

**KING COUNTY WATER
QUALITY ENTERPRISE**

FINANCIAL STATEMENTS AND
SUPPLEMENTAL SCHEDULE FOR THE
YEARS ENDED DECEMBER 31, 2001 AND 2000, AND
INDEPENDENT AUDITORS' REPORT

Deloitte & Touche LLP

KING COUNTY WATER QUALITY ENTERPRISE

TABLE OF CONTENTS

	<u>Page</u>
INDEPENDENT AUDITORS' REPORT	1
FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2001 AND 2000:	
Balance sheets	2
Statements of revenues, expenses, and changes in retained earnings	3
Statements of cash flows	4
Notes to financial statements	6
SUPPLEMENTAL SCHEDULE FOR THE YEAR ENDED DECEMBER 31, 2001:	
Supplemental schedule of net revenues available for debt service	16



INDEPENDENT AUDITORS' REPORT

King County Council
Seattle, Washington

We have audited the accompanying balance sheets of the King County Water Quality Enterprise (the Enterprise) as of December 31, 2001 and 2000, and the related statements of revenues, expenses, and changes in retained earnings and of cash flows for the years then ended. These financial statements and the supplemental schedule referred to below are the responsibility of the Enterprise's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, such financial statements present fairly, in all material respects, the financial position of the Enterprise as of December 31, 2001 and 2000, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1 to the financial statements, effective January 1, 2001, the Enterprise implemented Government Accounting Standards Board Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying supplemental schedule of net revenues available for debt service for the year ended December 31, 2001, is presented as required by bond resolutions and is not a required part of the basic financial statements. This information has been subjected to the auditing procedures applied in our audits of the basic financial statements and, in our opinion, is fairly stated in all material respects when considered in relation to the basic financial statements taken as a whole.

A handwritten signature in black ink that reads "Deloitte & Touche LLP". The signature is written in a cursive, slightly stylized font.

May 23, 2002

KING COUNTY WATER QUALITY ENTERPRISE

BALANCE SHEETS
DECEMBER 31, 2001 AND 2000

<u>ASSETS</u>	<u>2001</u>	<u>2000</u>
CURRENT ASSETS:		
Cash and cash equivalents	\$ 10,387,794	\$ 12,031,731
Interest receivable	649	5,783
Accounts receivable	12,431,322	12,871,823
Due from other governments	16,820	276,820
Inventory of supplies	<u>4,166,014</u>	<u>4,621,160</u>
	27,002,599	29,807,317
RESTRICTED ASSETS:		
Revenue Fund:		
Cash and cash equivalents	17,322,843	12,062,340
Interest receivable	549	6,081
Construction Fund:		
Cash and cash equivalents	97,660,914	8,934,197
Accounts receivable		718,719
Interest receivable	4,177	2,681
Grants receivable	2,466,043	
Due from other governments	1,873,917	1,909,712
Bond Fund:		
Cash and cash equivalents	91,333,060	77,025,533
Investments, at fair value	35,016,276	55,053,300
Interest receivable	<u>144,293</u>	<u>669,083</u>
	245,822,072	156,381,646
UTILITY PLANT, at cost:		
Building and land improvements	1,137,788,974	1,111,957,640
Plant in service and other equipment	846,050,692	760,556,216
Less accumulated depreciation	<u>(694,522,358)</u>	<u>(610,274,456)</u>
	1,289,317,308	1,262,239,400
Land	33,908,047	33,908,047
Construction work in progress	<u>226,195,841</u>	<u>175,090,378</u>
	1,549,421,196	1,471,237,825
OTHER ASSETS:		
Deferred environmental remediation costs	7,797,189	7,949,573
Other deferred charges	<u>4,906,488</u>	<u>2,689,186</u>
	<u>12,703,677</u>	<u>10,638,759</u>
TOTAL	<u>\$ 1,834,949,544</u>	<u>\$ 1,668,065,547</u>

See notes to financial statements.

<u>LIABILITIES AND FUND EQUITY</u>	<u>2001</u>	<u>2000</u>
CURRENT LIABILITIES:		
Accounts payable	\$ 3,249,483	\$ 4,581,531
Interest payable	1,141,787	1,644,909
Wages and benefits payable	9,280,659	9,063,313
Notes payable	83,500,000	100,000,000
State loans payable	2,864,434	2,746,666
Due to other funds	3,486,292	110,234
Estimated claims settlement	<u>1,715,322</u>	<u>1,125,100</u>
	105,237,977	119,271,753
CURRENT LIABILITIES PAYABLE FROM RESTRICTED ASSETS:		
Accounts payable	17,821,715	8,592,379
Interest payable	27,880,024	31,484,087
Wages and benefits payable	958,455	599,128
Due to other funds	2,772,713	3,418,525
Obligations under reverse repurchase agreement	656,968	
General obligation bonds payable, current portion	8,635,000	7,550,000
Revenue bonds payable, current portion	23,775,000	6,970,000
Estimated claims settlement	<u>7,339,447</u>	<u>11,838,523</u>
	89,839,322	70,452,642
LONG-TERM LIABILITIES:		
General obligation bonds payable	457,075,000	465,710,000
Revenue bonds payable	866,780,000	683,119,000
Deferred bond premium, discount and refunding losses	(78,670,348)	(85,907,575)
State loans payable	55,909,942	57,274,376
Environmental and property remediation costs	<u>501,083</u>	<u>501,083</u>
	<u>1,301,595,677</u>	<u>1,120,696,884</u>
Total liabilities	1,496,672,976	1,310,421,279
FUND EQUITY:		
Contributed capital	272,398,840	294,236,906
Reserved retained earnings	85,963,567	99,186,032
Unreserved retained deficit	<u>(20,085,839)</u>	<u>(35,778,670)</u>
Total fund equity	338,276,568	357,644,268
TOTAL	<u>\$1,834,949,544</u>	<u>\$1,668,065,547</u>

KING COUNTY WATER QUALITY ENTERPRISE

STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN RETAINED EARNINGS YEARS ENDED DECEMBER 31, 2001 AND 2000

	<u>2001</u>	<u>2000</u>
OPERATING REVENUES:		
Sewage disposal fees	\$ 167,360,642	\$ 162,787,658
Other operating revenues	<u>19,713,237</u>	<u>17,475,422</u>
	187,073,879	180,263,080
OPERATING EXPENSES:		
Sewage treatment, disposal, and transmission	76,613,411	73,587,537
General and administrative	12,460,032	9,191,371
Depreciation and amortization	<u>86,080,327</u>	<u>79,819,337</u>
	<u>175,153,770</u>	<u>162,598,245</u>
OPERATING INCOME	11,920,109	17,664,835
NONOPERATING REVENUES:		
Investment earnings	7,596,531	11,147,687
Capital grant revenues	24,219,722	
Other	<u>6,977,667</u>	<u>1,939,111</u>
	38,793,920	13,086,798
NONOPERATING EXPENSES:		
Interest	58,904,258	61,090,738
Amortization of bond premium, discount, and issuance costs	10,992,295	6,384,709
Loss on disposal of fixed assets	<u>109,769</u>	<u>4,678,700</u>
	<u>70,006,322</u>	<u>72,154,147</u>
Loss before operating transfers out	(19,292,293)	(41,402,514)
OPERATING TRANSFERS OUT	<u>(75,407)</u>	<u>(181,891)</u>
NET LOSS	(19,367,700)	(41,584,405)
DEPRECIATION ON PROPERTY AND EQUIPMENT ACQUIRED FROM CAPITAL GRANTS		
	<u>21,838,066</u>	<u>21,030,090</u>
INCREASE (DECREASE) IN RETAINED EARNINGS	2,470,366	(20,554,315)
RETAINED EARNINGS:		
Beginning of year	<u>63,407,362</u>	<u>83,961,677</u>
End of year	<u>\$ 65,877,728</u>	<u>\$ 63,407,362</u>

KING COUNTY WATER QUALITY ENTERPRISE

STATEMENTS OF CASH FLOWS

YEARS ENDED DECEMBER 31, 2001 AND 2000

	<u>2001</u>	<u>2000</u>
OPERATING ACTIVITIES:		
Cash received from customers	\$ 195,506,563	\$ 180,379,452
Cash payments to suppliers for goods and services	(47,353,666)	(52,799,749)
Cash payments for employee services	<u>(31,185,526)</u>	<u>(27,890,155)</u>
Net cash provided by operating activities	116,967,371	99,689,548
NONCAPITAL FINANCING ACTIVITIES:		
Operating transfers out	(75,407)	(181,891)
Interest paid on short-term loans	<u>(1,109,962)</u>	<u>(3,823)</u>
Net cash used by noncapital financing activities	(1,185,369)	(185,714)
CAPITAL AND RELATED FINANCING ACTIVITIES:		
Acquisition of capital assets	(160,060,660)	(102,042,051)
Principal paid on general obligation bonds	(7,550,000)	(10,480,000)
Interest paid on general obligation bonds	(24,921,158)	(25,401,559)
Proceeds of new bond issuance	370,060,000	
Principal paid on revenue bonds by refunding	(162,624,000)	
Principal paid on revenue bonds	(6,970,000)	(20,945,000)
Interest paid on revenue bonds	(38,413,727)	(37,415,896)
Principal paid on notes payable	(16,500,000)	
Interest paid on notes payable	(3,161,419)	(3,944,217)
Issuance costs of bonds and notes payable	(5,949,878)	(201,675)
Principal paid on state loans	(2,746,666)	(2,438,578)
Proceeds of new state loan	1,500,000	13,838,279
Interest paid on state loans	(2,501,737)	(2,410,941)
Capital grants received	21,753,679	8,557,236
Amortization of deferred charges	<u>129,892</u>	<u>213,379</u>
Net cash used by capital and related financing activities	(37,955,674)	(182,671,023)
INVESTING ACTIVITIES:		
Purchases of investment securities	(12,757,295,000)	(17,107,435,731)
Proceeds from sales of investment securities	12,777,332,024	17,245,048,784
Interest on investments	<u>8,787,458</u>	<u>11,264,684</u>
Net cash provided by investing activities	<u>28,824,482</u>	<u>148,877,737</u>
NET INCREASE IN CASH AND CASH EQUIVALENTS, <i>carried forward</i>		
	106,650,810	65,710,548

KING COUNTY WATER QUALITY ENTERPRISE

STATEMENTS OF CASH FLOWS *(continued)*
YEARS ENDED DECEMBER 31, 2001 AND 2000

	<u>2001</u>	<u>2000</u>
NET INCREASE IN CASH AND CASH EQUIVALENTS, <i>brought forward</i>	\$ 106,650,810	\$ 65,710,548
CASH AND CASH EQUIVALENTS:		
Beginning of year	<u>110,053,801</u>	<u>44,343,253</u>
End of year	<u>\$216,704,611</u>	<u>\$110,053,801</u>
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Operating income	\$ 11,920,109	\$ 17,664,835
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation and amortization	86,080,327	79,819,337
Other nonoperating revenue	6,977,667	1,939,111
Changes in assets:		
Due from other governments	295,795	(323,612)
Accounts receivable	1,159,220	(1,505,394)
Inventory of supplies	455,146	17,276
Other		85,287
Changes in liabilities:		
Accounts payable	7,897,288	(2,046,692)
Due to other funds	2,730,246	1,619,993
Wages and benefits payable	<u>(548,427)</u>	<u>2,419,407</u>
Total adjustments	<u>105,047,262</u>	<u>82,024,713</u>
NET CASH PROVIDED BY OPERATING ACTIVITIES	<u>\$116,967,371</u>	<u>\$ 99,689,548</u>
NONCASH INVESTING ACTIVITIES:		
Changes in fair value of investment	\$ 505,050	\$ (1,777,746)

KING COUNTY WATER QUALITY ENTERPRISE

NOTES TO FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2001 AND 2000

NOTE 1: OPERATIONS AND ACCOUNTING POLICIES

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

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

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

The Enterprise has long-term sewage disposal agreements with the cities and sewer districts that operate sewage collection systems within its service area. The monthly sewage disposal charge to the contracting cities and districts is based on the Enterprise's estimated annual monetary requirements, including operating costs and debt service. Revenues from the City of Seattle – Drainage and Wastewater Utility represent approximately 46% and 48% of total sewage disposal fees in 2001 and 2000, respectively.

The Enterprise purchases goods and services from other County agencies, including reimbursement of the County's General Fund for a share of general government. Expenses incurred in doing business with other County agencies amounted to \$26,449,000 and \$22,763,000 in 2001 and 2000, respectively.

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

Cash and cash equivalents: The Enterprise considers as cash and cash equivalents all balances held with the King County Treasurer in the King County Investment Pool (the Pool), balances held directly in the form of overnight U.S. Treasuries, demand deposits at banks, and petty cash. Unrealized gain or loss on the Enterprise's proportionate share of the Pool is reported as a component of investment earnings.

Investments: Investments are balances other than those invested in the Pool or in overnight treasuries or demand deposits at banks or petty cash and are reported at fair value in the balance sheets. The unrealized gain or loss on investments is reported as a component of investment earnings.

Due to/from other County funds: Due to other County funds consists of payments owed for services or advances provided by other funds and for cash collected on behalf of another fund. Amounts due from other County funds consist of cash lent to other funds.

Inventory of supplies: Inventory is recorded at the lower of cost or market using the weighted-average costing method. Inventory is written off in the year that it is determined obsolete.

Restricted assets: In accordance with the Enterprise's bond resolutions, state law, or other agreements, separate restricted assets have been established. These assets are restricted for specific purposes including debt service payments and funding of capital projects. These funds are maintained in the Revenue Fund, Construction Fund, and Bond Fund on the balance sheets.

Utility plant: The provision for depreciation is made on a straight-line basis over the estimated useful lives of the Enterprise's assets, which range from three to 50 years.

Total interest incurred was \$66,000,818 and \$69,505,013 during the years ended December 31, 2001 and 2000, respectively, of which \$7,096,560 and \$8,414,275 was capitalized.

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

Environmental and property remediation costs: In prior years, the Enterprise settled lawsuits related to certain environmentally damaged sites. In these settlements, the Enterprise agreed to pay its portion of remediation and cleanup costs.

The Enterprise funds the majority of its environmental expenditures with debt proceeds. The Enterprise also receives grant funding to offset a portion of these costs. The costs, net of the partial grant funding, are deferred and are being amortized over 40 years as revenues are collected from the Enterprise's customers.

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

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

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

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

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

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

Use of estimates: The preparation of the financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements. Changes in these estimates and assumptions are considered reasonably possible and may have a material impact on the financial statements.

Reclassifications: Certain reclassifications have been made to the prior year statements to conform to the current year presentation.

Change in accounting principle: Assets acquired through contributions from third parties are recorded as additions to the appropriate utility plant accounts. For the year ended December 31, 2000, the related contributions are considered direct additions to equity and are recorded in fund equity as contributions in aid of construction (CIAC). For the year ended December 31, 2001, pursuant to GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, contributions are included in nonoperating revenues as capital grant revenues. For both years, depreciation of such assets is treated as a deduction from the contributed capital portion of equity, rather than from retained earnings.

The Enterprise received capital grant revenues of \$24,219,722 for the year ended December 31, 2001, which are included in nonoperating revenues. For the year ended December 31, 2000, the Enterprise received capital grants of \$5,799,327, which are reported as additions to contributions in aid of construction.

New accounting pronouncement: In June 1999, the GASB issued Statement No. 34, *Basic Financial Statements for State and Local Governments*, which is effective for the Enterprise in fiscal year 2002. This statement requires governments to present certain basic financial statements as well as management's discussion and analysis and certain other required supplementary information. The Enterprise has not completed the process of evaluating the impact that will result from adopting GASB Statement No. 34.

NOTE 2: CASH AND INVESTMENTS

The King County Treasurer is the custodian of the Enterprise's cash and investments. With the exception of funds in the general obligation bond redemption subfunds and certain reserves, the Enterprise is authorized by bond resolution to only invest in direct obligations of the U.S. Treasury. Investments in U.S. government securities are traded through the book-entry system operated by the Federal Reserve Bank. Repurchase agreements are collateralized by obligations of the U.S. Treasury. Bankers' acceptances are registered in the County's name. The County's agent or correspondent bank holds investments in the County's name.

The general obligation redemption subfunds and certain revenues are considered cash funds on deposit with the King County Treasurer and are pooled with cash from other County funds and other jurisdictions and either deposited in the County's bank account or invested by the County at its risk. The Enterprise has a right-of-offset for cash in these funds, which are available to the Enterprise on demand. Funds in the Pool may be invested in reverse repurchase agreements that are recorded as an increase to assets and an offsetting increase to liabilities.

The first \$100,000 of bank deposits in each financial institution is federally insured. The Washington State Public Deposit Protection Commission (PDPC) collateralizes pool deposits in excess of \$100,000. The PDPC is a multiple financial institution collateral pool. There is no provision for the PDPC to make additional pro rata assessments if needed to cover a loss. Therefore, the PDPC protection is of the nature of collateral, not of insurance.

The Enterprise's pooled deposits and investments are categorized by risk into three basic categories. Risk Category 1 includes deposits insured or collateralized with securities held by the entity or by its agent in the entity's name. Risk Category 2 includes deposits collateralized with securities held by the pledging financial institution's trust department or agent in the entity's name. Risk Category 3 includes deposits that are uncollateralized, including any bank balance that is collateralized with securities held by the pledging financial institution, or by its trust department or agent, but not in the entity's name. Also, to the extent that uninsured public deposits of a financial institution exceed the PDPC's total pool value, equivalent proportions of the County's deposits in those institutions are classified as Risk Category 3.

Enterprise investments are stated at fair value, which is estimated based on quoted market prices for these investments. All of the Enterprise's investments are in Risk Category 1. All of the Enterprise's pooled deposits are in Risk Categories 1 and 3. As of December 31, 2001, the Enterprise's pooled deposits in Risk Category 3 consisted of \$287,591 of bank certificates of deposit in excess of the Federal Deposit Insurance Corporation (FDIC) limits that were not covered by the PDPC.

Statutes permit the Pool to enter into reverse repurchase agreements. The Enterprise has been allocated a proportionate share of the pooled investments and liabilities associated with reverse repurchase agreements based on total equity in the Pool. Reverse repurchase agreements are recorded as an increase to assets and an offsetting increase to liabilities. No reverse repurchase agreements were outstanding as of December 31, 2000. The Enterprise's share of the reverse repurchase agreements was \$656,968 as of December 31, 2001. County policy prohibits use of these agreements as a borrowing mechanism. The proceeds from the repurchase agreements are reinvested in other instruments with the same maturity as the collateral securities, resulting in a matched position.

The amount of cash received in reverse repurchase agreements is normally less than the market value of the underlying securities to provide a margin to the dealers against market fluctuations. Should the dealers default on their obligations to resell these securities to the County, the County would be faced with an economic loss equal to the difference in market value plus accrued interest of the underlying securities and the agreement obligation, including accrued interest. During the fiscal years ended 2001 and 2000, no losses were incurred as a result of default.

NOTE 3: RISK MANAGEMENT

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

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

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

The Enterprise retains all risk associated with environmental claims, as is more fully described in Notes 1 and 4.

NOTE 4: LONG-TERM LIABILITIES

Sewer revenue bonds: As of December 31, 2001, bonds outstanding include \$498,510,000 of serial bonds maturing from January 1, 2002 through 2023, bearing interest at stated rates of 4.75% to 6.25% per annum, and \$292,045,000 of term bonds maturing on January 1 in the years 2002 through 2035, bearing interest at stated rates of 3.6% to 6.2% per annum.

In August 2001, the Enterprise issued \$100,000,000 of variable rate sewer revenue bonds maturing January 1, 2032. Initially, the rate of interest paid on the variable rate bonds will be redetermined weekly. In November 2001, the Enterprise issued \$270,060,000 of sewer revenue bonds. The issue includes \$136,870,000 of serial bonds maturing from January 1, 2002, through 2023, bearing interest at a stated rate of 3.0% to 5.5% and \$133,190,000 of term bonds, maturing January 1, 2024 to 2035, bearing interest at a stated rate of 5%.

Certain serial bonds may not be redeemed prior to maturity; other bonds may be redeemed at declining premiums after the lapse of specific periods of time. Monies in the Sewer Revenue Bond Fund may be used to purchase term bonds prior to maturity.

Payments from revenues of the Enterprise are required to be made to the Sewer Revenue Bond Fund in annual amounts sufficient to retire serial or term bonds on or before maturity.

Pursuant to bond resolutions, amounts of \$85,963,567 and \$99,186,032 as of December 31, 2001 and 2000, respectively, have been designated as reserved retained earnings of the Enterprise. Reserved retained earnings represent the total of the minimum required balance in the Bond Reserve and actual amounts of the Term Bond Fund, Contingency Reserve, Operating Reserve, Betterment Reserve, and 2001 debt service requirement for revenue bonds as reduced by the amount of principal and accrued interest included as a current liability in the accompanying financial statements (Note 6).

Defeased debt: In November 2001, the Enterprise issued \$270,060,000 of Sewer Revenue and Refunding Bonds, 2001. The bond proceeds were used to finance capital projects, advance refund of existing debt, as well as pay costs of issuance, bond insurance, and underwriter's discount. The loss recognized on defeasance was \$2,391,600, which will be amortized over the life of the old bonds. The transaction will reduce aggregate debt service payments by \$29,934,883 over the life of the bonds. The present value of the reduction of aggregate debt service is \$15,711,574.

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

<u>Issue</u>	<u>2001</u>	<u>2000</u>
Sewer Revenue Bonds, Series 1964E	\$ 7,890,000	\$ —
Sewer Revenue Bonds, Series 1964F	8,214,000	
Sewer Revenue Bonds, Series 1965G	7,735,000	
Sewer Revenue Bonds, Series 1965H	4,825,000	
Sewer Revenue Bonds, Series 1966I	12,040,000	
Sewer Revenue Bonds, Series 1969J	2,340,000	
Sewer Refunding Revenue Bonds, Series 1992V	119,580,000	
Sewer Refunding Revenue Bonds, Series 1993W	90,000,000	90,000,000
Limited Tax General Obligation Bonds, 1994 Series A	<u>151,990,000</u>	<u>151,990,000</u>
	<u>\$ 404,614,000</u>	<u>\$ 241,990,000</u>

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

General obligation bonds: As of December 31, 2001, bonds outstanding include \$124,770,000 of serial bonds maturing January 1, 2002 through 2018, bearing interest at stated rates of 4.75% to 5.875% per annum, and \$340,940,000 of term bonds maturing on January 1, 2017 through 2035, bearing interest at stated rates of 4.75% to 6.25% per annum.

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

State loans: In December 1990 and August 2000, the Enterprise received loans from the Washington Department of Ecology (DOE) under the Water Pollution Control State Revolving Fund Loan Program. The Enterprise used these funds for planning and construction of the West Point Secondary Treatment Facility in accordance with plans and specifications approved by DOE. Under the terms of the 1990 loan, the Enterprise makes semiannual principal and interest payments of \$2,225,500 from 2001 through 2015. The loan bears interest at a 5% rate. The balance due on the 1990 loan is \$44,428,199 as of December 31, 2001. The August 2000 loan requires semiannual payments of \$398,884 of principal and interest from 2001 through 2020 and bears an interest rate of 1.5%. The balance due on the August 2000 loan is \$12,846,177 as of December 31, 2001.

In July 2001 the Enterprise received a loan from the Washington Public Works Trust Fund. The loan requires equal annual payments of principal over 20 years plus interest of 0.5%. As of December 31, 2001, the balance due on the loan is \$1,500,000.

The 1990 loan was repaid on February 28, 2002, with proceeds received from issuance of bonds in November 2001.

Environmental and property remediation costs: The Enterprise agreed to pay its portion of Lake Hills sewer property remediation costs to clean up contaminated property. The Enterprise's cost of cleanup is estimated to be \$4,523,000. As of December 31, 2001, \$501,083 remains to be paid on this liability.

Maturities of long-term liabilities: As of December 31, 2001, required principal and interest payments are as follows:

	Sewer revenue bonds	Variable rate revenue bonds	General obligation bonds	State loans	Total
2002	\$ 58,512,289	\$ 4,725,000	\$ 30,863,496	\$ 5,330,610	\$ 99,431,395
2003	58,581,069	4,725,000	30,853,869	5,330,527	99,490,465
2004	58,034,904	4,725,000	31,500,784	5,330,152	99,590,840
2005	59,856,144	4,725,000	29,682,346	5,329,777	99,593,267
2006	60,498,544	4,725,000	29,158,734	5,329,402	99,711,680
Thereafter	1,146,034,812	222,850,000	820,930,780	50,417,120	2,240,232,712
Less interest	<u>650,962,762</u>	<u>146,475,000</u>	<u>507,280,009</u>	<u>18,293,212</u>	<u>1,323,010,983</u>
Net principal	<u>\$ 790,555,000</u>	<u>\$ 100,000,000</u>	<u>\$ 465,710,000</u>	<u>\$ 58,774,376</u>	<u>\$ 1,415,039,376</u>

The annual payments for the variable rate revenue bonds are estimates. The 1990 state loan of \$44,428,199 was repaid on February 28, 2002.

Compliance with bond resolutions: With respect to the year ended December 31, 2001, the Enterprise complied with all covenants stipulated by its bond resolutions except for providing audited financial statements within 120 days of year end. The Enterprise has six months beyond the 120 days to comply

with the covenants by providing such financial statements. It is management's intention to remedy noncompliance within the applicable six-month period.

Commercial paper: In December 1995, the Enterprise initiated a commercial paper program that gives the Enterprise the ability to issue up to \$100,000,000. The program is authorized through August 14, 2002. As of December 31, 2001, \$83,500,000 was issued and outstanding under this program. The commercial paper has maturities ranging between 33 and 98 days and is classified as a current liability of the Enterprise's operating fund.

NOTE 5: FUND EQUITY

Contributed capital: Contributed capital activity for 2001 and 2000, is as follows:

	<u>2001</u>	<u>2000</u>
Balance, January 1	\$ 294,236,906	\$ 316,129,710
Depreciation on property and equipment acquired from capital grants	(21,838,066)	(21,030,090)
Additions to contributions in aid of construction		5,799,327
Accrual for Environmental Protection Agency Fort Lawton settlement		<u>(6,662,041)</u>
Balance, December 31	<u>\$ 272,398,840</u>	<u>\$ 294,236,906</u>

As more fully described in Note 1, additions to CIAC in 2001 in the amount of \$24,219,722 were reported as nonoperating revenues in the statements of revenues, expenses, and changes in retained earnings.

Retained earnings: The activity in retained earnings for 2001 and 2000 is as follows:

	<u>Unreserved</u>	<u>Reserved</u>
Balance, January 1, 2000	\$ (3,002,888)	\$ 86,964,565
Decrease in retained earnings	(20,554,315)	
Increase (decrease) in bond reserves	<u>(12,221,467)</u>	<u>12,221,467</u>
Balance, December 31, 2000	(35,778,670)	99,186,032
Increase in retained earnings	2,470,366	
Increase (decrease) in bond reserves	<u>13,222,465</u>	<u>(13,222,465)</u>
Balance, December 31, 2001	<u>\$ (20,085,839)</u>	<u>\$ 85,963,567</u>

Reserved retained earnings: The Enterprise has legally reserved retained earnings as of December 31 as follows:

	<u>2001</u>	<u>2000</u>
Required balance, Bond Reserve	\$ 61,587,198	\$ 54,090,365
Term Bond Fund	13,775,534	30,254,426
Contingency Reserve	2,000,000	2,000,000
Operating Reserve	4,139,000	3,740,935
Betterment Reserve	5,900,811	5,049,193
Debt service requirement (revenue bonds only)	44,747,341	50,055,200
Current principal and interest payable (all bonds)	<u>(46,186,317)</u>	<u>(46,004,087)</u>
	<u>\$ 85,963,567</u>	<u>\$ 99,186,032</u>

NOTE 6: EMPLOYEE BENEFIT PLANS

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

Historical trend and other information regarding PERS is presented in the Washington State Department of Retirement Systems' 2000 Comprehensive Annual Financial Report. A copy of this report may be obtained from Department of Retirement Systems, P.O. Box 48380, Olympia, Washington, 98504-8380.

The State Legislature (the Legislature) established PERS in 1947 under RCW Chapter 41.40. PERS is a cost-sharing, multiple-employer defined benefit system. Membership in the system includes elected officials; state employees; employees of the Supreme, Appeals, and Superior Courts (other than judges); employees of legislative committees; college and university employees (not in national higher education retirement programs); judges of district and municipal courts; noncertificated employees of school districts; and employees of local government.

The PERS plan contains two tiers. Participants who joined the system by September 30, 1977, are Plan I members. Those joining thereafter are enrolled in Plan II. Retirement benefits are financed from employee and employer contributions and investment earnings. Retirement benefits in both Plan I and Plan II are vested after completion of five years of eligible service.

Plan I members are eligible for retirement after 30 years of service, at the age of 60 with five years of service, or at the age of 55 with 25 years of service. The annual pension is 2% of the final average salary per year of service, capped at 60%. If qualified, after reaching age 66, a cost-of-living allowance is granted based on years of service credit and is capped at 3% annually.

Plan II members may retire at the age of 65 with five years of service, or at 55 with 20 years of service, with an allowance of 2% per year of service of the final average salary. Plan II retirements prior to the age of 65 are actuarially reduced. There is no cap on years-of-service credit and a cost-of-living allowance is granted, capped at 3% annually.

Each biennium, the Legislature establishes Plan I employer contribution rates and Plan II employer and employee 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 are developed by the Office of the State Actuary to fully fund the system. All employers are required to contribute at the level

established by the Legislature. The methods used to determine the contribution requirements were established under state statute.

The Enterprise's contribution rates expressed as a percentage of covered payroll as of December 31, 2001, were:

	<u>PERS Plan I</u>	<u>PERS Plan II</u>
Employer	1.77%	1.77%
Employee	<u>6.00</u>	<u>0.88</u>
	<u>7.77%</u>	<u>2.65%</u>

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

	<u>PERS Plan I</u>	<u>PERS Plan II</u>
2001	\$ 211,000	\$ 1,035,000
2000	281,000	1,246,000

NOTE 7: OPERATING SUBSIDIES AND CONTRIBUTIONS IN AID OF CONSTRUCTION

Various federal and state government agencies make grants to the Enterprise to aid in financing construction costs (capital grants), including those on various projects included in the comprehensive plan, and for operating costs (operating subsidies). Operating subsidies are recorded as revenues in the statements of revenues, expenses, and changes in retained earnings. Capital grants amounted to \$24,219,722 and \$5,799,327 for the years ended December 31, 2001 and 2000, respectively.

Capital grants and operating subsidies are subject to audit. Expenditures subsequently determined to be disallowed may result in liabilities for the Enterprise to the original granting organization. Management uses its best efforts to determine that grant-funded expenditures are in accordance with grant terms. During 2000, completion of an Environmental Protection Agency (EPA) audit of the Fort Lawton sewer construction project resulted in a claim against the Enterprise of \$6,662,041, representing unsupported and ineligible costs previously paid with grant funds. While the Enterprise intends to appeal the EPA finding, it recorded the full amount of the claim as a liability at December 31, 2000. As of December 31, 2001, the matter remains unresolved and under appeal.

NOTE 8: COMMITMENTS AND CONTINGENCIES

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

The Enterprise is continuing to design, acquire, and construct treatment facilities and transmission lines within the guidelines of the construction plan. As of December 31, 2001, the Enterprise plans to expend approximately \$763,497,000 through 2006 to complete the requirements of the construction plan. The

majority of the expenditures will be used for construction of secondary treatment facilities (including an additional sewage treatment plant) and combined sewer overflow control facilities.

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

Office facilities: The Enterprise currently rents office space from the Department of Construction and Facilities Maintenance of King County. The Enterprise has not entered into a formalized legal contract for the use of these spaces but is expected to continue to rent office space for future years. Rent expenses incurred in 2001 and 2000 were approximately \$955,000 and \$1,053,000, respectively.

NOTE 9: OPERATING AND RESIDUAL EQUITY TRANSFERS

As a result of ongoing integration of the Enterprise into the County, during 2001 and 2000, the King County Council approved ordinances and/or motions authorizing the Enterprise to contribute \$75,407 and \$181,891, respectively, to various County funds. These amounts are shown as operating transfers out on the statements of revenues, expenses, and changes in retained earnings.

KING COUNTY WATER QUALITY ENTERPRISE

SUPPLEMENTAL SCHEDULE OF NET REVENUES
AVAILABLE FOR DEBT SERVICE
YEAR ENDED DECEMBER 31, 2001

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

Coverage (1.15 required by covenant, adopted policy 1.25) 1.36

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

Coverage (1.15 adopted target) 1.20

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

Coverage (1.00 required by covenant) 1.07

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

Coverage (1.10 required by covenant) 26.58