 2007.

Additional amounts of $68.0 million and $68.9 million held in the bond fund as bond reserves, as of December 31, 2006 and 2005, 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 2006, and Sewer Revenue Refunding Bonds, Series 2006, Second Series, by purchase of a surety policy issued by a private insurer. The amount required in the cash reserves and surety policies are based on the highest year of debt service over the life of all outstanding revenue bonds. As of December 31, 2006, Water Quality is in compliance with the combined amount required for the reserve and surety policies.

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

	Final Maturity	**Interest Rates**	**Original Issue Amount**	**Outstanding at 12/31/06**
1999 (2nd Series)	1/1/09	5.00-5.25%	$ 60,000	$ 3,365
2001A-B Jr. lien var. rate	1/1/32	(variable)	100,000	100,000
2001 Refunding	1/1/35	3.50-5.25%	270,060	233,010
2002A	1/1/35	5.00-5.50%	100,000	94,960
2002B Refunding	1/1/33	4.00-5.50%	346,130	311,310
2003A Refunding	1/1/35	3.00-5.50%	96,470	93,665
2004A	1/1/35	4.50-5.00%	185,000	185,000
2004B Refunding	1/1/35	3.00-5.00%	61,760	60,290
2006 Refunding	1/1/36	5.00%	124,070	124,070
2006A-B Jr. lien multi-modal	1/1/36	(variable)	100,000	100,000
2006 (2nd Series) Refunding	1/1/36	3.50-5.00%	193,435	193,435
			$ 1,636,925	$ 1,499,105

General Obligation Bonds—As of December 31, 2006, bonds outstanding include $204.0 million of serial bonds maturing January 1, 2007 through 2031, bearing interest at stated rates of 4.5% to 5.25% per annum. General Obligation Bonds outstanding also include $252.6 million of term bonds maturing on January 1, 2020 through 2035, bearing interest at stated rates of 4.6% to 6.25%. The bonds were issued to provide funding for Water Quality's construction plan. Certain serial bonds cannot be redeemed prior to maturity; other bonds may be redeemed at declining premiums after the lapse of specific periods of time.

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

	Final Maturity	**Interest Rates**	**Original Issue Amount**	**Outstanding at 12/31/06**
1996 Series C LTGO Refunding	1/1/08	5.25%	$ 130,965	$ 5,325
1998 Series B LTGO Refunding	1/1/34	4.75-5.25%	261,625	251,220
2005 LTGO	1/1/35	4.50-5.00%	200,000	200,000
			$ 592,590	$ 456,545

Defeased Debt— In May 2006, Water Quality defeased $24.2 million in Sewer Revenue Bonds with a reduction in total debt service of $1.8 million over the life of the refunded bonds and a total present value savings of $1.2 million. In November 2006, Water Quality defeased $60.8 million in Sewer Revenue Bonds and $85.3 million in LTGO Bonds with a reduction in total debt service of $20.8 million over the life of the refunded bonds and a total present value savings of $12.6 million.

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 2005 through 2025 and bear interest at stated rates from 0.5% and 1.5%. As of December 31, 2006, the balance due on all state loans is $118.6 million. Water Quality maintains separate cash reserves of $5.9 million. These reserves are treated as restricted, being required under the Revolving Fund Loan Program.

At December 31, 2006, the required principal and interest payments for all classes of long-term debt are as follows (in thousands):

	Revenue Bonds		Variable Rate Revenue	
Year(s) Beginning	**Principal**	**Interest**	**Principal**	**Interest**
January 1, 2007	$ 24,885	$ 55,206	$ -	$ 9,900
January 1, 2008	26,315	63,213	-	9,900
January 1, 2009	30,540	61,871	-	9,900
January 1, 2010	32,090	60,339	-	9,900
January 1, 2011	33,710	58,743	-	9,900
January 1, 2012–2016	194,945	267,553	-	49,500
January 1, 2017–2021	167,925	219,967	-	49,500
January 1, 2022–2026	214,650	174,251	-	49,500
January 1, 2027–2031	276,250	116,075	100,000	49,500
January 1, 2032–2036	297,795	40,234	100,000	29,700
	$ 1,299,105	$ 1,117,452	$ 200,000	$ 277,200

	General Obligation Bonds		State Loans		
Year(s) Beginning	**Principal**	**Interest**	**Principal**	**Interest**	**Total**
January 1, 2007	$ 6,005	$ 27,053	$ 5,850	$ 1,483	$ 130,382
January 1, 2008	6,270	22,429	6,346	1,407	135,880
January 1, 2009	3,700	22,117	6,417	1,327	135,872
January 1, 2010	3,845	21,942	6,488	1,247	135,851
January 1, 2011	4,000	21,759	6,561	1,165	135,838
January 1, 2012–2016	22,555	105,787	33,931	4,557	678,828
January 1, 2017–2021	80,340	95,032	34,233	2,358	649,355
January 1, 2022–2026	101,290	73,183	18,748	488	632,110
January 1, 2027–2031	127,945	45,318	49	-	715,137
January 1, 2032–2036	100,595	11,591	-	-	579,915
	$ 456,545	$ 446,211	$ 118,623	$ 14,032	$ 3,929,168

The future annualized interest payments for the variable rate revenue bonds are estimated based on conversion to long-term bonds at 90% of the current long-term bond rate of 4.95%.

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, 2006, $50.0 million was issued and outstanding under this program. The commercial paper has maturities ranging between 30 and 154 days and is classified as a current liability of Water Quality's operating fund.

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

Financial Policy Reserves—In addition to bond reserves related to Sewer Revenue Bonds, Water Quality maintains liquidity and asset management reserves in noncurrent assets totaling $30.0 million at December 31, 2006.

Compliance With Bond Resolutions—With respect to the year ended December 31, 2006, Water Quality complied with all covenants stipulated by its bond resolutions.

Changes in Long-Term Liabilities—Long-term liability activity for the years ended December 31, 2006 and 2005 was as follows (in thousands):

	Balance 1/1/2006	Additions	Reductions	Balance 12/31/2006	Due Within One Year
Bonds Payable	$ 1,737,845	$ 417,505	$ (199,700)	$1,955,650	$ 30,890
Bond Premiums	20,337	13,311	(2,128)	31,520	(2,927)
Issuance Costs	(11,447)	(1,819)	633	(12,633)	695
Refunding Losses	(71,462)	(9,151)	5,767	(74,846)	5,311
Total bonds payable	1,675,273	419,846	(195,428)	1,899,691	33,969
State Loans	111,483	10,618	(3,479)	118,622	5,850
Compensated Absences	8,310	971	(511)	8,770	605
Environmental Remediation	6,964	3,465	(73)	10,356	-
Rate Stabilization	14,500	-	-	14,500	-
Total long-term Liabilities	$ 1,816,530	$ 434,900	$ (199,491)	$2,051,939	$ 40,424

	Balance 1/1/2005	Additions	Reductions	Balance 12/31/2005	Due Within One Year
Bonds Payable	$ 1,566,400	$ 200,000	$ (28,555)	$1,737,845	$ 29,330
Bond Premiums	14,748	7,299	(1,710)	20,337	(1,746)
Issuance Costs	(10,561)	(1,601)	715	(11,447)	715
Refunding Losses	(77,893)	-	6,431	(71,462)	6,293
Total bonds payable	1,492,694	205,698	(23,119)	1,675,273	34,592
State Loans	93,465	20,278	(2,260)	111,483	4,395
Compensated Absences	8,613	102	(405)	8,310	706
Environmental Remediation	4,474	2,490	-	6,964	1,803
Rate Stabilization	-	14,500	-	14,500	2,000
Total long-term Liabilities	$ 1,599,246	$ 243,068	$ (25,784)	$1,816,530	$ 43,496

5. CHANGES IN CAPITAL ASSETS

Changes in capital assets for the years ended December 31, 2006 and 2005 are shown in the following table (in thousands):

	Balance 01/01/06	Increases	Decreases	Balance 12/31/06
Land	$ 110,370	$ 38,568	$ -	$ 148,938
Work in progress	525,865	286,175	(68,995)	743,045
Total nondepreciable assets	636,235	324,743	(68,995)	891,983
Building and land improvements	$1,938,297	$ 37,899	$ (5,977)	$1,970,219
Major equipment and vehicles	8,396	77	(4)	8,469
Shop and other equipment	490,281	7,900	(5,881)	492,300
Software development	7,721	1	-	7,722
Total depreciable assets	2,444,695	45,877	(11,862)	2,478,710
Accumulated depreciation and amortization:				
Building and land improvements	(560,799)	(44,911)	153	(605,557)
Major equipment and vehicles	(4,582)	(739)	4	(5,317)
Shop and other equipment	(286,133)	(30,522)	465	(316,190)
Software development	(7,717)	(1)	-	(7,718)
Total depreciation and	(859,231)	(76,173)	622	(934,782)
Depreciable assets - net	1,585,464	(30,296)	(11,240)	1,543,928
Total capital assets - net	$2,221,699	$ 294,447	$ (80,235)	$2,435,911

	01/01/05	Increases	Decreases	12/31/05
Land	67,980	42,390	-	110,370
Work in progress	607,312	221,923	(303,370)	525,865
Total nondepreciable assets	675,292	264,313	(303,370)	636,235
Building and land	$ 1,679,989	$ 261,685	$ (3,377)	$ 1,938,297
Major equipment and vehicles	8,419	113	(136)	8,396
Shop and other equipment	466,026	26,457	(2,202)	490,281
Software development	7,719	2	-	7,721
	2,162,153	288,257	(5,715)	2,444,695
Accumulated depreciation and amortization:				
Building and land	(520,853)	(39,946)	-	(560,799)
Major equipment and vehicles	(3,858)	(739)	15	(4,582)
Shop and other equipment	(257,795)	(30,247)	1,909	(286,133)
Software development	(7,716)	(1)	-	(7,717)
Total depreciation and	(790,222)	(70,933)	1,924	(859,231)
Depreciable assets - net	1,371,931	217,324	(3,791)	1,585,464
Total capital assets - net	$ 2,047,223	$ 481,637	$ (307,161)	$ 2,221,699

6. 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 principals for nonregulated entities. Changes to these balances and their inclusion in rates may occur only at the direction of the Council.

Rate Stabilization—In 2005, pursuant to the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 71 (FAS 71), *Accounting for the Effects of Certain Types of Regulation,* the Council established a Rate Stabilization Reserve. This action created a regulatory liability which deferred $14.5 million from 2005 operating revenue to be set aside in a reserve and recognized in subsequent years to maintain stable sewer rates. In 2006, it was not necessary to transfer amounts from this reserve.

Pollution Remediation—In 2006, the Council approved the application of FAS 71 to treat pollution remediation obligations as regulatory assets, in lieu of current expense. Based on revised cost estimates for pollution remediation obligations, $3.5 million was capitalized as a regulatory asset, to be amortized over a period of 30 years.

7. EMPLOYEE BENEFIT PLANS

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

Historical trend and other information regarding PERS are presented in the State of Washington Department of Retirement Systems' 2006 Comprehensive Annual Financial Report. A copy of this report may be obtained from the Department of Retirement Systems, P.O. Box 48380, Olympia, Washington, 98504-8380.

Historical trend and other information regarding SCERS are presented in the Seattle City Employees' Retirement System's 2006 Comprehensive Annual Financial Report. A copy of this report may be obtained from the Seattle City Employees' Retirement System, 801 Third Avenue, Suite 300, Seattle, Washington, 98104.

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

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

Plan I members are eligible for retirement after 30 years of service or at the age of 60 with 5 years of service, or at the age of 55 with 25 years of service. The annual pension is 2% of the final average salary per year of service, capped at 60%. If qualified, after reaching age 66, a limited cost of living allowance is granted.

Plan II members may retire at the age of 65 with 5 years of service or at 55 with 20 years of service, with an allowance of 2% per year of service of the final average salary. Plan II retirements prior to the age of 65 are actuarially reduced. There is no cap on years-of-service credit and a limited cost-of-living allowance is granted.

Plan III members may retire with 10 years of service or with 5 service years, including one year earned after age 54 and 5 service years under Plan II prior to transfer to Plan III. Plan III retirements prior to age 65 are actuarially reduced. With respect to the defined benefit portion of Plan III, there is no cap on years-of-service credit, and a limited cost of living allowance is granted.

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

Water Quality's contribution rates expressed as a percentage of covered payrolls as of December 31, 2006, were as follows:

	PERS Plan I 1/1–6/30/06	PERS Plan I 7/1–12/31/06	PERS Plan II 1/1–6/30/06	PERS Plan II 7/1–12/31/06	PERS Plan III 1/1–6/30/06	PERS Plan III 7/1–12/31/06
Employer	2.44 %	3.69 %	2.44 %	3.69 %	2.44 %	3.69 %
Employee	6.00 %	6.00 %	2.25 %	3.50 %	5%-15%	5%-15%
	8.44 %	9.69 %	4.69 %	7.19 %	7.44%-17.44%	8.69%-18.69%

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

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

	PERS Plan I	PERS Plans II and III
2006	$ 99	$ 1,542
2005	66	881
2004	52	526

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

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

Within SCERS, there were no material changes in benefit provisions in 2006.

The SCERS member contribution rate is 8.03% of compensation, except for members qualifying prior to June 1972 for lower rates. Water Quality is required to contribute at an actuarially determined rate. The current rate is 8.03% of annual covered payroll. The contribution requirements of plan members and Water Quality are established and may be amended by the Board of Administration. Both Water Quality and the employees made the required contributions. Water Quality's required employer contributions for the years ended 2006, 2005, and 2004 were $3.2 thousand, $2.1 thousand, and $175, respectively.

8. OPERATING SUBSIDIES AND GRANT REVENUES

Various federal and state government agencies make grants to Water Quality to aid in financing construction costs (capital grants), including those on various projects included in the comprehensive plan, and for operating costs (operating subsidies). Operating subsidies are recorded as revenues in the statements of revenues, expenses, and changes in net assets. Capital grants amounted to $2.3 million and $3.2 million for the years ended December 31, 2006 and 2005, respectively.

9. TRANSFERS AND CAPITAL CONTRIBUTIONS

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 2006 and 2005, the net cash transfers to other funds from Water Quality were $11.0 thousand and $268.0 thousand, respectively.

10. PRIOR PERIOD ADJUSTMENT

In 2006 it was determined that the West Point Treatment Plant expansion, capitalized primarily in 1995, was assigned a depreciable life that was not representative of the useful life of the underlying assets. To correct this, the useful life was increased from 15 years to 50 years, resulting in a restatement of net assets as of December 31, 2004 from $339.9 million to $494.1 million.

11. COMMITMENTS AND CONTINGENCIES

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

Water Quality is continuing to design, acquire, and construct treatment facilities and conveyance lines within the guidelines of the construction plan. As of December 31, 2006, Water Quality plans to expend approximately $1.9 billion through 2012 to complete the requirements of the construction plan. The majority of the expenditures will be used for construction of secondary treatment facilities (including an additional sewage treatment plant) and combined sewer overflow control facilities.

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

In prior years, Water Quality agreed to pay a portion of remediation costs to clean up contaminated sediments and restore aquatic habitats in Elliott Bay and the Lower Duwamish River. Although the Department of Ecology has not mandated remediation of any of these sites, Water Quality has conducted a review and has identified seven areas near combined sewer overflows that may require sediment remediation. Due to the high level of regulatory review, approval requirements, and the environmental permitting associated with these projects, and the uncertainty related to the particular remediation alternative for each project, the schedule of required remediation and costs of remediation has not been fully determined. However, Water Quality has accrued $8.9 million and $5.5 million for the sediment remediation plan as of December 31, 2006 and 2005, respectively. Water Quality has accrued $1.4 million and $1.5 million for the Lower Duwamish Waterway remediation project as of December 31, 2006 and 2005, respectively.

Office Facilities— Water Quality currently rents office space from the Department of Construction and Facilities Maintenance 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 2006 and 2005 were approximately $1.3 million and $1.4 million, respectively.

12. SUBSEQUENT EVENT

In June 2007, Water Quality will issue $225 million of Sewer Revenue bonds. The proceeds of the bonds will be used to fund Water Quality's on-going program to improve and maintain the sewer system. In addition, Water Quality will increase the outstanding balance of Commercial Paper by $37 million.

KING COUNTY WATER QUALITY ENTERPRISE

SUPPLEMENTAL SCHEDULE OF NET REVENUES AVAILABLE FOR DEBT SERVICE
FOR THE YEAR ENDED DECEMBER 31, 2006

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

Coverage (1.15 required by covenant, adopted policy 1.25)	1.43

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)	1.28

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)	1.20

In 2001 and 2006, 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, and 2006A-B, Junior Lien Multi-Modal, require that sewage disposal rates provide net revenue equal to at least 1.10 times the annual debt service requirements for all Junior Lien obligations after payment of senior lien requirements.

Coverage (1.10 required by covenant)	11.98