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LESLIE I. TANAKA, CPA
CITY AUDITOR

January 7, 2009

Ms. Denise De Costa
City Clerk
City and County of Honolulu
Office of the City Clerk
530 South King Street, Room 100
Honolulu, Hawaii 96813

Dear Ms. De Costa:

Enclosed are two (2) copies of the Sewer Fund Financial Statements as of June 30, 2007 and 2006. The audit was conducted by Nishihama & Kishida, CPA's, Inc. in accordance with Contract No. C60637—Financial Audit of the City and County of Honolulu for the fiscal year ended June 30, 2007.

If you have any questions, please do not hesitate to call me at 768-3134.

Sincerely,

Leslie I. Tanaka, CPA
City Auditor

LT:ss
Enclosure

COUNCIL COM. 2

FINANCIAL AUDIT OF THE
CITY AND COUNTY OF HONOLULU
SEWER FUND

Fiscal Years Ended June 30, 2007 and 2006

NISHIHAMA & KISHIDA, CPAs, INC.

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CITY AND COUNTY OF HONOLULU
SEWER FUND

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NISHIHAMA & KISHIDA, CPAS, INC.
CERTIFIED PUBLIC ACCOUNTANTS

AMERICAN SAVINGS BANK TOWER
1001 BISHOP STREET, SUITE 1700
HONOLULU, HAWAII 96813-3696
TELEPHONE (808) 524-2255
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INDEPENDENT AUDITORS' REPORT

To the Chair and Members of the City Council
City and County of Honolulu
Honolulu, Hawaii

We have audited the accompanying statements of net assets of the Sewer Fund, City and County of Honolulu (Sewer Fund) as of June 30, 2007 and 2006, and the related statements of revenues, expenses and changes in net assets, and cash flows for the fiscal years then ended. These financial statements are the responsibility of the management of the Sewer Fund. Our responsibility is to express an opinion on these financial statements based on our audits.

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

As discussed in Note A, the financial statements of the Sewer Fund, are intended to present the financial position, and the changes in financial position and cash flows, of only that portion of the business-type activities of the City and County of Honolulu that is attributable to the transactions of the Sewer Fund. They do not purport to, and do not, present fairly the financial position of the City and County of Honolulu as of June 30, 2007 and 2006, and the changes in its financial position and its cash flows for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Sewer Fund as of June 30, 2007 and 2006, and the changes in its financial position and its cash flows for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Nishihama & Kishida, CPAs, Inc.

Honolulu, Hawaii
December 21, 2007

The following summary discussion and analysis of the financial statements, for fiscal years ended June 30, 2007 and 2006, are provided by the City and County of Honolulu's Wastewater Enterprise. The summary is designed to provide an introduction to the financial statements and the financial condition of the Wastewater Enterprise. We encourage readers to also review the financial statements as a whole.

Financial Highlights

- 105.1 million gallons per day of wastewater were collected and treated in fiscal year 2007, a decrease of 9.1% from fiscal year 2006 reflecting drier weather conditions. There were 115.8 million gallons per day of wastewater collected and treated in fiscal year 2006, an increase of 3.1% from fiscal year 2005 reflecting slightly more wet weather. As of June 30, 2007, the Wastewater Enterprise had approximately 142,000 customer accounts and served approximately 640,000 residents.

- Total assets were $1,934.9 million and exceeded total liabilities by $690.7 million as of June 30, 2007. As of June 30, 2006, total assets were $1,654.8 million and exceeded total liabilities by $666.4 million. As of June 30, 2007, net assets (difference between assets and liabilities) increased by $24.3 million, or 3.6%, from June 30, 2006, while net assets at June 30, 2006, increased by $10.8 million, or 1.7%, from June 30, 2005. The increase in net assets in 2007 is primarily due to increased cash and the increase in net assets in 2006 is also primarily due to increased cash.

- As of June 30, 2007, total assets increased by $280 million to $1,934.9 million, representing a 16.9% increase from the prior fiscal year, while total assets increased by $156 million to $1,654.8 million at June 30, 2006, representing a 10.4% increase from June 30, 2005. The increase in fiscal year 2007 was primarily due to increased cash and additional capital assets. The increase in fiscal year 2006 was primarily due to increased cash and additional capital assets.

- Total current assets increased by 124.7% or $173.9 million to $313.3 million at June 30, 2007, while current assets increased by 190% or $91.3 million to $139.4 million at June 30, 2006. The increase in 2007 and 2006 was primarily due to the addition of revenue bond proceeds.

- Total current liabilities increased by 14.5% or $8.3 million to $65.3 million primarily due to an increase in interest and bonds payable. At June 30, 2007, total liabilities increased 25.9% or $255.9 million to $1,244.2 million due to the issuance of additional long-term debt. At June 30, 2006, total current liabilities increased by 4.7% or $2.5 million to $57.0 million primarily due to the issuance of additional long-term debt. Total liabilities also increased by 17.2% or $145.1 million to $988.3 million due to the issuance of additional long-term debt.

Overview of the Financial Statements

This discussion and analysis is intended to serve as an introduction to the Wastewater Enterprise's financial statements, which consist of the basic financial statements and notes to the financial statements.

Basic financial statements. The basic financial statements are designed to provide readers with a broad overview of the Wastewater Enterprise's finances, in a manner similar to a private-sector business.

The statements of net assets presents information on the Wastewater Enterprise's assets and liabilities, with the difference reported as net assets. Over time, increases or decreases in net assets may serve as a useful indicator of whether the financial position of the Wastewater Enterprise is improving or deteriorating. Net assets increase when revenues and subsidies exceed expenses. Increases to assets without a corresponding increase to liabilities, results in increased net assets, which indicate an improved financial position.

The statements of revenues, expenses and changes in net assets present information showing how the Wastewater Enterprise's net assets changed during the past two fiscal years. All changes in net assets are reported as soon as the underlying event occurs, regardless of timing of related cash flows. Thus, revenues and expenses are reported in this statement for some items that will result in cash flows in future fiscal periods (e.g., earned but unused vacation leave).

The statements of cash flows presents changes in cash and cash equivalents, resulting from operating, financing, and investing activities. This statement presents cash receipts and cash disbursements information, without consideration of the earnings event, when an obligation arises, or depreciation of capital assets.

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

Financial Analysis

The following are the highlights of the condensed statements of net assets (in thousands of dollars) for the Wastewater Enterprise:

Net Assets

	2007	2006	2005
Current assets	$ 313,362	$ 139,444	$ 48,099
Capital assets, net	1,616,817	1,513,603	1,450,690
Other noncurrent assets	4,753	1,717	--
Total assets	$ 1,934,932	$ 1,654,764	$ 1,498,789
Current liabilities	$ 65,328	$ 57,039	$ 54,492
Noncurrent liabilities	1,178,926	931,309	788,715
Total liabilities	1,244,254	988,348	843,207
Invested in capital assets, net of related debt	596,298	600,603	648,889
Restricted for debt service	59,409	35,425	26,882
Unrestricted	34,971	30,388	(20,189)
Total net assets	690,678	666,416	655,582
Total liabilities and net assets	$ 1,934,932	$ 1,654,764	$ 1,498,789

Net assets (the difference between assets and liabilities) may serve, over time, as a useful indicator of a government's financial position. In the case of the Wastewater Enterprise, assets exceeded liabilities by $690.7 million and $666.4 million at the end of fiscal year 2007 and 2006, respectively. Addition of capital assets and cash resulted in a 1.7% increase in net assets from fiscal year 2005 to 2006. The largest portion of the Wastewater Enterprise's net assets represented its investment in capital assets (e.g., land, buildings, transmission and distribution system, etc.). The Wastewater Enterprise uses these capital assets to provide wastewater services on the Island of Oahu and consequently, capital assets are not available to liquidate liabilities or other spending.

The following are the highlights of the condensed statements of revenues, expenses and changes in net assets:

Changes in Net Assets

	2007	2006	2005
Operating revenues	$ 165,914	$ 151,200	$ 118,893
Operating expenses	(112,053)	(107,437)	(98,973)
Operating income	53,861	43,763	19,920
Nonoperating revenues (expenses):			
Interest income	13,736	4,166	1,590
Interest expense	(44,266)	(29,556)	(27,677)
Other	(1,405)	(3,249)	(4,801)
	(31,935)	(28,639)	(30,888)
Income (losses) before transfers and contributed capital	21,926	15,124	(10,968)
Transfer in	5,139	--	--
Transfers out	(7,031)	(6,963)	(6,255)
Contributed capital	4,228	2,673	1,148
Change in net assets	24,262	10,834	(16,075)
Net assets			
Beginning of Fiscal Year	666,416	655,582	671,657
End of Fiscal Year	$ 690,678	$ 666,416	$ 655,582

The changes in net assets were primarily due to:

- Operating revenues, comprised mainly of sewer service charges, increased 9.7% to $165.9 million for the fiscal year 2007 compared to the prior fiscal year and increased 27.2% to $151.2 million for fiscal year 2006 compared to fiscal year 2005. Sewer service charge rates were raised 10 percent effective July 1, 2006.

- Operating expenses increased $4.6 million or 4.3% to $112.1 million for fiscal year 2007 compared to the prior fiscal year and increased $8.5 million or 8.6% to $107.4 million for fiscal year 2006 compared to fiscal year 2005. The primary increase in 2007 was in administration and general. The majority of the increase in 2006 was in utilities.

- Interest expense increased by $14.7 million or 49.8% to $44.3 million for fiscal 2007 compared to the prior fiscal year and increased by $1.9 million or 6.9% to $29.6 million for fiscal 2006 compared to fiscal year 2005. The increase in 2007 was due to the increase in outstanding revenue bonds and in 2006 was due to higher interest on 2003 variable rate bonds.

- Contributed capital increased to $4.2 million in fiscal year 2007 exceeding $2.7 million in fiscal year 2006 and $1.1 million in fiscal year 2005. Contributed capital represents assets (primarily capital assets) transferred from other city governmental funds and other entities.

- Approximately $7.0 million was transferred out during fiscal years 2007 and 2006 for the Wastewater Enterprise's share of central administrative expenses incurred by the City.

Capital Asset and Debt Administration

Capital assets. The Wastewater Enterprise's investment in capital assets amounted to $1.62 billion and $1.51 billion, net of accumulated depreciation, as of June 30, 2007 and 2006, respectively, an increase of $103.2 million or 6.8% in 2007 and $62.9 million or 4.3% in 2006. Capital assets include land, buildings, infrastructure, land improvements, equipment and machinery for the 8 treatment plants, 68 pumping stations, and over 2,100 miles of sewer line that makes up the Wastewater Enterprise. Capital assets are added, rehabilitated or replaced according to the infrastructure and facilities twenty-year capital plan.

Long-term debt. Wastewater revenue bonds and State revolving fund loans are the primary long-term financing instruments used to fund the acquisition of capital assets. Senior Series Wastewater System Revenue Bonds of $340.8 million were issued on August 22, 2006. Revenue bonds outstanding as of June 30, 2007 and 2006 totaled $1,055.6 million and $838.2 million, respectively. State revolving fund notes payable outstanding at June 30, 2007 and 2006 totaled $112.7 million and $68.3 million, respectively.

Debt service coverage was 456% on Senior Revenue Bonds, 240% on all revenue bonds, and 194% on all debt at June 30, 2007, compared to 584% on Senior Revenue Bonds, 310% on all revenue bonds, and 235% on all debt at June 30, 2006. Debt service coverage exceeded the requirements of bond covenants and policies of the City Council in 2007 and 2006.

The Wastewater Enterprise issued $171.9 million in Senior Lien Wastewater Revenue Bonds on August 14, 2007. The proceeds will be used to fund the acquisition and construction of capital assets and to refund existing debt. These insured bonds were rated Aaa by Moody's Investor Services, AAA by Fitch, Inc., and AAA by Standard & Poor's. Underlying ratings were Aa3 by Moody's Investor Services, AA- by Fitch, Inc., and AA- by Standard & Poor's.

Additional information on the Wastewater Enterprise's capital assets and long-term debt can be found in the notes to the financial statements.

Requests for Information

Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the City and County of Honolulu, Department of Environmental Services, 1000 Uluohia Street, Suite 308, Kapolei, Hawaii 96707.

City and County of Honolulu
Sewer Fund
STATEMENTS OF NET ASSETS
June 30, 2007 and 2006

	2007	2006
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	$ 35,361,254	$ 34,350,119
Investments	240,484,016	75,342,745
Receivables		
Accounts (net of allowance for uncollectible accounts of $1,210,793 in 2007 and $884,480 in 2006)	23,530,505	20,875,187
Interest	733,147	995,336
Due from other City funds	3,927,743	3,966,692
Inventories of materials and supplies	6,350,254	3,914,525
Prepaid expenses	2,975,000	--
Total current assets	313,361,919	139,444,604
NON-CURRENT ASSETS		
Capital assets, net	1,616,817,356	1,513,603,037
Deferred charges	4,753,177	1,716,561
Total non-current assets	1,621,570,533	1,515,319,598
Total assets	$ 1,934,932,452	$ 1,654,764,202
LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES		
Accounts payable	$ 16,792,382	$ 19,221,127
Due to other City funds	26,170	26,368
Interest payable	23,751,459	18,120,300
Bonds payable	15,374,587	13,096,814
Notes payable	8,851,729	6,043,972
Other current liabilities	532,088	530,007
Total current liabilities	65,328,415	57,038,588
LONG-TERM OBLIGATIONS		
Notes payable	103,893,954	62,294,325
General obligation bonds payable	21,417,889	29,477,595
Revenue bonds payable, net	1,048,322,974	834,458,623
Other liabilities	5,290,876	5,079,114
Total long-term obligations	1,178,925,693	931,309,657
Total liabilities	1,244,254,108	988,348,245
NET ASSETS		
Invested in capital assets, net of related debt	596,298,147	600,603,105
Restricted for debt service	59,409,019	35,424,715
Unrestricted	34,971,178	30,388,137
Total net assets	690,678,344	666,415,957
	$ 1,934,932,452	$ 1,654,764,202

See accompanying notes to financial statements.

City and County of Honolulu
Sewer Fund
STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS
Fiscal Years Ended June 30, 2007 and 2006

	2007	2006
OPERATING REVENUES		
Sewer service charges	$ 160,963,313	$ 142,167,282
Other revenue	4,951,193	9,033,041
Total operating revenues	165,914,506	151,200,323
OPERATING EXPENSES		
Depreciation	35,310,846	31,438,992
Administrative and general	36,749,484	33,762,368
Fringe benefits	11,762,185	11,875,666
Contractual services	8,686,893	9,950,309
Utilities	11,867,529	11,757,297
Materials and supplies	5,078,906	6,430,793
Fuel and lubricants	2,161,560	2,048,691
Maintenance	436,012	173,636
Total operating expenses	112,053,415	107,437,752
Operating income	53,861,091	43,762,571
NONOPERATING REVENUES (EXPENSES)		
Interest income	13,736,148	4,165,568
Interest expense	(44,265,860)	(29,555,658)
Other	(1,404,987)	(3,248,704)
Total nonoperating expenses	(31,934,699)	(28,638,794)
Income before transfers and contributed capital	21,926,392	15,123,777
TRANSFERS IN	5,139,061	--
TRANSFERS OUT	(7,031,300)	(6,962,500)
CAPITAL CONTRIBUTIONS	4,228,234	2,672,797
CHANGE IN NET ASSETS	24,262,387	10,834,074
NET ASSETS AT BEGINNING OF FISCAL YEAR	666,415,957	655,581,883
NET ASSETS AT END OF FISCAL YEAR	$ 690,678,344	$ 666,415,957

See accompanying notes to financial statements.

City and County of Honolulu
Sewer Fund
STATEMENTS OF CASH FLOWS
Fiscal Years Ended June 30, 2007 and 2006

	2007	2006
Cash flows from operating activities		
Cash received from customers	$ 162,932,875	$ 145,829,321
Cash payments to suppliers	(47,535,031)	(36,994,634)
Cash payments to employees	(28,871,512)	(31,795,437)
Receipts from other funds for internal activity	322,401	179,982
Other payments	(176,300)	(62,159)
Net cash provided by operating activities	86,672,433	77,157,073
Cash flows from noncapital financing activities		
Transfers out	(7,031,300)	(6,962,500)
Net cash used in noncapital financing activities	(7,031,300)	(6,962,500)
Cash flows from capital and related financing activities		
Acquisition and construction of capital assets	(124,084,730)	(84,868,028)
Proceeds from issuing notes	51,718,608	--
Repayments on notes	(7,311,222)	(5,919,770)
Interest paid on notes	(2,506,552)	(2,537,301)
Proceeds from issuance of bonds, net of discount	202,736,123	140,002,710
Repayments on bonds	(7,355,592)	(4,588,891)
Interest paid on bonds	(39,987,049)	(29,364,769)
Interest paid to vendors	(589)	--
Net cash provided by capital and related financing activities	73,208,997	12,723,951
Cash flows from investing activities		
Purchase of investments	(561,840,321)	(308,280,754)
Proceeds from maturity of investments	396,699,050	241,300,325
Interest on investments	13,302,276	2,887,659
Net cash used in investing activities	(151,838,995)	(64,092,770)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	1,011,135	18,825,754
Cash and cash equivalents at beginning of fiscal year	34,350,119	15,524,365
Cash and cash equivalents at end of fiscal year	$ 35,361,254	$ 34,350,119

City and County of Honolulu
Sewer Fund
STATEMENTS OF CASH FLOWS (Continued)
Fiscal Years Ended June 30, 2007 and 2006

	2007	2006
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES		
Operating income	$ 53,861,091	$ 43,762,571
Adjustments to reconcile operating income to net cash provided by operating activities		
Depreciation	35,310,846	31,438,992
Other revenue	4,732,760	--
Write-off of capital assets	246,696	404,003
(Increase) decrease in		
Accounts receivable	(2,655,318)	(5,139,929)
Due from other City funds	38,949	94,759
Materials and supplies inventory	(2,435,729)	293,187
Increase (decrease) in		
Accounts payable	(2,428,745)	6,303,513
Due to other City funds	(198)	26,368
Other liabilities	2,081	(26,391)
Net cash provided by operating activities	$ 86,672,433	$ 77,157,073

SUPPLEMENTAL DISCLOSURE OF NONCASH CAPITAL AND RELATED FINANCING ACTIVITIES

The Sewer Fund received $4,228,234 and $2,672,797 in contributions of capital assets from government agencies and developers, which are recorded as contributed capital at their cost or estimated cost at June 30, 2007 and 2006, respectively.

Amortization of net bond discounts and premiums amounted to $395,440 and $1,455,773 in fiscal 2007 and 2006, respectively. Amortization of bond issue costs amounted to $313,576 and $96,663 in fiscal 2007 and 2006, respectively.

See accompanying notes to financial statements.

NOTE A - FINANCIAL REPORTING ENTITY

The Sewer Fund was established as an enterprise fund effective July 1, 1999 in conjunction with the November 1998 City Resolution 98-193, CD1, authorizing the issuance of the Wastewater System Revenue Bonds for the Wastewater System. The fund accounts for the operations of the City and County of Honolulu's (City) wastewater system.

The Sewer Fund is one of various enterprise funds of the City. The Sewer Fund's financial statements reflect only its portion of the proprietary fund type. The City's Director of Budget and Fiscal Services maintains the central accounts for all City funds and publishes financial statements for the City annually, which includes the Sewer Fund's financial activities.

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accounting policies of the City for the Sewer Fund conform to generally accepted accounting principles as applicable to enterprise activities of governmental units as promulgated by the Governmental Accounting Standards Board (GASB). In accordance with GASB standards, the City has elected not to apply the Financial Accounting Standards Board pronouncements on accounting and financial reporting that were issued after November 30, 1989.

(1) ***Basis of accounting*** - The accompanying financial statements are presented using the economic resources measurement focus and the accrual basis of accounting, whereby revenues and expenses are recognized in the period earned or incurred.

(2) ***Use of estimates*** - The preparation of 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 reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(3) ***Cash and cash equivalents*** - Cash includes amounts in demand and time deposits primarily with various financial institutions in the State of Hawaii (State). Cash on deposit with financial institutions is collateralized in accordance with State statutes. Investments with original maturity of three months or less when purchased are considered cash equivalents.

(4) ***Investments*** - Investments consist of U.S. government securities and are stated at cost, which approximates fair value.

(5) ***Inventories of materials and supplies*** - Inventories of materials and supplies are stated at weighted average cost. The costs of inventories are recorded as expenditures when consumed rather than when purchased.

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

(6) ***Receivables*** - Sewer service charge revenues are accrued by the City based on estimated billings for services provided through the end of the fiscal year. Receivables included estimated unbilled sewer charges amounting to approximately $15 million and $12.7 million at June 30, 2007 and 2006, respectively.

(7) ***Capital assets*** - Capital assets include property, plant and equipment, including infrastructure (sewer system, network of pipes and sewer mains). Assets with an initial, individual cost of $5,000 or more for equipment and $100,000 for buildings, structures and infrastructure, and an estimated useful life of more than one year are capitalized. All infrastructure assets acquired prior to fiscal year ended June 30, 1980 are also capitalized. Such assets are recorded at cost or estimated cost. Interest cost is capitalized as part of the cost of acquiring certain assets.

Depreciation is calculated on a straight-line basis over the following estimated useful lives:

	Years
Buildings and land improvements	10 - 50
Transmission and distribution system	60
Equipment and machinery	5 - 20

Sales and retirements of depreciable property are recorded by removing the related cost and accumulated depreciation from the accounts. Gains or losses on sales and retirements of property are reflected in results of operations.

Normal maintenance and repairs that do not add to the value of the assets or materially extend asset lives are not capitalized. Betterments are capitalized and depreciated over the remaining useful lives of the related assets, as applicable.

(8) ***Bond issue costs*** - Bond issue costs are deferred and are amortized over the life of the respective issue on a straight-line basis.

(9) ***Original issue discounts or premiums*** - Original issue discounts or premiums on bonds are amortized ratably over the terms of the respective issues and are offset against the bonds payable in the statements of net assets.

(10) ***Refunding of debt*** - The difference between the reacquisition price and the net carrying amount of the old debt is deferred and amortized as a component of interest expense in a systematic and rational manner over the remaining life of the old debt or the life of the new debt, whichever is shorter. The deferred amount is reported as a deduction from or an addition to the new debt liability.

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

(11) ***Accrued vacation*** - Employees are credited with vacation at the rate of one and three-quarters working days per month. Accumulation of such vacation credits is limited to 90 days at calendar year-end and is convertible to pay upon termination of employment. Such accumulated vacation has been accrued and reflected in the statements of net assets.

(12) ***Net assets*** - Net assets comprise income (losses) from operating and nonoperating revenues, expenses, operating transfers and contributed capital. Net assets are classified in the following three components: invested in capital assets, net of related debt; restricted for debt service; and unrestricted net assets. Invested in capital assets, net of related debt, consists of capital assets, net of accumulated depreciation and is reduced by outstanding debt that is attributable to the acquisition, construction or improvement of those assets. Debt related to unspent proceeds or other restricted cash and investments at fiscal year-end are not included in the calculation of the amount invested in capital assets, net of related debt. Restricted for debt service consists of net assets for which constraints are placed thereon by external parties, such as lenders, grantors, contributors, laws, regulations and enabling legislation, including self-imposed legal mandates. Unrestricted net assets consists of all other net assets not included in the above categories.

(13) ***Operating revenues and expenses*** - The City distinguishes operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services in connection with the Sewer Fund's principal wastewater operations. The principal operating revenues are from charges for wastewater system usage, while operating expenses include cost of services, administrative expenses and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.

(14) ***Capital contributions*** - Capital contributions represent assets transferred from or constructed utilizing contributions from governmental agencies and developers and recorded at cost on the date placed in service.

(15) ***Transfers*** - Transfers include authorized transfers of resources from the fund legally required to receive them to the fund through which such resources are to be expended. Transfers also include reimbursement of funds to the general fund for expenditures paid by the general fund on behalf of the Sewer Fund in prior fiscal years.

(16) ***Risk management*** - The City is exposed to various risks for losses related to torts; theft of, damage to, or destruction of assets; errors or omissions; natural disasters; and injuries to employees. A liability for a claim for a risk of loss is established if the information indicates that it is probable that a liability has been incurred at the date of the financial statements and the amount of the loss is reasonably estimable.

NOTE C - CASH AND INVESTMENTS

The cash and investment balances reported in the accompanying statements of net assets are included in the City's cash and investment pool that is used by substantially all of the City's funds. Information pertaining to credit risk and interest rate risk is available for only the total cash and investment pool.

State statutes authorize the City to invest in obligations of the U.S. Treasury and U.S. agencies, obligations of other states, cities, and counties, mutual funds and bank repurchase agreements. Investments in repurchase agreements are primarily U.S. government or federal agency securities. The City does not have a policy relative to interest rate risk.

NOTE D - CREDIT RISK

Financial instruments, which potentially expose the City to concentrations of credit risk, consist primarily of cash, investments in debt securities, and accounts receivable from customers. Cash and cash equivalents are maintained in various financial institutions in the State. Credit risk related to investments in debt securities has been mitigated by limiting such investments to debt obligations of the U.S. government.

The customer base is concentrated among commercial, industrial, residential and governmental customers located within the City. Although the City is directly affected by the City's economy, management does not believe significant credit risk exists at June 30, 2007, except as provided in the allowance for uncollectible accounts. The City manages its credit exposure through procedures designed to identify and monitor credit risk.

NOTE E - DUE FROM OTHER CITY FUNDS

Due from other City funds consists primarily of bond proceeds relating to bond issuances for the Sewer Fund held by the City's General Improvement Bond Fund of approximately $3.9 million and $4.0 million at June 30, 2007 and 2006, respectively.

NOTE F - CAPITAL ASSETS

The capital assets activity for the fiscal years ended June 30, 2007 and 2006, were as follows:

	Balance June 30, 2006	Additions	Deductions	Balance June 30, 2007
Depreciable assets				
Buildings and improvements	$ 449,269,016	$ 259,785,064	$ --	$ 709,054,080
Transmission and distribution system	872,543,130	97,623,642	(525,498)	969,641,274
Equipment and machinery	28,408,700	3,327,744	(1,638,739)	30,097,705
Land improvements	3,674,661	--	(164,238)	3,510,423
Total depreciable assets	1,353,895,507	360,736,450	(2,328,475)	1,712,303,482
Less accumulated depreciation:				
Buildings and improvements	(67,201,497)	(13,012,982)	--	(80,214,479)
Transmission and distribution system	(122,251,945)	(19,906,254)	146,170	(142,012,029)
Equipment and machinery	(15,218,825)	(2,272,430)	1,035,194	(16,456,061)
Land improvements	(827,712)	(119,180)	24,635	(922,257)
Total accumulated depreciation	(205,499,979)	(35,310,846)	1,205,999	(239,604,826)
	1,148,395,528	325,425,604	(1,122,476)	1,472,698,656
Land	6,003,338	110,418	(48,998)	6,064,758
Construction in progress	359,204,171	131,369,260	(352,519,489)	138,053,942
	$ 1,513,603,037	$ 456,905,282	$ (353,690,963)	$ 1,616,817,356

	Balance June 30, 2005	Additions	Deductions	Balance June 30, 2006
Depreciable assets				
Buildings and improvements	$ 436,357,566	$ 12,911,450	$ --	$ 449,269,016
Transmission and distribution system	808,051,447	68,106,051	(3,614,368)	872,543,130
Equipment and machinery	26,055,303	2,752,820	(399,423)	28,408,700
Land improvements	3,674,661	--	--	3,674,661
Total depreciable assets	1,274,138,977	83,770,321	(4,013,791)	1,353,895,507
Less accumulated depreciation:				
Buildings and improvements	(56,857,881)	(10,343,616)	--	(67,201,497)
Transmission and distribution system	(104,197,950)	(18,616,580)	562,585	(122,251,945)
Equipment and machinery	(13,153,286)	(2,354,273)	288,734	(15,218,825)
Land improvements	(703,189)	(124,523)	--	(827,712)
Total accumulated depreciation	(174,912,306)	(31,438,992)	851,319	(205,499,979)
	1,099,226,671	52,331,329	(3,162,472)	1,148,395,528
Land	5,882,338	121,000	--	6,003,338
Construction in progress	345,581,560	95,938,560	(82,315,949)	359,204,171
	$ 1,450,690,569	$ 148,390,889	$ (85,478,421)	$ 1,513,603,037

NOTE F - CAPITAL ASSETS (Continued)

Depreciation expense was $35,310,846 and $31,438,992 for the fiscal years ended June 30, 2007 and 2006, respectively.

NOTE G - LONG-TERM OBLIGATIONS

The City issues general obligation bonds for the construction of major capital facilities. The Sewer Fund's general obligation bonds are collateralized by or expected to be paid from sewer user charges. These instruments are a direct obligation of the City for which its full faith and credit is pledged. The general obligation bonds for the Sewer Fund were issued during 1992 through 2005 in the original amount totaling $373.8 million, and maturing serially through fiscal year 2019. The general obligation bonds bear interest at rates ranging from 2% to 8% at June 30, 2007.

Wastewater system revenue bonds were issued during 1999 through 2006 in the original amount totaling $1.2 billion, less a net premium ($6.8 million at June 30, 2007, which is being amortized over the related term of the bond). The bonds are subject to redemption, at the option of the City, prior to maturity, on or after July 1, 2011. The bonds bear interest at 3.2% to 5.5% at June 30, 2007, and mature at various dates through fiscal year 2036. The bonds are collateralized by the Sewer Fund's revenues.

In August 2005, the City issued wastewater system revenue bonds in the aggregate amount of $152.8 million, Series 2005A for $133.5 million and Series 2005B for $19.3 million. The bonds bear interest rates of 3.2% to 5% and mature annually on July 1, 2010 through 2035. The bonds maturing after July 1, 2015 are subject to redemption on or after July 1, 2015 in whole or in part at any time from any maturities or portions thereof to be redeemed. Proceeds of the bond were used to fund additions and improvements to the wastewater system of the City, to fund the reserve fund policy premium and currently refund certain outstanding general obligations and certain tax-exempt commercial paper of the City.

In September 2006, the City issued wastewater system revenue bonds in the aggregate amount of $340.8 million, Series 2006A for $190.9 million, Series 2006B for $31.3 million and Series 2006C for $118.6 million. The bonds bear interest rates of 4% to 5% and mature annually on July 1, 2007 through 2036. The bonds maturing after July 1, 2016 are subject to redemption at the option of the City on or after July 1, 2016, in whole or in part at any time from any maturity. Proceeds of the bond were used to fund additions and improvements to the wastewater system of the City, to fund the reserve account, currently refund certain outstanding general obligations and wastewater system revenue bonds and advance refund wastewater system revenue bonds. All of the refunded bonds are considered to be defeased and the liability for those bonds has been removed from the financial statements. The premium and discount generated by each issue will be amortized over the life of the related bonds.

NOTE G - LONG-TERM OBLIGATIONS (Continued)

A portion of the variable rate Series 2003A-1 was currently refunded by the Series 2006B to set interest rates. The Series 2006C advance refunded a portion of the Series 2001 decreasing debt service payments by $6.8 million with an economic gain of $4.5 million.

The notes payable to the State are for the construction of necessary treatment works and for other projects intended for wastewater reclamation or waste management. The notes amounted to $112.7 million and $68.3 million at June 30, 2007 and 2006, respectively, bearing interest ranging from 2.06% to 3.02%, and require annual principal and interest payments through fiscal year 2023.

Total interest costs incurred in 2007 and 2006 was $54.1 million and $40.5 million, respectively, of which $10.2 million and $10.9 million was capitalized in 2007 and 2006, respectively.

	Balance July 1, 2006	Additions	Reductions	Balance June 30, 2007	Amount Due Within One Year
General obligation bonds	$ 38,864,409	$ --	$ (9,361,933)	$ 29,502,476	$ 8,084,587
Revenue bonds	851,050,000	340,760,000	(143,035,000)	1,048,775,000	7,290,000
Notes payable	68,338,297	51,718,608	(7,311,222)	112,745,683	8,851,729
	958,252,706	392,478,608	(159,708,155)	1,191,023,159	24,226,316
Add:					
Unamortized net premium (discount) and deferred amount on refunding	(12,881,377)	19,323,142	394,878	6,836,643	--
Total long-term debt	945,371,329	411,801,750	(159,313,277)	1,197,859,802	24,226,316
Compensated absences	5,344,411	1,951,299	(1,778,084)	5,517,626	225,419
Total long-term obligations	$ 950,715,740	$ 413,753,049	$ (161,091,361)	$ 1,203,377,428	$ 24,451,735

NOTE G - LONG-TERM OBLIGATIONS (Continued)

Long-term obligations activity for the fiscal years ended June 30, 2007 and 2006, were as follows:

	Balance July 1, 2005	Additions	Reductions	Balance June 30, 2006	Amount Due Within One Year
General obligation bonds	$ 48,424,715	$ --	$ (9,560,306)	$ 38,864,409	$ 9,386,814
Revenue bonds	701,785,000	152,815,000	(3,550,000)	851,050,000	3,710,000
Notes payable	74,123,430	112,827	(5,897,960)	68,338,297	6,043,972
Tax-exempt commercial paper	10,021,810	--	(10,021,810)	--	--
	834,354,955	152,927,827	(29,030,076)	958,252,706	19,140,786
Add:					
Unamortized premium (discount) and deferred amount on refunding	(22,417,854)	8,080,704	1,455,773	(12,881,377)	--
Total long-term debt	811,937,101	161,008,531	(27,574,303)	945,371,329	19,140,786
Compensated absences	5,856,545	1,309,534	(1,821,668)	5,344,411	265,297
Total long-term obligations	$ 817,793,646	$ 162,318,065	$ (29,395,971)	$ 950,715,740	$ 19,406,083

Scheduled maturities of long-term debt are as follows:

	General Obligation Bonds	Revenue Bonds	Notes Payable	Total Principal	Total Interest
Fiscal year ending June 30					
2008	$ 8,084,587	$ 7,290,000	$ 8,851,729	$ 24,226,316	$ 56,635,498
2009	8,019,425	10,115,000	9,013,325	27,147,750	50,914,183
2010	6,955,678	12,400,000	9,178,570	28,534,248	49,791,949
2011	5,171,402	18,975,000	9,348,483	33,494,885	48,423,628
2012	1,213,482	28,040,000	9,521,619	38,775,101	47,068,511
2013 - 2017	45,309	164,815,000	36,879,503	201,739,812	213,964,848
2018 - 2022	12,593	200,935,000	20,836,540	221,784,133	173,257,422
2023 - 2027	--	253,950,000	9,115,914	263,065,914	118,155,841
2028 - 2032	--	235,565,000	--	235,565,000	55,438,295
2033 - 2037	--	116,690,000	--	116,690,000	12,841,321
	29,502,476	1,048,775,000	112,745,683	1,191,023,159	$ 826,491,496
Less: current portion	(8,084,587)	(7,290,000)	(8,851,729)	(24,226,316)	
	$ 21,417,889	$ 1,041,485,000	$ 103,893,954	$ 1,166,796,843	

NOTE H - NET ASSETS

At June 30, 2007 and 2006, net assets consisted of the following:

	2007	2006
Invested in capital assets, net of related debt		
Net property, plant and equipment	$ 1,616,817,356	$ 1,513,603,037
Less:		
Wastewater general obligation bonds payable	(29,502,476)	(38,864,409)
Wastewater system revenue bonds payable, net of unamortized premium, discount, and issue cost	(1,050,859,797)	(836,452,062)
Notes payable	(112,745,683)	(68,338,297)
Amount of debt related to unspent debt proceeds	172,588,747	30,654,836
	596,298,147	600,603,105
Restricted for debt service	59,409,019	35,424,715
Unrestricted	34,971,178	30,388,137
Total	$ 690,678,344	$ 666,415,957

NOTE I - EMPLOYEE BENEFIT PLANS

Defined benefit pension plan. Substantially all eligible employees of the City are members of the Employees' Retirement System of the State of Hawaii (ERS), a cost-sharing multiple-employer defined benefit pension plan. The ERS provides retirement benefits as well as death and disability benefits and is governed by a board of trustees. All contributions, benefits and eligibility requirements are established by Chapter 88 of the Hawaii Revised Statutes and can be amended by legislative action.

The ERS is composed of a contributory retirement plan and a noncontributory retirement plan. Prior to June 30, 1984, the plan consisted of only a contributory option. In 1984, legislation was enacted to create a new noncontributory option for members of the ERS who are also covered under social security. Persons employed in positions not covered by social security are precluded from the noncontributory option. The noncontributory options provides for reduced benefits and covers most eligible employees hired after June 30, 1984. Employees hired before that date were allowed to continue under the contributory option or to elect the new noncontributory option and receive a refund of employee contributions. All benefits vest after five and ten years of credited service under the contributory and noncontributory options, respectively. Both options provide a monthly retirement allowance based on the employee's age, years of credited service, and average final compensation (AFC). The AFC is the average salary earned during the five highest paid years of service,

NOTE I - EMPLOYEE BENEFIT PLANS (Continued)

including vacation payment, if the employee became a member prior to January 1, 1971. The AFC for members hired on or after that date and prior to January 1, 2003 is based on the three highest paid years of service, excluding vacation payment. Effective January 1, 2003, the AFC is the highest three calendar years or highest five calendar years plus lump sum vacation payment, or last 36 credited months or last 60 credited months plus lump sum vacation payment.

Most covered employees of the contributing option are required to contribute 7.8% or 12.2% of their salary. The City is required to contribute the remaining amounts necessary to pay contributory plan benefits and all amounts necessary to pay noncontributory benefits when due. The funding method used to calculate the total employer contribution requirement is the Entry Age Normal Actuarial Cost Method. Under this method, employer contributions to the ERS are comprised of normal cost plus level annual payments required to amortize the unfunded actuarial accrued liability over the remaining period of 29 years from July 1, 2000. Effective July 1, 2005 a dollar contribution is not determined under the provisions of Act 181 of the 2004 Session Laws of Hawaii. Instead a fixed percentage of 13.75% of payroll is contributed. The Sewer Fund's contribution to the ERS was $3.8 million, $3.8 million and $4.7 million in 2007, 2006, and 2005 respectively, which was equal to the required contributions for the respective fiscal years.

The 2004 State of Hawaii legislative sessions approved a hybrid retirement plan, which took effect on July 1, 2006. Employees who chose to be under this plan are required to contribute 6.0% of their salary and will receive pensions based on a 2.0% benefit formula instead of a 1.25% benefit formula under the current noncontributory plan. The hybrid plan does not affect the City's contributions to the ERS.

The ERS issues a Comprehensive Annual Financial Report that may be obtained by writing to the Employees' Retirement System of the State of Hawaii, 201 Merchant Street, Suite 1400, Honolulu, Hawaii 96813.

Post-retirement health care and life insurance benefits. In addition to providing pension benefits, the State provides certain health care and life insurance benefits for retired City employees. Contributions are based on negotiated collective bargaining agreements and are limited by State statute to the actual cost of benefit coverage. Prior to July 1, 1996, the City paid 100% of these benefits for employees who have at least 10 years of service. According to Act 217, Session Laws of Hawaii 1995, employees hired after June 30, 1996, with 25 years or more of service receive 100% employer funding. The City's share of the cost of these benefits is prorated for employees with less than 25 years of service. The City also reimburses 100% of Medicare premium costs for retirees and qualified dependents (through the State) who are at least 65 years of age and have at least 10 years of service. Approximately 10,100 retirees and qualified dependents are currently receiving post retirement health care and benefits paid for by the City. The City's contributions for post retirement benefits, which are funded on a pay-as-you-go basis, amounted to approximately $44.5 million and $44.4 million for the fiscal years ended June 30, 2007 and 2006, respectively. Separate information for the Sewer Fund is not available.

NOTE J - MANAGEMENT AGREEMENT

The City had an agreement with the Board of Water Supply (Board) to provide certain services relating to the billing and collection of sewer service charges for $700,000 and $100,000 for the fiscal years ended June 30, 2007 and 2006, respectively. Fees for future years are negotiable and no less than $700,000 per fiscal year.

NOTE K - COMMITMENTS

Construction contracts. The City has contractual commitments for the Sewer Fund of approximately $339 million at June 30, 2007, primarily for construction contracts.

Accumulated sick leave pay. Sick leave accumulates at the rate of one and three-quarters working days for each month, without limit. Sick leave is taken only in the event of illness and is not convertible to pay; accordingly, sick leave is not accrued. Employees who retire or leave government service in good standing with sixty or more unused sick leave days are entitled to an additional service credit in the retirement system. At June 30, 2007 and 2006, accumulated sick leave, including vested and nonvested accumulated rights to receive sick leave benefits, amounted to approximately $16 million and $15 million, respectively.

Deferred compensation plan. All full-time employees of the Sewer Fund are eligible to participate in the City and County of Honolulu's Public Employees' Deferred Compensation Program (Plan), adopted pursuant to Internal Revenue Code Section 457. The Plan permits eligible employees to defer a portion of their salary until future years by contributing to a fund managed by a plan administrator. The deferred compensation amounts are not available to employees until termination, retirement, death or unforeseeable emergency.

A trust fund was established to protect plan assets from claims of general creditors and from diversion to any uses other than paying benefits to participants and beneficiaries. Deferred compensation plan assets are not reported in the financial statements.

NOTE L - LITIGATION

The City is a party to various legal proceedings arising in the normal course of business. Some of these matters relate to the Sewer Fund as follows:

A lawsuit filed by the U.S. Environmental Protection Agency (EPA) and the State against the City in 1994 resulted in a consent decree which requires the City, among other things, to comply with the Clean Water Act, to establish a schedule under which the City will implement preventive maintenance and sewer replacement and rehabilitation necessary to reduce and prevent spills, to implement and enforce its pretreatment program to regulate industrial discharges, and to develop and implement an effluent and sludge reuse program. The court has retained continuing jurisdiction over implementation of the consent decree. Pursuant to the consent decree, the City has

NOTE L - LITIGATION (Continued)

established and is currently implementing a $3.7 billion, 20-year capital improvement plan (Fiscal Year 1998 to Fiscal Year 2017) to upgrade its wastewater collection and treatment system.

In July 2004, the Sierra Club and other environmental groups filed a lawsuit against the City seeking injunctive relief and penalties for alleged Clean Water Act violations arising from the City's wastewater collection and treatment system. Of plaintiffs' original twelve claims, the court dismissed five claims and the plaintiffs agreed to dismiss three more. The plaintiffs filed a motion for summary judgment with respect to three of the four remaining claims in this litigation, which the court granted in part and denied in part in October 2007. The court's decision did not address the amount of penalties, if any, that would be assessed against the City. The outcome of this litigation cannot be predicted at this stage of the proceedings, and any potential liability in this litigation beyond the costs of the 20-year wastewater system capital improvement plan is speculative.

As a result of a March 2006 sewer spill and after one year of negotiations, the EPA, the U.S. Department of Justice, the State and the City signed a stipulated order that requires the City to take certain actions to evaluate, repair, rehabilitate or replace certain force mains and one pump station in its wastewater collection system, and develop site-specific spill contingency plans. This stipulated order, which has been accepted by the court, resolves the entire civil enforcement action that was simultaneously filed with the stipulated order against the City with respect to the spill. The estimated cost of the work in the stipulated order is approximately $300 million.

Although the outcome of individual matters is not predictable, no provision for any liability that may result from these lawsuits has been made in the Sewer Fund's financial statements since any such liabilities are normally paid from the City's General Fund. In the opinion of management, the final outcome of these matters is unknown at this time but should not have a material adverse effect on the Sewer Fund's financial statements.

NOTE M - HONOULIULI AND SAND ISLAND WASTEWATER TREATMENT PLANT PERMITS

In March and December 2007, the EPA issued a tentative decision to deny an application for a renewed variance from secondary treatment for the Honouliuli and Sand Island wastewater treatment plants, respectively. The City is vigorously challenging the tentative decisions. If the City's applications are denied, the project costs of secondary treatment at Honouliuli and Sand Island is estimated to be $400 million and $800 million, respectively.

NOTE N - SUBSEQUENT EVENT

In August 2007, the City issued Series 2007A and Series 2007B wastewater system revenue bonds in the aggregate amount of $171.9 million. The bonds bear interest rates of 4% to 5% and mature annually on July 1, 2012 through July 1, 2037. The bonds maturing after July 1, 2018 are subject to redemption at the option of the City on or after July 1, 2017, in whole or in part at any time, from any maturity. The proceeds from the bonds will be used to fund the cost of certain additions and improvements to the wastewater system of the City, a common reserve account and current and advance refunding of certain City general obligation bonds.