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

King County Water Quality Enterprise Fund (An Enterprise Fund of King County, Washington)

December 31, 2012 and 2011

MOSS-ADAMS LLP

Certified Public Accountants | Business Consultants

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REPORT OF INDEPENDENT AUDITORS

To the Metropolitan King County Council
Seattle, Washington

Report on Financial Statements

We have audited the accompanying financial statements of the King County Water Quality Enterprise Fund (Water Quality), which comprise the statements of net position as of December 31, 2012 and 2011, and the related statements of revenues, expenses, and changes in net position, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the King County Water Quality Enterprise Fund as of December 31, 2012 and 2011, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matter

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 3 through 12 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

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

Moss Adams LLP

Seattle, Washington
May 24, 2013

The management of King County Water Quality Enterprise Fund (Water Quality) presents to readers of its financial statements this narrative overview and analysis of its activities and financial performance for the fiscal years ended December 31, 2012 and 2011.

THE SEWER SYSTEM

Water Quality provides wastewater treatment services to King County, part of Snohomish County, and part of Pierce County with a service area encompassing over 420 square miles. The major wastewater treatment facilities include three secondary treatment plants at West Point in Seattle, South Plant in Renton and the Brightwater treatment plant located near Woodinville and two smaller secondary treatment plants at Vashon Island and Carnation, 353 miles of interceptors, 42 pump stations, 19 regulator stations. Other facilities include two combined sewer overflow treatment plants (CSO) and 38 CSO control locations. The sewer system collects and treats an average of 175 million gallons per day from approximately 1.5 million residents.

FINANCIAL HIGHLIGHTS

During 2012, Water Quality provided sewage treatment services to 708,900 residential customer equivalents (RCE) compared to 707,300 in 2011 and 704,400 in 2010. An RCE is one single-family residence or an equivalent unit of 750 cubic feet of monthly water consumption for all other customers such as multifamily residential, commercial, and industrial properties. The capacity charge program added 7,915 new connections to its customer billing base in 2012. The program added 5,855 and 6,974 new connections in 2011 and 2010, respectively. The average flow of the treatment plants was 188 million gallons per day (MGD) with a peak daily flow of 523 MGD. Maximum system capacity remained at 895 MGD in 2012 and 2011 with full implementation of the Brightwater Treatment Plant. The average daily flow fluctuated between a peak of 188 MGD in 2012 and a low of 173 MGD in 2011. The annual fluctuation in flows largely depends on the amount of annual precipitation.

In 2012, Water Quality distributed 114,093 wet tons of biosolids to end users engaged in forestry, agriculture and soil enhancement. About 308 million gallons of reclaimed water were used for landscape irrigation, industrial processes, and for heating and cooling. Water Quality sold 1.8 million therms of natural gas to Puget Sound Energy and produced 1.1 million kilowatt hours of electricity that was used on site at South Treatment Plant. Reclaimed water capacity has expanded capacity by 7 MGD with the completion of the Brightwater Treatment Plant. Brightwater can produce up to 21 MGD of reclaimed water with the addition of more pipeline capacity.

The Industrial Pretreatment Program conducted 424 inspections and took 1998 compliance samples in 2012. The program currently tracks 306 facilities with discharge authorization permits and 120 significant industrial users.

Water Quality currently has 38 combined sewer overflow facilities. An aggressive effort conducted in concert with the City of Seattle has resulted in a significant reduction in combined sewer overflows in years 1980-1983 from a baseline of 2.3 billion gallons per year to 1.4 billion gallons in 2012. 2012 was a high precipitation year compared to 2011 with a CSO overflow volume of 816 million gallons.

In 2012, the Environmental Protection Agency (EPA) entered into a consent decree with Water Quality to reduce CSO overflows over a 25 year period. The consent decree required the payment of a $400 thousand fine for past CSO overflows and the possibility of future fines for CSO overflows exceeding EPA limits. The EPA accepted Water Quality's 10 year CSO control plan as part of the consent decree and has established an ongoing process for alternative CSO control activities to reduce CSO's at lower costs than traditional methods. The EPA will monitor Water Quality's progress with CSO control and work closely with the enterprise going forward to achieve acceptable CSO levels.

In 1999, the Metropolitan King County Council adopted the Regional Wastewater Services Plan (RWSP) to construct additional capacity, protect public health and provide for future projected population growth in its service area through 2030. Major RWSP projects include the building of the Brightwater Treatment Plant, improvements to the regional conveyance system, construction of 21 CSO control projects, and expansion of the South Treatment Plant to 135 million gallons per day capacity by 2029. The RWSP also includes projects to control infiltration and inflow into the conveyance system, process additional biosolids, and produce additional reclaimed water. Total Water Quality capital program expenditures were $192.7 million for 2012 and $274.2 million for 2011.

Service was initiated on November 2, 2012 for the combined Brightwater Treatment Plant located in southern Snohomish County and the associated conveyance system. The plant was placed in service on September 6, 2011 with initial flows conveyed to the West Point Treatment Plant or the South Treatment Plant for final treatment and discharge. An average of 8.1 MGD was treated in that manner during 2011 and this increased to 10.9 MGD per day in 2012. The $74.0 million project expenditure in 2012 pushed life to date expenditures to $1.9 billion. The treatment plant entered full operation with a peak capacity of 130 MGD.

Water Quality operating revenues increased by 13.2 percent to $381.9 million in 2012 from $337.4 million in 2011 while operating expenses before depreciation increased by 10.0 percent to $117.0 million in 2012 from $106.4 million in 2011.

The monthly sewer rate remained at $36.10 per RCE in 2012. In 2011, it increased from $31.90 in 2010. The capacity charge rate increased to $53.50 per RCE in 2012 from $50.45 in 2011. Capacity charge revenues increased 5.5 percent to $51.4 million in 2012 from $48.7 million in 2011. The RCE's billed for sewer treatment services increased to 708,900 in 2012 from 707,300 in 2011. The rate stabilization reserve decreased to $62.6 million in 2012 from $76.5 million in 2011. This decrease of $13.9 million in the reserve balance increases operating revenues for the year and has been included in the calculation of debt service coverage for 2012. Future deposits to the rate stabilization reserve will decrease operating revenues and debt service coverage in the year of the deposit. Withdrawals will have the opposite effect of increasing operating revenues and debt service coverage in the year the rate stabilization reserve is reduced.

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

Water Quality issued $234.1 million in Sewer Revenue and Refunding Bonds in 2012, including $81.3 million for new construction and $3.6 million in additional bond reserves. The enterprise issued $163.5 million in LTGO Refunding bonds. This resulted in $29.3 million in savings over the lives of the refunded issues or $21.4 million in present value of debt service savings. In December 2012, Water Quality received $100 million in Junior Lien Variable Rate Demand Revenue bond proceeds. $15.3 million in low interest state loans at rates between 0.5% and 2.8% were received in 2012. This compares to $701.7 million of Revenue and Refunding bonds issued in 2011, including $167.5 million for new construction and $11.7 million for bond reserves, $100 million in Junior Lien Variable Rate Demand Revenue bond proceeds, and $1.2 million in state loan proceeds.

The results of operations for 2012 and 2011 produced a debt service coverage ratio on senior lien debt of 1.36 and 1.42, respectively, exceeding the coverage covenant requirement of 1.15 in both years. The total debt coverage ratio of 1.28 in 2012 and 1.32 in 2011 exceeded the 1.15 policy minimum in both years.

OVERVIEW OF THE FINANCIAL STATEMENTS

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

REQUIRED FINANCIAL STATEMENTS

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

The comparative statement of net position presents information on all of Water Quality's assets and liabilities, with the difference between assets and liabilities presented as net position as of each year-end. The statement of net position provides information about the nature and amount of investments in resources (assets) and obligations to creditors (liabilities). Over time, the statements demonstrate Water Quality's financial health by providing a basis for the reader to evaluate capital structure, liquidity, and financial flexibility.

The two most recent years' operating and nonoperating revenues and expenses of Water Quality are accounted for in the statements of revenues, expenses and changes in net position. The statements illustrate the current and prior period results of operations and recovery of costs by receipt of fees, and are instrumental in demonstrating Water Quality's continued creditworthiness. All changes in net position are reported as soon as the underlying event occurs, irrespective of the timing of related cash flows. The receipt of monthly sewage treatment charges provides the principal support for Water Quality's activities. Sewage treatment charges of $321.1 million provided 84.1 percent of operating revenues in 2012 and $280.9 million provided 83.2 percent of operating revenues in 2011. Water Quality is a wholesale provider of sewage treatment services to thirty-four municipal and three nonmunicipal participants in King, Pierce, and Snohomish counties. The receipt of the monthly payments is governed by service agreements, the majority of which expire in July 2036.

The statements of cash flows report cash receipts, cash payments, and net changes in cash derived from operations, financing, and investment activities. From the statements, the reader can discern Water Quality's sources and applications of cash during 2012 and 2011, reasons for differences between operating cash flows and operating income, and the effect on the statements of net position from investing, capital, and financing activities.

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

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

FINANCIAL ANALYSIS OF THE STATEMENTS OF NET POSITION

Comparative data, stated in millions of dollars:

	Years Ended December 31,		
	2012	2011	2010
Current assets	$ 304.3	$ 281.6	$ 258.7
Noncurrent assets	249.7	231.2	191.4
Capital assets	4,141.2	4,062.1	3,859.0
Other	102.5	109.0	98.3
Total assets	4,797.7	4,683.9	4,407.4
Current liabilities	295.9	307.8	386.2
Long term liabilities	3,920.9	3,788.0	3,458.8
Total liabilities	4,216.8	4,095.8	3,845.0
Net position-net investment in capital assets	221.2	298.0	407.2
Net position-restricted	254.8	297.3	234.4
Net positon-unrestricted	104.9	(7.2)	(79.2)
Total position	$ 580.9	$ 588.1	$ 562.4

Net position serves as a useful indicator of Water Quality's financial position. As of December 31, 2012 and 2011, assets exceeded liabilities by $580.9 million and $588.1 million, respectively.

Of the total assets of Water Quality, 86.3 percent or $4,141.2 million were invested in capital assets such as treatment plants, pumping and regulator stations, interceptors, and other equipment at year-end 2012. For the year-end 2011, 86.7 percent or $4,062.1 million were invested in capital assets. Water Quality uses its capital assets to provide wholesale wastewater collection and treatment services in King, Pierce, and Snohomish counties. Current operating and debt service requirements are met by operating and nonoperating revenues composed of monthly sewage treatment charges, a capacity charge for new customers, other special-handling charges, miscellaneous operating revenues, and investment earnings.

The net position decreased by 1.2 percent or $7.2 million in 2012 to $580.9 million from $588.1 million in 2011. The reduction to construction work in progress increased the value of plant in service and depreciation expense and increased the loss on disposal and impairment of capital assets. Restricted net position decreased by 14.3 percent or $42.5 million in 2012 to $254.8 million from $297.3 million in 2011. The unrestricted net position increased by $112.1 million in 2012 to $104.9 million from $(7.2) million in 2011.

The net position increased by 4.6 percent or $25.7 million in 2011 from $562.4 million in 2010. The restricted net position increased by $62.9 million in 2011 from $234.4 million in 2011. The unrestricted net position increased by $72.0 million in 2012 from $(79.2) million in 2011.

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

Comparative data, stated in millions of dollars:

	Years Ended December 31,		
	2012	2011	2010
Sewage treatment fees	$ 307.2	$ 306.4	$ 269.6
Rate stabilization	13.9	(25.5)	(15.9)
Capacity charge revenue	51.4	48.7	41.4
Other revenue	9.4	7.8	9.7
Operating revenues	381.9	337.4	304.8
Operating expenses	252.4	214.7	197.8
Operating income	129.5	122.7	107.0
Non operating (expenses)	(136.7)	(104.3)	(90.8)
Grant revenues	-	7.3	2.4
Change in net position	(7.2)	25.7	18.6
Net position beginning of year	588.1	562.4	543.8
Net positon end of year	$ 580.9	$ 588.1	$ 562.4

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

During 2012, operating revenues increased by 13.2 percent or $44.5 million to $381.9 million from $337.4 million in 2011. Operating expenses increased by 17.5 percent or $37.7 million to $252.4 million in 2012 from $214.7 million in 2011.

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

The operating expenses and revenues were driven by:

- Chemicals expenses increased by 31.9 percent or about $1.6 million in 2012 to $6.6 million primarily due to price increases in polymers, caustic soda, sodium hypochlorite, and carbon. This was affected by the addition of the Brightwater Treatment Plant. Chemicals expenses increased by 3.6 percent or about $171 thousand in 2011 to $5.0 million in 2010.

- Electricity expenses increased by 25.9 percent or $2.8 million to $13.5 million in 2012 after increasing by 1.0 percent or $102 thousand to $10.7 million in 2011.

- Services expenses increased by 3.5 percent or $943 thousand to $28.2 million for 2012 from $27.2 million in 2011. Services expenses increased by 3.5 percent or $923 thousand to $27.2 million for 2011 from $26.3 million in 2010.

- Intergovernmental expenses increased by 3.8 percent or $922 thousand in 2012 to $25.4 million from $4.4 million in 2011. Intergovernmental expenses decreased by 7.3 percent or $1.9 million in 2011 to $24.4 million from $26.3 million in 2010.

- Water Quality collected a monthly sewage treatment charge of $36.10 per RCE in 2012 and 2011, and $31.90 in 2010 and 2009. Sewer disposal revenues before rate stabilization increased by 1.6 percent or $5.0 million in 2012 to $11.4 million. Sewer disposal revenues before rate stabilization increased by 13.6 percent or $36.8 million to $306.4 million in 2011 from $269.6 million in 2010.

- Other operating revenues, including capacity charges for new customers and other treatment charges, increased by 0.2 percent or $100 thousand in 2012 to $56.6 million from $56.5 million in 2011. These revenues increased by 10.6 percent or $5.4 million in 2011 to $56.5 million from $51.1 million in 2010. Capacity charge early payoff revenues were 25.3 percent or $13.0 million of total capacity charge revenues in 2012, while in 2011, capacity charge early payoff revenues were 24.3 percent or $11.8 million of the annual total. Actual new capacity charge connections were 7915 in 2012 and 5855 in 2011.

- Net nonoperating revenues and expenses decreased by 31.1 percent or $32.4 million to $(136.7) million in 2012 from $(104.3) million in 2011. Net nonoperating revenues and expenses decreased by 14.9 percent or $13.5 million to $(104.3) million in 2011 from $(90.8) million in 2010.

- Capital grant revenues received from federal and state agencies decreased by $7.3 million in 2011 to zero in 2012. Capital grant revenues received from federal and state agencies increased by $4.9 million to $7.3 million in 2011 from $2.4 million in 2010. The lack of grant revenue was primarily due to exhausting the waste to energy grant for co-generation at the West Point Treatment plant in 2012. Low interest loans have largely replaced grants as the primary method of state agency support in recent years.

CAPITAL ASSETS

At December 31, 2012, Water Quality's investment in capital assets, net of accumulated depreciation, was $4.1 billion, an increase of $79.2 million or 1.9 percent over the balance at December 31, 2011. The increase from December 31, 2010 to December 31, 2011 was $203.1 million or 5.3 percent. These increases are a result of the Brightwater Treatment Plant and Conveyance project, replacement and additions to the interceptor and siphon systems, purchases of land, additional storage capacity, extension of sewer trunk lines, and continued efforts to control odor and improved sewage-handling technology.

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

Large 2012 construction project expenditures include:

- $5.1 million for the Interbay Pumping Station;
- $6.3 million for the Murray CSO;
- $7.1 million for the Kirkland Pumping Station;
- $21.3 million for the Ballard Siphon;
- $82.4 million spent toward the Brightwater Treatment Plant and conveyance.

Large 2011 construction project expenditures include:

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

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

DEBT ADMINISTRATION

Water Quality issued $104.4 million of revenue and refunding bonds and $68.4 million of LTGO refunding bonds in April 2012 with an average life of 21.7 years at an average rate of 4.98 percent and an effective rate of 4.0 percent, $64.3 million of revenue refunding bonds and $41.7 million of LGTO refunding bonds in August 2012 with an average life of 16.7 years at an average rate of 4.86 percent and effective rate of 3.66 percent, and $65.4 million of revenue refunding bonds and $53.4 million in LTGO refunding bonds in September 2012 with an average life of 17.4 years at an average rate of 4.91 percent and an effective rate of 3.62 percent. In December 2012, Water Quality issued $100 million in variable rate revenue bonds.

Water Quality issued $175 million of revenue bonds in January 2011 with an average life of 19.5 years at an average rate of 5.19 percent and an effective rate of 4.90 percent, $494.3 million of revenue and refunding bonds in August with an average life of 12.8 years at an average rate of 4.99 percent and effective rate of 3.79 percent, and $32.5 million of revenue refunding bonds in October 2011 with an average life of 20 years at an average rate of 4.88 percent and an effective rate of 4.24 percent. In October 2011, Water Quality issued $100 million in variable rate revenue bonds.

Water Quality received $15.3 million in low-interest loans from the state of Washington in 2012 and $1.2 million in 2011. The loans carry below-market rates between 0.5 percent and 2.8 percent with repayment terms up to 20 years.

Water Quality has $2.8 billion of sewer revenue bonds and variable rate revenue bonds outstanding at the end of 2012 and $2.7 billion outstanding at the end of 2011. 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, including receipts from sewage treatment fees, and other income of Water Quality. Revenue bonds are not guaranteed by the full faith and credit of King County.

At the end of 2012, Water Quality has $821 million of general obligation bonds and variable rate general obligation bonds outstanding and $828 million of general obligation bonds and variable rate general obligation bonds outstanding at the end of 2011. Although repaid from a portion of receipts from sewage treatment fees and other income, the full faith and credit of King County guarantees repayment of principal and interest on general obligation bonds.

King County received long-term ratings of AAA from Standard and Poor's for the multimodal limited tax general obligation bond issued in January 2010 and "Aa1" from Moody's Investor's with short-term ratings of "VMIG 1" and "A-1+". At the time of the issuance of the sewer revenue bonds in 2012 and 2011, Water Quality's bond ratings were:

Moody's Investor's Service	Standard & Poor's
Aa2	AA+

As required by bond covenant, Water Quality maintains a bond reserve account, which is funded by cash balances and surety policies. At December 31, 2012, the cash balance in the reserve account was $170.3 million and $153.2 million at the end of 2011. In addition to bond covenant reserves, Water Quality also maintains financial policy reserves. At December 31, 2012 and 2011, respectively, the rate stabilization, liquidity, and asset management financial policy reserves totaled $94.2 million and $107.5 million.

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

DEBT SERVICE COVERAGE RATIOS

	FY 2012	FY 2011
Parity Debt	1.36	1.42
Total Debt	1.28	1.32

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

REQUESTS FOR INFORMATION

This financial report is designed to provide an overview of Water Quality's financial condition as of the years ended December 31, 2012 and 2011. Questions concerning this report or requests for additional information should be addressed to Manny Cristobal, Interim Chief Accountant for King County, 500 Fourth Avenue, Room 653, Seattle, WA 98104.

KING COUNTY WATER QUALITY ENTERPRISE FUND
STATEMENTS OF NET POSITION
DECEMBER 31, 2012 AND 2011
(in thousands)

ASSETS

	2012	2011
CURRENT ASSETS		
Cash and cash equivalents	$ 116,800	$ 4,052
Restricted cash and cash equivalents	135,449	234,673
Accounts receivable, net	42,569	33,274
Inventory of supplies	6,972	6,332
Due from other funds	2,321	3,175
Prepayments	144	77
	304,255	281,583
NONCURRENT ASSETS		
Revenue fund		
Cash and cash equivalents	79,200	76,523
Accounts receivable, net	325	325
Construction fund—cash and cash equivalents	-	1,167
Bond fund—cash and cash equivalents	170,259	153,204
	249,784	231,219
Capital assets		
Building and land improvements	1,872,943	1,730,562
Artwork	5,520	4,817
Infrastructure and right of way	2,131,466	1,353,990
Plant in service and other equipment	1,018,686	969,655
Less accumulated depreciation	(1,423,889)	(1,299,758)
	3,604,726	2,759,266
Land and easements	244,663	229,930
Construction work in progress	291,826	1,072,858
	4,141,215	4,062,054
Other noncurrent		
Regulatory assets - environmental remediation	46,918	48,536
Other utility assets, net of amortization	29,731	28,634
Deferred environmental remediation costs	4,675	4,912
Other deferred charges	21,145	26,966
	102,469	109,048
TOTAL ASSETS	$ 4,797,723	$ 4,683,904

See accompanying notes.

KING COUNTY WATER QUALITY ENTERPRISE FUND
STATEMENTS OF NET POSITION (CONTINUED)
DECEMBER 31, 2012 AND 2011
(in thousands)

LIABILITIES AND NET POSITION

	2012	2011
CURRENT LIABILITIES		
Accounts payable	$ 30,619	$ 33,043
Interest payable	80,520	74,399
Wages and benefits payable	4,471	3,643
Compensated absences	617	405
Taxes payable	4	-
Unearned revenue	865	-
Environmental remediation costs	6,246	5,104
Notes payable	100,000	100,000
State loans payable	8,841	8,599
Due to other funds	851	1,347
Interfund loans payable	20,158	39,583
General obligation bonds payable	3,435	2,730
Revenue bonds payable	39,290	39,005
	295,917	307,858
NONCURRENT LIABILITIES		
Retainage payable	-	18
Compensated absences	10,632	10,799
Other post-employment benefits	1,040	856
General obligation bonds payable	817,180	825,155
Revenue bonds payable	2,802,465	2,670,710
Deferred bond premium, discount, and refunding losses	70,877	50,954
Rate stabilization	62,600	76,500
Environmental remediation costs	28,955	32,318
State loans payable	127,161	120,677
	3,920,910	3,787,987
Total liabilities	4,216,827	4,095,845
NET POSITION		
Net investments in capital assets	221,227	298,014
Restricted for		
Debt service	221,825	265,305
Regulatory assets and environmental liabilities	32,992	32,017
Unrestricted	104,852	(7,277)
Total net position	580,896	588,059
TOTAL	$ 4,797,723	$ 4,683,904

KING COUNTY WATER QUALITY ENTERPRISE FUND
STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET POSITION
YEARS ENDED DECEMBER 31, 2012 AND 2011
(in thousands)

	2012	2011
OPERATING REVENUES		
Sewage disposal fees	$ 321,066	$ 280,907
Other operating revenues	60,809	56,523
Total operating revenues	381,875	337,430
OPERATING EXPENSES		
Sewage treatment, disposal, and transmission	92,595	77,019
General and administrative	22,344	26,976
Environmental related amortization	2,035	2,376
Depreciation and amortization	135,391	108,384
Total operating expenses	252,365	214,755
OPERATING INCOME	129,510	122,675
NONOPERATING REVENUES (EXPENSES)		
Investment earnings	2,141	2,824
Interest	(140,153)	(103,807)
Amortization of debt related accounts	739	(144)
Loss on disposal and impairment of capital assets	(1,556)	(3,900)
Other	2,156	706
Total nonoperating expenses	(136,673)	(104,321)
INCOME (LOSS) BEFORE GRANTS AND CONTRIBUTIONS	(7,163)	18,354
CAPITAL GRANT REVENUES	-	7,311
CHANGE IN NET POSITION	(7,163)	25,665
NET POSITION		
Beginning of year	588,059	562,394
End of year	$ 580,896	$ 588,059

 See accompanying notes.

KING COUNTY WATER QUALITY ENTERPRISE FUND
STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 31, 2012 AND 2011
(in thousands)

	2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash received from customers	$ 368,413	$ 369,436
Cash payments to suppliers for goods and services	(71,257)	(89,356)
Cash payments for employee services	(39,541)	(41,573)
Net cash provided by operating activities	257,615	238,507
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
Operating grant and subsidy received	190	-
Transfers out	(275)	(11)
Interfund loan principal received	20,158	39,583
Interfund loan principal paid	(39,583)	(96,313)
Interest paid on short-term loans	-	(1,581)
Assistance to other agencies	(130)	-
Net cash used in noncapital financing activities	(19,640)	(58,322)
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Acquisition of capital and other utility assets	(198,764)	(270,797)
Proceeds from disposal of capital assets	36	-
Financing of environmental remediation	(2,401)	(3,930)
Principal paid on capital debt	(50,388)	(535,876)
Interest paid on capital debt	(159,750)	(114,692)
Proceeds of new bond issuance	187,915	801,715
Proceeds of state loans	15,325	1,177
Capital grants received	-	7,311
Other receipts	-	706
Net cash used in capital and related financing activities	(208,027)	(114,386)
CASH FLOWS FROM INVESTING ACTIVITIES		
Interest and realized gains	2,141	2,824
NET INCREASE IN CASH AND CASH EQUIVALENTS	32,089	68,623
CASH AND CASH EQUIVALENTS		
Beginning of year	469,619	400,996
End of year	$ 501,708	$ 469,619

See accompanying notes.

(in thousands)

	2012	2011
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES		
Operating income	$ 129,510	$ 122,675
Adjustments to reconcile operating income to net cash provided by operating activities		
Depreciation and amortization	137,426	110,760
Other nonoperating revenue	8,734	-
Changes in assets		
Accounts receivable	(9,177)	(5,714)
Due from other funds	15	2,670
Due from other governments	-	9,550
Inventory of supplies	(640)	(574)
Prepayments	(68)	-
Changes in liabilities		
Accounts payable	2,855	(24,583)
Due to other funds	849	(721)
Retainage payable	19	(1,322)
Taxes payable	(31)	-
Unearned revenue	865	-
Rate stabilization	(13,899)	25,500
Wages and benefits payable	928	(47)
Compensated absences	45	130
Other post-employment benefits	184	183
Total adjustments	128,105	115,832
NET CASH PROVIDED BY OPERATING ACTIVITIES	$ 257,615	$ 238,507

NONCASH INVESTING, CAPITAL, AND FINANCING ACTIVITIES

Water Quality issued bonds in 2012 to refund debt issued in 2004 and 2005. The $371,443 thousand proceeds were placed in escrow for the defeasance of $334,150 thousand of outstanding bond principal and $37,293 thousand of interest.

Note 1 - Operations and Accounting Policies

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

Water Quality is an integral part of the County reporting entity and is included, as an enterprise fund, in the County's comprehensive annual financial report. As an enterprise fund, Water Quality is funded and operated separately from other operations of the County. Revenues, bond proceeds, and grants are restricted by purpose. Accordingly, Water Quality maintains separate accounting records and issues stand-alone financial statements.

Water Quality has long-term sewage disposal agreements with the cities and sewer districts that operate sewage collection systems within its service area. The monthly sewage disposal charge to the contracting cities and districts is based on Water Quality's estimated annual monetary requirements, including operating costs and debt service. Revenues from Water Quality's largest customer, the City of Seattle (Seattle Public Utilities), represent approximately 40 percent of total sewage disposal fees in 2012 and in 2011.

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 $31.5 million and $24.4 million in 2012 and 2011, respectively.

Significant Accounting Policies - Water Quality is accounted for using the flow of economic resources measurement focus similar to that of a private enterprise organized for profit. Water Quality's financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) as applied to governmental units using the accrual basis of accounting. Under this method, revenues are recorded when earned, and expenses are recorded at the time liabilities are incurred. Water Quality, regardless of the timing of cash flows, applies all applicable Governmental Accounting Standards Board (GASB) pronouncements.

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

b. *Due to/From Other Funds* - Due to/from other funds consists of current receivables/payables from or to other funds within the King County primary government. These typically arise from exchange transactions, reimbursements, and from authorized transfers to or from the other funds.

Note 1 - Operations and Accounting Policies (Continued)

c. *Interfund Loans Payable/Receivable* - Interfund loans consist of authorized short-term borrowing/lending between Water Quality and other funds within the King County primary government.

d. *Inventory of Supplies* - Inventory is recorded at the lower of cost or market using the weighted-average cost method. Materials and supplies are expensed as consumed. Inventory is written off in the year that it is determined obsolete.

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

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

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

Water Quality capitalizes certain interest income and expense related to borrowings until the assets are ready for their intended use. The amount capitalized is the difference between the interest revenue and interest expense associated with the applicable tax free borrowings, applied to assets under construction. Total interest incurred was $165.7 million and $159.6 million during the years ended December 31, 2012 and 2011, respectively, of which $25.5 million and $55.8 million, respectively, was capitalized.

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

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

Note 1 - Operations and Accounting Policies (Continued)

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

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

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

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

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

j. *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.

k. *Capital Grant Revenues* - Pursuant to GASB Statement No. 33, Accounting and Financial Reporting for Nonexchange Transactions, grant revenues are reported separately from operating and nonoperating revenues as capital grant revenues. Water Quality received capital grant revenues of $7.3 million for the year ended December 31, 2011.

Note 1 - Operations and Accounting Policies (Continued)

l. *Net Position* - Resources set aside for debt services and other obligations, net of related liabilities, are classified as restricted net position on the statements of net position as their use is limited by externally-imposed restrictions. Capital assets, net of related debt, are reported as a separate component of net position. Any net position not subject to classification as restricted or invested in capital assets are reported as unrestricted.

m. *Reclassification* – Certain reclassifications were made to 2011 amounts to conform to 2012 presentation. These reclassifications did not have an impact on total change in net position.

New Accounting Standards - GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncement*, was issued in December 2010, which incorporates into the GASB's authoritative literature certain accounting and financial reporting guidance included in the Financial Accounting Standards Board (FASB) and American Institute of Certified Public Accountants (AICPA) pronouncements. This statement also supersedes Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*. The statement is effective for reporting periods beginning after December 15, 2011 and was adopted by Water Quality in 2012 without a material impact on its financial statements.

In June 2011, GASB issued Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*, which provides financial reporting guidance for deferred outflows and inflows of resources. The statement amends the net asset reporting requirements in Statement No. 34, *Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments*. This statement is effective for reporting periods beginning after December 15, 2011 and was adopted by Water Quality in 2012 without a material impact on its financial statements.

GASB Statement No. 65, *Items Previously Reported as Asset and Liabilities*, was issued in March 2012. This statement establishes accounting and financial reporting standards that reclassify, as deferred outflows of resources or deferred inflows of resources, certain items that were previously reported as assets and liabilities and recognizes, as outflows of resources or inflows of resources, certain items that were previously reported as assets and liabilities. The requirements of this statement are effective for financial statements for periods beginning after December 15, 2012. Water Quality is currently evaluating the impact of the adoption of this standard on its financial statements.

GASB Statement No. 67, *Financial Reporting for Pension Plans—an amendment of GASB Statement No. 25*, was issued in June 2012. This statement replaces the requirements of Statements No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and Statement No. 50, *Pension Disclosures*. This statement applies to pension plan reporting and is effective for financial statements for periods beginning after June 15, 2013. Water Quality is currently evaluating the impact of the adoption of this standard on its financial statements.

Note 1 - Operations and Accounting Policies (Continued)

GASB Statement No. 68, *Accounting and Financial Reporting for Pensions—an amendment of GASB Statement No. 27*, was issued in June 2012. This statement replaces the requirements of Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, as well as the requirements of Statement No. 50, *Pension Disclosures*. This Statement applies to pension reporting for the sponsoring state or local governmental entity, and is effective for fiscal years beginning after June 15, 2014. Water Quality is currently evaluating the impact of the adoption of this standard on its financial statements.

Note 2 - Deposits and Investments

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

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

The County has deposit and investment policies addressing risks that have the potential to result in losses of deposits and investments. All deposits not insured by the Federal Depository Insurance Corporation (FDIC) are fully collateralized by the Public Deposit Protection Commission of the State of Washington (PDPC), a statutory authority established under chapter 39.58 RCW. It constitutes a multiple financial institution collateral pool that can make pro rata assessments to all public depositaries within the state for their public deposits. PDPC protection is of the nature of collateral, not of insurance. The custodial credit risk for deposits is the risk that Water Quality's deposits may not be returned to it in the event of a bank failure. Assessing Water Quality's risk exposure, Water Quality's cash and cash equivalents balance of $501.7 million and $469.6 million were fully insured and collateralized as of December 31, 2012 and 2011, respectively.

Note 2 - Deposits and Investments (Continued)

Credit Risk - Investments: Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligation. As of December 31, 2012, the Pool was not rated by a Nationally Recognized Statistical Rating Organization (NRSRO). In compliance with state statutes, Pool policies authorize investments in U.S. Treasury securities, U.S. agency securities and mortgage-backed securities, municipal securities (rated at least “A” by two NRSROs), commercial paper (rated at least the equivalent of “A-1” by two NRSROs), certificates of deposit issued by qualified public depositaries, repurchase agreements, and the Local Government Investment Pool managed by the Washington State Treasurer’s office. The Pool’s policies limit the maximum amount that can be invested in various securities. At 2012 and 2011 year-end the Pool was in compliance. The Pool’s actual composition, as of December 31, 2012, consisted of Repurchase Agreements, 3.2 percent; U.S. Agency Discount Notes, 8.5 percent; U.S. Treasury Notes, 36.1 percent; U.S. Agency Notes, 34.8 percent; U.S. Agency Mortgage Backed Securities, 0.4 percent, and the State Treasury’s Investment Pool, 17.0 percent. The December 31, 2011 composition comprised U.S. Treasury Notes, 20.7 percent; U.S. Agency Notes, 61.8 percent; U.S. Agency Mortgage Backed, 0.5 percent, and the State Treasurer’s Investment Pool, 17.0 percent.

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

Concentration of Credit Risk - Investments: Concentration of credit risk is the risk of loss attributed to the magnitude of a government’s investment in a single issue. At 2012 year-end the Pool had concentrations greater than 5 percent of the total investment pool portfolio in the following issues: Federal Home Loan Mortgage Corporation-15.2 percent, Federal National Mortgage Association-13.6 percent, Federal Home Loan Bank-5.8 percent, and Federal Farm Credit Bank-9.0 percent. The issues with concentrations greater than 5 percent of the pool portfolio at 2011 year-end were as follows: Federal Home Loan Mortgage Corporation-15 percent, Federal National Mortgage Association-24 percent, Federal Home Loan Bank-15 percent, and Federal Farm Credit Bank-8 percent.

Interest Rate Risk - Investments: Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. Through its investment policy, the County manages its exposure to fair value losses arising from increasing interest rates by setting maturity and effective duration limits for the Pool. The policy limit for the Pool’s maximum effective duration is 1.5 years, and 40 percent of the Pool’s total value in securities must have a maturity of 12 months or fewer. Securities in the portfolio cannot have an average life greater than five years at purchase. The combined effective duration of the liquidity and core portfolios was 1.357 years and 0.724 years, respectively, at December 31, 2012 and 2011.

Note 2 - Deposits and Investments (Continued)

As of December 31, 2012, the Pool has four impaired commercial paper investments which have completed enforcement events. The County completed the restructuring of three of the four securities in 2008 and completed the restructuring of the fourth security in 2009. The Pool has suspended investments in commercial paper securities since 2007. Water Quality's share of the unrealized loss from the Pool's impaired investments was $880 thousand at December 31, 2012 and $926 thousand at December 31, 2011. Losses from impaired investments are offset against other investment earnings.

Note 3 - Restricted Assets

A significant portion of Water Quality's assets is restricted as to use by legal and contractual provisions and by fiscal management policy. Restricted assets comprise $385.2 million in 2012 and $465.9 million in 2011 to comply with debt service, bond reserve, and other requirements. Current restricted assets consist of cash reserved to fund the current portion of long-term debt, prefunded interest payments, the current portion of the retainage held on contractual payments, and other obligations, totaling $135.4 million in 2012 and $234.7 million in 2011. The non-current restricted assets consist primarily of cash reserved to fund the non-current portion of the retainage held on contractual payments, $1.2 million in 2011, bond reserves of $170.3 million in 2012 and $153.2 million in 2011, and other requirements of $79.2 million in 2012 and $76.5 million in 2011.

Note 4 - Risk Management

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

Water Quality participates in three County internal service funds to account for and finance its (1) property/casualty, (2) workers' compensation, and (3) employee medical and dental benefits, through self-insurance programs. The County contracts with a plan administrator to process medical and dental claims. County fund/claims managers, together with the Civil Division of the King County Prosecuting Attorney's Office, are responsible for processing all tort and workers' compensation claims.

During 2012 and 2011, Water Quality claims paid by the Insurance Fund of King County were $293 thousand and $376 thousand, respectively. In the past three years there was no occurrence that resulted in payment in excess of the self-insured retention of $7.5 million.

Note 4 - Risk Management (Continued)

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

Water Quality retains all risk associated with environmental claims.

Note 5 - Long-Term Liabilities and Notes Payable

Sewer Revenue Bonds - As of December 31, 2012, bonds outstanding include $2,841.8 million of serial and term bonds maturing from January 1, 2013 through January 1, 2052, bearing interest at stated rates of 1.00 percent to 5.75 percent per annum.

On April 18, 2012, Water Quality issued $104.4 million in sewer revenue and refunding bonds and $68.4 million in limited tax GO refunding bonds (payable from sewer revenues), Series A, with an effective interest cost of 2.7 percent to advance refund $26.1 million of outstanding sewer revenue bonds, 2004A, and $71.7 million of limited tax GO bond (sewer revenues) bonds, 2005A, with an effective interest rate of 4.8 percent. The reacquisition price exceeded the net carrying amount of the old debt by $10.7 million. This advance refunding was undertaken to reduce total debt service payments by $8.2 million over the life of the bonds, resulting in an economic gain (difference between the present values of the old and new debt service payments) of $6.8 million.

On August 8, 2012, Water Quality issued $64.3 million in sewer revenue refunding bonds and $41.7 million in limited tax GO refunding bonds (payable from sewer revenues), Series B, with an effective interest cost of 3.7 percent to advance refund $67.9 million of outstanding sewer revenue bonds, 2004A, and $43.8 million of limited tax GO bond (sewer revenues) bonds, 2005A, with an effective interest rate of 4.8 percent. The reacquisition price exceeded the net carrying amount of the old debt by $8.8 million. This advance refunding was undertaken to reduce total debt service payments by $10.2 million over the life of the bonds, resulting in an economic gain (difference between the present values of the old and new debt service payments) of $7.0 million.

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

On September 19, 2012, Water Quality issued $65.4 million in sewer revenue refunding bonds and $53.4 million in limited tax GO refunding bonds (payable from sewer revenues), Series C, with an effective interest cost of 3.6 percent to advance refund $69.1 million of outstanding sewer revenue bonds, 2004A and 2006, and $55.6 million of limited tax GO bond (sewer revenues) bonds, 2005A, with an effective interest rate of 4.8 percent. The reacquisition price exceeded the net carrying amount of the old debt by $11.6 million. This advance refunding was undertaken to reduce total debt service payments by $10.8 million over the life of the bonds, resulting in an economic gain (difference between the present values of the old and new debt service payments) of $7.5 million.

In 2012, Water Quality issued $100.0 million in Sewer Jr Lien variable rate demand bonds to fund capital projects.

Bond issues provide funding for Water Quality's construction plan. Certain serial bonds may not be redeemed prior to maturity; other bonds may be redeemed at declining premiums after the lapse of specific periods of time. Amounts from the sewer revenue bond fund may be used to purchase term bonds prior to maturity.

The bonds are secured by a pledge of the revenue of the sewer system subject to payment of all operating and maintenance expenses of the sewer system. Payments from revenues of Water Quality are required to be made to the sewer revenue bond fund in annual amounts sufficient to retire serial or term bonds on or before maturity. 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, 2012, Water Quality is in compliance with the combined amount required for the reserve and surety policies.

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

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

	Final Maturity	Interest Rates	Original Issue Amount	Outstanding at December 31, 2012
2001A-B Jr Lien Variable	1/1/32	(variable)	$ 100,000	$ 100,000
2003A Refunding	1/1/35	2.00-5.25%	96,470	89,380
2004B Refunding	1/1/35	2.00-5.00%	61,760	53,095
2006 Refunding	1/1/36	5.00%	124,070	102,970
2006 (2nd Series) Refunding	1/1/36	3.50-5.00%	193,435	179,870
2007	1/1/47	5.00%	250,000	250,000
2008	1/1/48	5.00-5.75%	350,000	350,000
2009	1/1/42	4.00-5.25%	250,000	250,000
2010	1/1/50	2.00-5.00%	334,365	334,215
2011	1/1/41	5.00-5.125%	175,000	175,000
2011 Series B	1/1/41	1.00-5.00%	494,270	490,660
2011 Series C	1/1/35	3.00-5.00%	32,445	32,445
2011 Sewer Jr Lien Variable	1/1/42	(variable)	100,000	100,000
2012A Refunding	1/1/52	5.00%	104,450	104,445
2012B Refunding	1/1/35	4.00-5.00%	64,260	64,260
2012C Refunding	1/4/33	2.50-5.00%	65,415	65,415
2012 Sewer Jr Lien Variable	1/1/43	(variable)	100,000	100,000
			$ 2,895,940	$ 2,841,755

General Obligation Bonds - As of December 31, 2012, bonds outstanding include $820.6 million of serial and term bonds maturing January 1, 2013 through 2040, bearing interest at stated rates of 2.20 percent to 5.25 percent per annum.

In 2012, Water Quality issued $3.0 million of Limited Tax General Obligation (LTGO) bonds maturing December 31, 2022. 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.

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

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

	Final Maturity	Interest Rates	Original Issue Amount	Outstanding at December 31, 2012
2005 LTGO	1/1/35	5.00%	$ 200,000	$ 28,925
2008 LTGO	1/1/34	3.25-5.25%	236,950	225,155
2009B LTGO	7/1/39	5.00-5.25%	300,000	300,000
2010A-B Multi-Modal LTGO	1/1/40	(variable)	100,000	100,000
2012A LTGO	1/1/25	2.00-5.00%	68,395	68,395
2012B LTGO	1/1/29	5.00%	41,725	41,725
2012C LTGO	1/1/34	5.00%	53,405	53,405
2012F LTGO	12/1/22	2.20%	3,010	3,010
			$ 1,003,485	$ 820,615

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 2013 through 2033 and bear interest at stated rates from 0.00 percent to 3.10 percent. As of December 31, 2012, the balance due on all state loans is $136.0 million. Water Quality maintains separate cash reserves of $8.3 million. These reserves are treated as restricted, being required under the Revolving Fund Loan Program.

At December 31, 2012, the required principal and interest payments for all classes of long-term debt are as follows (in thousands):

	Revenue Bonds		General Obligation Bonds		State Loans		
Year(s) Beginning	Principal	Interest	Principal	Interest	Principal	Interest	Total
January 1, 2013	$ 39,290	$ 135,501	$ 3,435	$ 39,481	$ 8,841	$ 2,281	$ 228,829
January 1, 2014	47,320	134,339	8,750	39,969	9,261	2,153	241,792
January 1, 2015	49,485	132,137	9,000	39,527	9,696	2,009	241,854
January 1, 2016	51,845	129,739	9,420	39,089	9,838	1,858	241,789
January 1, 2017	42,225	127,537	21,000	38,353	9,909	1,705	240,729
January 1, 2018—2022	244,185	604,045	124,480	174,517	48,523	6,168	1,201,918
January 1, 2023—2027	310,470	536,458	154,700	139,601	29,893	2,610	1,173,732
January 1, 2028—2032	496,725	448,384	197,340	96,154	9,538	583	1,248,724
January 1, 2033—2037	450,185	311,364	152,900	48,152	503	7	963,111
January 1, 2038—2042	444,470	203,237	139,590	15,389	-	-	802,686
January 1, 2043—2047	540,670	79,776	-	-	-	-	620,446
January 1, 2048—2052	124,885	10,381	-	-	-	-	135,266
	$ 2,841,755	$ 2,852,898	$ 820,615	$ 670,232	$ 136,002	$ 19,374	$ 7,340,876

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

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

Commercial Paper (Notes Payable) - In December 1995, Water Quality initiated a commercial paper program that gives Water Quality the ability to issue up to $100.0 million. The program is supported by an annually renewable line of credit that expires November 30, 2015. As of December 31, 2012, $100.0 million was issued and outstanding under this program. The commercial paper has maturities ranging between 62 and 94 days and is classified as a current liability of Water Quality's operating fund. Changes in short-term note payables for the year ended December 31, 2012 and 2011 were as follows (in thousands):

	Balance January 1, 2012	Additions	Reductions	Balance December 31, 2012
Commercial paper	$ 100,000	$ 1,173,650	$ (1,173,650)	$ 100,000

	Balance January 1, 2011	Additions	Reductions	Balance December 31, 2011
Commercial paper	$ 100,000	$ 909,110	$ (909,110)	$ 100,000

Variable Rate General Obligation and Revenue Bonds - The variable rate bonds, 2001 Series A and Series B revenue bonds are supported by a periodically renewable letter of credit that expires December 31, 2015. The variable rate bonds, 2010 Series A and Series B general obligation bonds are supported by a Standby Bond Purchase Agreement that expires January 21, 2013. The variable rate bonds, 2011 and 2012 Sewer Jr Lien variable rate demand bonds, do not have a liquidity facility.

Financial Policy Reserves - In addition to bond reserves related to Sewer Revenue Bonds, Water Quality maintains liquidity and asset management reserves totaling $31.6 million at December 31, 2012.

Compliance with Bond Resolutions - With respect to the year ended December 31, 2012, Water Quality complied with all financial covenants stipulated by its bond resolutions.

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

Changes in Long-Term Liabilities - Long-term liability activity for the years ended December 31, 2012 and 2011 was as follows (in thousands):

	Balance January 1, 2012	Additions	Reductions	Balance December 31, 2012	Due Within One Year
Bonds payable	$ 3,537,600	$ 500,655	$ (375,885)	$ 3,662,370	$ 42,725
Bond premiums and discounts	122,365	52,891	(9,950)	165,306	-
Refunding losses	(71,411)	(31,055)	8,037	(94,429)	-
Total bonds payable	3,588,554	522,491	(377,798)	3,733,247	42,725
Retainage payable	1,167	683	(1,485)	365	365
State loans	129,276	15,325	(8,599)	136,002	8,841
Compensated absences	11,204	744	(699)	11,249	617
Other post-employment benefits	856	246	(62)	1,040	-
Environmental remediation	37,422	180	(2,401)	35,201	6,246
Rate stabilization	76,500		(13,900)	62,600	-
Total long-term liabilities	$ 3,844,979	$ 539,669	$ (404,944)	$ 3,979,704	$ 58,794

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

Note 6 - Changes in Capital Assets

Changes in capital assets for the years ended December 31, 2012 and 2011 are shown in the following table (in thousands):

	Balance January 1, 2012	Increases	Decreases	Balance December 31, 2012
Land	$ 218,461	$ 14,734	$ (1)	$ 233,194
Easements	11,469	-	-	11,469
Construction work in progress	1,072,858	164,276	(945,308)	291,826
Total nondepreciable assets	1,302,788	179,010	(945,309)	536,489
Buildings	1,671,702	144,069	(7,518)	1,808,253
Land improvements	58,860	6,383	(553)	64,690
Right of way	7,635	-	-	7,635
Infrastructure	1,346,355	777,924	(448)	2,123,831
Artwork	4,817	703	-	5,520
Major equipment and vehicles	9,904	52	-	9,956
Shop and other equipment	927,083	56,773	(8,365)	975,491
Software development	32,668	2,967	(2,396)	33,239
Total depreciable assets	4,059,024	988,871	(19,280)	5,028,615
Accumulated depreciation and amortization:				
Building	(464,351)	(48,045)	500	(511,896)
Land improvements	(16,068)	(2,389)	-	(18,457)
Right of way	(55)	(473)	255	(273)
Infrastructure	(360,756)	(30,413)	57	(391,112)
Artwork	(157)	(177)	-	(334)
Major equipment and vehicles	(8,075)	(231)	-	(8,306)
Shop and other equipment	(432,428)	(45,255)	3,017	(474,666)
Software development	(17,868)	(3,252)	2,275	(18,845)
Total depreciation and amortization	(1,299,758)	(130,235)	6,104	(1,423,889)
Depreciable assets - net	2,759,266	858,636	(13,176)	3,604,726
Total capital assets - net	$ 4,062,054	$ 1,037,646	$ (958,485)	$ 4,141,215

Note 6 - Changes in Capital Assets (Continued)

	Balance January 1, 2011	Increases	Decreases	Balance December 31, 2011
Land	$ 129,952	$ 88,509	$ -	$ 218,461
Easements	21,475	27	(10,033)	11,469
Construction work in progress	1,992,454	273,735	(1,193,331)	1,072,858
Total nondepreciable assets	2,143,881	362,271	(1,203,364)	1,302,788
Building	1,194,050	495,517	(17,865)	1,671,702
Land improvements	24,687	34,173	-	58,860
Right of way	-	7,635	-	7,635
Infrastructure	1,064,898	281,871	(414)	1,346,355
Artwork	418	4,399	-	4,817
Major equipment and vehicles	9,936	1	(33)	9,904
Shop and other equipment	638,712	315,727	(27,356)	927,083
Software development	12,482	20,186	-	32,668
Total depreciable assets	2,945,183	1,159,509	(45,668)	4,059,024
Accumulated depreciation and amortization:				
Building	(439,314)	(31,956)	6,919	(464,351)
Land improvements	(14,947)	(1,121)	-	(16,068)
Right of way	-	(55)	-	(55)
Infrastructure	(336,624)	(26,927)	2,795	(360,756)
Artwork	(92)	(65)	-	(157)
Major equipment and vehicles	(7,872)	(231)	28	(8,075)
Shop and other equipment	(418,900)	(46,130)	32,602	(432,428)
Software development	(12,329)	(5,551)	12	(17,868)
Total depreciation and amortization	(1,230,078)	(112,036)	42,356	(1,299,758)
Depreciable assets - net	1,715,105	1,047,473	(3,312)	2,759,266
Total capital assets - net	$ 3,858,986	$ 1,409,744	$ (1,206,676)	$ 4,062,054

Note 7 - Environmental Remediation

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

Note 7 - Environmental Remediation (Continued)

Water Quality follows GASB Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations* (GASB 49), which mandates the disclosure of "obligations to address current or potential detrimental effects of existing pollution by participating in pollution remediation activities." GASB 49 establishes five events, any one of which obligates Water Quality to record a liability for pollution remediation expenditures. Liabilities are related to ongoing projects, which include the sediment management of aquatic habitats along Elliot Bay and the clean-up of certain sites along the Lower Duwamish Waterway (LDW).

The Sediment Management Project has been approved by the Metropolitan King County Council as a self-obligated pollution remediation program. The LDW project became a Water Quality obligation when King County entered into an Administrative Order on Consent (AOC) with the DOE and EPA. This AOC also includes The Boeing Company, the City of Seattle and the Port of Seattle as parties conduct the studies on which to base the cleanup decision.

Both projects may result in additional cleanup efforts as a result of additional regulatory orders. These potential cleanup liabilities cannot be currently estimated. Ongoing, regulatory action may identify other Potentially Responsible Parties (PRP) for the LDW cleanup.

There are no estimated recoveries at this time that will reduce the amount of Water Quality's pollution remediation obligations. However, the State of Washington has indicated that it intends to fund grants in support of Water Quality's LDW cleanup. The total environmental remediation liability at December 31, 2012 stands at $35.2 million and $37.4 million in 2011.

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

The methodology for estimating liabilities continues to be based on Water Quality engineering analysis, program experience and cost projections for the remediation activities scheduled to be undertaken in future years as programmed under Water Quality's Regional Wastewater Services Plan. Certain costs were developed by consulting engineers. Costs were estimated using the expected cash flow method set out by GASB 49. For the LDW project a weighted average method is used to calculate the liability. The Sediment Management Plan does not employ weighted average cost estimation because the remaining work is well-defined and negates the utility of multiple estimates. The cost estimates continue to be re-measured as succeeding benchmarks are reached or when cost assumptions are modified. All pollution remediation obligations are being deferred as permitted by regulatory accounting standards (see Note 8 - Regulatory Deferrals).

Note 8 - Regulatory Deferrals

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

Rate Stabilization - In 2005, the Council established a Rate Stabilization Reserve. This action created a regulatory liability which deferred operating revenue to be set aside in a reserve and recognized in subsequent years to maintain stable sewer rates. The reserve was $76.5 million in 2011 and decreased by $13.9 million to $62.6 million in 2012.

Pollution Remediation - In 2006, the Council approved the application of regulatory accounting to treat pollution remediation obligations as regulatory assets to allow for cost recovery through future rate increases. The portion of regulatory asset costs that have been accrued is being amortized over a recovery period of 30 years.

Note 9 - Employee Benefit Plans

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

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

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

Note 9 - Employee Benefit Plans (Continued)

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

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

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

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

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

Note 9 - Employee Benefit Plans (Continued)

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

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

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

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

Each biennium, the state Pension Funding Council adopts Plan 1 employer contribution rates, Plan 2 employer and employee contribution rates, and Plan 3 employer contribution rates. Employee contribution rates for Plan 1 are established by statute at 6.0 percent for state agencies and local government unit employees, and at 7.5 percent for state government elected officials. The employer and employee contribution rates for Plan 2 and the employer contribution rate for Plan 3 are developed by the Office of the State Actuary to fully fund Plan 2 and the defined benefit portion of Plan 3. All employers are required to contribute at the level established by the Legislature. Under PERS Plan 3, employer contributions finance the defined benefit portion of the plan, and member contributions finance the defined contribution portion. The Employee Retirement Benefits Board sets Plan 3 employee contribution rates. Six rate options are available ranging from 5 to 15 percent; two of the options are graduated rates dependent on the employee’s age.

Note 9 - Employee Benefit Plans (Continued)

Water Quality's contribution rates expressed as a percentage of covered payrolls as of December 31, 2012 were as follows:

	PERS Plan 1	PERS Plan 2	PERS Plan 3
Employer	7.21%	7.21%	7.21%
Employee	6.00%	4.64%	5.00%-15.00%

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

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

	PERS	
	Plan I	Plans II and Ill
2012	$ 98	$ 3,657
2011	$ 124	$ 3,665
2010	$ 119	$ 3,107

Note 10 - Operating Subsidies and Grant Revenues

Various federal and state government agencies make grants to Water Quality to aid in financing construction costs (capital grants), including those on various projects included in the comprehensive plan, and for operating costs (operating subsidies). Operating subsidies are recorded as revenues in the statements of revenues, expenses, and changes in net position. Capital grants amounted to $7.3 million for the year ended December 31, 2011.

Note 11 - Other Post-Employment Benefits

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

Note 11 - Other Post-Employment Benefits (Continued)

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

Funding Policy - Law Enforcement Officers' and Fire Fighters' Retirement System Plan (LEOFF) 1 retirees are not required to contribute to the Health Plan. All other retirees are required to pay the COBRA rate associated with the elected plan. Water Quality contributed an estimated $62 thousand to the Health Plan during both 2012 and 2011. The contribution was entirely to fund "pay-as-you-go" costs under the Health Plan and not to advance fund the cost of benefits.

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

Water Quality's allocated annual OPEB costs, the percentage of annual OPEB cost contributed to the Health Plan, and the net OPEB obligation for the years ended December 31, 2012 and 2011 were as follows (in thousands):

	2012	2011
Normal cost - Unit Credit Method	$ 216	$ 215
Amortization of unfunded actuarial accrued liability (UAAL)	33	33
Annual Required Contribution (ARC)	249	248
Interest on net OPEB obligation	3	3
Adjustment to annual required contribution	(6)	(6)
Annual OPEB cost (expense)	246	245
Contributions made	(62)	(62)
Increase in net OPEB obligation	184	183
Net OPEB obligation - beginning of year	856	673
Net OPEB obligation - end of year	$ 1,040	$ 856

Year Ended	Annual OPEB Cost	Percentage of Annual OPEB Cost Contributed	Net OPEB Obligation
12/31/2012	$ 246	25.2%	$ 1,040
12/31/2011	$ 245	25.3%	$ 856
12/31/2010	$ 252	32.5%	$ 673

Note 11 - Other Post-Employment Benefits (Continued)

Required Supplementary Information: Funded Status and Funding Progress - The funded status of the Health Plan as of December 31, 2012 and 2011 was as follows (in thousands):

	2012	2011	2010
Actuarial Value of Plan Assets	$ -	$ -	$ -
Actuarial Accrued Liability (AAL)	178,502	178,502	149,390
Unfunded Actuarial Accrued Liability (UAAL)	$ 178,502	$ 178,502	$ 149,390
Funded Ratio (actuarial value assets/AAL)	0%	0%	0%
Covered Payroll (active plan members)	$ 961,982	$ 969,750	$ 969,082
UAAL as a percentage of covered payroll (AAL less actuarial value of assets/UAAL)	18.6%	18.7%	15.4%

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

The December 31, 2011 valuation used the projected unit credit actuarial cost method. The actuarial assumption included a 2.8 percent investment rate of return (net of administrative expenses) and an initial healthcare cost trend rate of 10.0 percent for KingCare medical, 8.0 percent for KingCare pharmacy, and 10.0 percent for HMO medical/pharmacy, each reduced by decrements to an ultimate rate of 4.2 percent after 71 years and 12 years for medical and pharmacy, respectively. The vision trend rate is 4.0 percent, the miscellaneous trend rate is 7.0 percent, and the Medicare premium trend rate is 7.0 percent, for all years. All trend rates include a 3.0 percent inflation assumption, with the exception of vision trends. The amortization of the UAAL at transition uses a level dollar amount on an open basis. The UAAL is recalculated each year and amortized as a level dollar amount on an open basis over 30 years.

Note 12 - Interfund Borrowing and Transfers

At December 31, 2012 and 2011, Water Quality had outstanding interfund short-term loans in the amount of $20.2 million and $39.6 million, respectively, borrowed from the King County Public Transportation Enterprise as authorized by the King County Executive Finance Committee. The loan proceeds were used to: 1) reimburse the operating fund that financed the early retirement of certain sewer revenue bonds, and 2) reimburse the construction fund for capital expenses incurred in anticipation of bond issuance in 2013 and 2012.

The King County Council approves ordinances and/or motions authorizing Water Quality to contribute and receive amounts to and from various County funds. During 2012 and 2011, the transfers to other funds from Water Quality were $275 thousand and $11 thousand, respectively.

Note 13 - Net Position Deficit

The deficit of $7.3 million in unrestricted net position in 2011 was the result of short-term borrowings by Water Quality from other County funds. Water Quality revenue bonds were issued in 2012 to cover the capital construction loans.

Note 14 - Commitments and Contingencies

Construction and Maintenance Programs - To ensure the continued operation, reliability, and compliance with regulatory standards of existing wastewater treatment facilities, Water Quality is committed to expending approximately $63.2 million on active construction contracts as of December 31, 2012.

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

Note 14 - Commitments and Contingencies (Continued)

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

- An administrative order from the EPA that requires the County, the City of Seattle, the Boeing Company, and the Port of Seattle to conduct a feasibility study to determine the nature and extent of the contamination in the Lower Duwamish Waterway. The feasibility study has been issued in final form by EPA. The proposed plan is subject to public comment and may be changed by EPA as a result. EPA has stated that it will issue a Record of Decision (ROD) in the first quarter of 2014. Due to the high level of regulatory review, the County is unable to determine the particular remediation alternative that may be required, the schedule and cost of any required remediation, or the extent of County responsibility.

- A potential requirement for more cleanup in the area contaminated when the Denny Way combined sewer outflow was replaced in 2005. The King County Wastewater Treatment Division (WTD) has already performed interim cleanup costing $3.6 million to comply with a formal agreement with the Washington State Department of Ecology, who reserves its rights to require additional remediation.

- Potential claims for past and future cleanup costs at the Harbor Island Superfund Site. Certain removal costs already incurred by the Port of Seattle are expected to be defrayed by the County and the City of Seattle. The parties have also agreed to share the cost of a supplemental investigation and feasibility study required by the EPA. The agreement states that WTD has only a one-third pro rata share of the study costs and that portion is still potentially allocable among the several potentially responsible parties. Further remediation costs cannot be reasonably estimated until the study is completed.

- A series of requests for change orders and claims for damages from the prime contractor for the Brightwater Treatment Plant central conveyance system alleging differing site conditions and defective specifications. The County vigorously defended against the claims and filed suit alleging contract default by the contractor for failure to complete the contract work within time limits. Contractor asserted damages of approximately $66 million. The County estimated its damages at $158 million. The County received a jury verdict of $155 million on December 21, 2012. The contractor received a verdict of $26.2 million. Rulings on post-trial motions were issued on April 19, 2013, leaving in place the verdict amounts. In addition, the rulings awarded the County its legal fees and denied motions for a new trial by the contractor. In April 2013, Water Quality received a net amount of $144.3 million related to this matter.

Note 14 - Commitments and Contingencies (Continued)

- In March 2011, a contractor initiated a suit against the County in the amount of $3.7 million related to the Juanita Bay Pump Station Replacement project alleging defective specifications. The County issued counterclaims in the amount of over $11.0 million. Prior to the December 2012 trial, the contractor settled with the County for a net payment of $4.8 million, which was paid in 2013.

- A claim by a vendor for additional compensation of approximately $427 thousand to cover unexpected tariff increases on imported construction materials. The dispute is still being handled through contract administration.

Note 15 - Subsequent Event

Water Quality issued $122.9 million of sewer revenue refunding bonds in April 2013. The proceeds of these bonds were used to refund all of the sewer revenue bonds, series 2003A, a portion of sewer revenue bonds, series 2006, and all of the outstanding limited tax general obligation bonds (payable from sewer revenues), series 2005.

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

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

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)	1.22

In 2001, Water Quality issued an additional tier of revenue bonds. The bond covenants of the Junior Lien Variable Rate Demand Sewer Revenue Bonds, Series 2001A and Series 2001B, require that sewage disposal rates provide net revenue equal to at least 1.10 times the annual debt service requirements for all Junior Lien obligations after payment of senior lien requirements. In 2010, Water Quality issued Multi-Modal Limited Tax General Obligation Sewer Revenue Bonds, series 2010A and 2010B, which incorporate the identical requirement as Junior Lien obligations.

Coverage (1.10 required by covenant)	22.60