

**CITY OF BALTIMORE
WASTEWATER UTILITY FUND**

Financial Statements

June 30, 2013 and 2012

(With Independent Auditors' Report Thereon)

**CITY OF BALTIMORE
WASTEWATER UTILITY FUND**

Financial Statements
June 30, 2013 and 2012

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CITY OF BALTIMORE
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Independent Auditors' Report

The Mayor, City Council, Comptroller and
Board of Estimates
City of Baltimore, Maryland:

Report on the Financial Statements

We have jointly audited the accompanying financial statements of the Wastewater Utility Fund of the City of Baltimore, Maryland (the Fund), which comprise the statements of financial position as of June 30, 2013 and 2012, 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 U.S. generally accepted accounting principles; 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.

Auditors' 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 and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit 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 auditors' 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 we have 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 Wastewater Utility Fund as of June 30, 2013 and 2012, and the changes in its financial position and its cash flows for the years then ended in accordance with U.S. generally accepted accounting principles.

Emphasis of Matter

As discussed in Note 1, the financial statements present only the Wastewater Utility Fund and do not purport to, and do not, present fairly the financial position of the City of Baltimore, Maryland, as of June 30, 2013 and 2012, the changes in its financial position, or its cash flows for the year ended in accordance with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

Other Matters

Required Supplementary Information

U.S. generally accepted accounting principles require that the management's discussion and analysis on pages 3 through 7 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.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated June 20, 2014 on our consideration of the City's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the City's internal control over financial reporting and compliance.

Robert L. McCarty Jr., CPA
City Auditor
Department of Audits

Independent Auditors

June 20, 2014

CITY OF BALTIMORE
WASTEWATER UTILITY FUND
Management's Discussion and Analysis
June 30, 2013 and 2012

This section of the City of Baltimore, Maryland's Wastewater Utility Fund (Wastewater Utility) financial statements presents our discussion and analysis of the Wastewater Utility's financial performance during the years ended June 30, 2013 and 2012.

Background

The Wastewater Utility, through its system of sanitary sewers, interceptors, pumping stations, and wastewater treatment facilities, provides for the treatment and disposal of sanitary sewage flow of approximately two-thirds of the population of the Baltimore metropolitan area. The wastewater system presently receives wastewater directly from Anne Arundel and Baltimore Counties, as well as the City. In addition, portions of Anne Arundel and Howard Counties discharge wastewater into the system through Baltimore County.

Highlights

- For fiscal year 2013, total operating revenues were \$183.5 million, which represents an increase of 2.0% from the previous year's revenues. For fiscal year 2012, total operating revenues were \$179.9 million, which represents an increase of 12.4% from the previous year's revenues.
- Total operating expenses for fiscal year 2013 were \$162.0 million, an increase of \$7.7 million over fiscal year 2012 operating expenses of \$154.3 million.
- Net position increased in fiscal years 2013 and 2012 by \$111.2 million and \$83.1 million, respectively.

Overview of the Financial Statements

This report consists of three parts: 1) management's discussion and analysis (this section), 2) financial statements, and 3) notes to the financial statements.

The financial statements provide both long-term and short-term information about the Wastewater Utility's overall financial status. The notes to the financial statements explain some of the financial information in the financial statements and provide more detailed information.

**CITY OF BALTIMORE
WASTEWATER UTILITY FUND**

Management's Discussion and Analysis

June 30, 2013 and 2012

The Wastewater Utility's financial statements are prepared in conformity with accounting principles generally accepted in the United States as applied to governmental units on an accrual basis. Under this basis, revenues are recognized in the period in which they are earned, expenses are recognized in the period in which they are incurred, and depreciation of assets is recognized in the statement of revenues, expenses, and changes in fund net assets. All assets and liabilities associated with the operation of the Wastewater Utility are included in the statement of net position.

Net Position

Wastewater Utility Fund

(Expressed in thousands)

| | June 30 | | | Change 2013 – 2012 | Change 2012 – 2011 |
|--|--------------------|--------------------|--------------------|-----------------------|-----------------------|
| | 2013 | 2012 | 2011 | | |
| Current and other assets | \$267,433 | \$259,792 | \$285,951 | \$7,641 | (\$26,159) |
| Capital assets | 1,821,444 | 1,689,671 | 1,585,901 | 131,773 | 103,770 |
| Total assets | 2,088,877 | 1,949,463 | 1,871,852 | 139,414 | 77,611 |
| Deferred outflows of resources | 24,601 | 33,728 | 21,719 | (9,127) | 12,009 |
| Current liabilities | 98,679 | 77,597 | 60,832 | 21,082 | 16,765 |
| Noncurrent liabilities | 732,109 | 734,131 | 744,371 | (2,022) | (10,240) |
| Total liabilities | 830,788 | 811,728 | 805,203 | 19,060 | 6,525 |
| Net assets: | | | | | |
| Invested in capital assets, net of related debt | 1,187,466 | 1,091,025 | 975,108 | 96,441 | 115,917 |
| Restricted | 69,857 | 69,019 | 64,970 | 838 | 4,049 |
| Unrestricted | 25,367 | 11,419 | 48,290 | 13,948 | (36,871) |
| Total net position | \$1,282,690 | \$1,171,463 | \$1,088,368 | \$111,227 | \$83,095 |

Analysis of Financial Position

Net position may serve as a useful indicator of the Wastewater Utility's financial position. For the Wastewater Utility, assets exceeded liabilities by \$1,282.7 million, \$1,171.5 million, and \$1,088.3 million in fiscal years 2013, 2012, and 2011, respectively. The Wastewater Utility's net position includes its investment of \$1,187.5 million, \$1,091.0 million, and \$975.1 million in capital assets (e.g., land, buildings, and equipment), less any related outstanding debt used to acquire those assets, at the end of fiscal years 2013, 2012, and 2011, respectively. The Wastewater Utility uses these capital assets to provide wastewater services to citizens; consequently, these assets are not available for future spending.

**CITY OF BALTIMORE
WASTEWATER UTILITY FUND**

Management's Discussion and Analysis

June 30, 2013 and 2012

Although the Wastewater Utility's investment in its capital assets is reported net of related debt, it should be noted that the resources needed to repay this debt must be provided from customers of the Wastewater Utility through rates and charges, since the capital assets themselves cannot be liquidated for these liabilities. A portion of the Wastewater Utility's net position, \$69.9 million, represents restricted resources that are legally obligated for revenue bond repayment requirements for fiscal year 2013. The Wastewater Utility had unrestricted net position of \$25.4 million, \$11.4 million, and \$48.3 million as of June 30, 2013, 2012, and 2011, respectively.

During fiscal years 2013, 2012, and 2011, the Wastewater Utility expended \$142.8 million, \$127.7 million, and \$87.5 million for capital assets, respectively. These assets primarily represent facility enhancements to comply with environmental regulations. The assets were funded primarily through new issues of revenue bonds of \$31.8 million, \$3.7 million, and \$103.8 million, in fiscal years 2013, 2012, and 2011, respectively. Moody's Investor Services, Inc., and Standard & Poor's Rating Services show the utilities' bonds are rated Aa2 and AA for senior lien debt and Aa3 and AA- for subordinate lien debt, respectively.

Revenues, Expenses, and Changes in Net Position

Wastewater Utility Fund

(Expressed in thousands)

| | June 30 | | | Change 2013 - 2012 | Change 2012 - 2011 |
|-------------------------------------|-------------|-------------|-------------|-----------------------|-----------------------|
| | 2013 | 2012 | 2011 | | |
| Operating revenues | \$183,521 | \$179,873 | \$160,076 | \$3,648 | \$19,797 |
| Operating expenses: | | | | | |
| Salaries and wages | 38,760 | 39,518 | 39,216 | (758) | 302 |
| Other personnel costs | 17,354 | 16,711 | 11,617 | 643 | 5,094 |
| Contractual services | 59,877 | 54,572 | 51,611 | 5,305 | 2,961 |
| Material and supplies | 8,479 | 8,069 | 7,517 | 410 | 552 |
| Minor Equipment | 745 | 486 | 170 | 259 | 316 |
| Depreciation | 36,794 | 34,903 | 34,595 | 1,891 | 308 |
| Total operating expenses | 162,009 | 154,259 | 144,726 | 7,750 | 9,533 |
| Operating income | 21,512 | 25,614 | 15,350 | (4,102) | 10,264 |
| Nonoperating (expense), net | (14,610) | (15,783) | (14,186) | 1,173 | (1,597) |
| Income before capital contributions | 6,902 | 9,831 | 1,164 | (2,929) | 8,667 |
| Capital contributions | 104,325 | 73,264 | 49,582 | 31,061 | 23,682 |
| Change in net position | 111,227 | 83,095 | 50,746 | \$28,132 | \$32,349 |
| Beginning net position | 1,171,463 | 1,088,368 | 1,037,622 | | |
| Ending net position | \$1,282,690 | \$1,171,463 | \$1,088,368 | | |

**CITY OF BALTIMORE
WASTEWATER UTILITY FUND**

Management's Discussion and Analysis

June 30, 2013 and 2012

Analysis of Revenues, Expenses, and Changes in Net Position

The overall increase in the Wastewater Utility's net position amounted to \$111.2 million, and \$83.1 million, for fiscal years 2013, and 2012, respectively. These increases are due to improved operating margins that resulted from the implementation of a 9% wastewater rate increase in fiscal years 2013 and 2012 to customers located in Baltimore City, offset by a decline in consumer consumption in 2012.

Capital Assets

The Wastewater Utility's capital assets as of June 30, 2013, 2012, and 2011 amounted to \$1,821.4 million, \$1,689.7 million, and \$1,585.9 million (net of accumulated depreciation), respectively. Capital assets include land, equipment, buildings, improvements, and construction in progress. Total increases in the Wastewater Utility's net capital assets for fiscal years 2013, and 2012, \$131.8 million, and \$103.8 million, respectively. These increases were funded primarily by issuance of revenue bonds. The following schedule presents the capital asset activities for fiscal years 2013, 2012, and 2011 (amounts expressed in thousands):

| | Balance at June 30 | | | Change 2013 – 2012 | Change 2012 – 2011 |
|------------------------------|--------------------|--------------------|--------------------|-----------------------|-----------------------|
| | 2013 | 2012 | 2011 | | |
| Land | \$8,931 | \$8,931 | \$8,931 | — | — |
| Buildings and improvements | 1,167,354 | 1,156,543 | 1,186,068 | \$10,811 | (\$29,525) |
| Equipment | 35,734 | 38,190 | 16,887 | (2,456) | 21,303 |
| Construction in progress | 502,596 | 443,186 | 374,015 | 59,410 | 69,171 |
| Infrastructure | 106,829 | 42,821 | — | 64,008 | 42,821 |
| Total capital assets, net | <u>\$1,821,444</u> | <u>\$1,689,671</u> | <u>\$1,585,901</u> | <u>\$131,773</u> | <u>\$103,770</u> |

As of June 30, 2013, the Wastewater Utility had commitments of \$321.3 million for the acquisition and construction of capital assets. See note 5 for further information. During fiscal year 2013, the City determined certain assets recorded as buildings and improvements were actually infrastructure assets. Those assets were reclassified into the appropriate category for reporting purposes.

Debt Administration

For fiscal years 2013, 2012, and 2011, the Wastewater Utility had long-term obligations of \$714.9 million, \$705.6 million, and \$728.1 million, respectively. These long-term obligations consisted primarily of revenue bonds, which are secured by revenue derived from the treatment of Wastewater. During fiscal years 2013, and 2012, the Wastewater Utility's debt increased by \$9.3 million in 2013 and decreased by \$22.5 million, in fiscal year 2012. See note 6 for further information.

**CITY OF BALTIMORE
WASTEWATER UTILITY FUND**

Management's Discussion and Analysis

June 30, 2013 and 2012

Economic Condition of the Wastewater Utility

The Wastewater Utility is a large regional utility system that provides for the treatment and disposal of sanitary sewage flow for the diverse Baltimore metropolitan area, which includes Baltimore City, as well as portions of Baltimore, Anne Arundel, and Howard Counties. Modest growth is expected in the future. The Wastewater Utility has ample long-term wastewater treatment capacity. The Wastewater Utility is currently under a consent decree with the U.S. Environmental Protection Agency to eliminate sanitary and combined sewer overflows. Although the Wastewater Utility is expected to make substantial investments in capital improvements to meet Clean Water Act and consent decree requirements, management expects continued good financial performance, including adequate debt service coverage and liquidity. In fiscal years 2013, 2012 and 2011, the City Board of Estimates approved annual rate increases of 9% per year for Baltimore City. Increased costs of wastewater service are passed along to the counties under the terms of agreements with Baltimore and Anne Arundel counties.

**CITY OF BALTIMORE
WASTEWATER UTILITY FUND**

Statements of Financial Position

June 30, 2013 and 2012

(Expressed in thousands)

| | 2013 | 2012 |
|---|-------------|-------------|
| Assets and deferred outflows of resources: | | |
| Current assets: | | |
| Cash and cash equivalents | \$48,753 | \$49,771 |
| Accounts receivable, net: | | |
| Service billings | 39,392 | 33,579 |
| Other | 187 | 296 |
| Due from other governments | 32,759 | 5,681 |
| Inventories | 285 | 283 |
| Total current assets | 121,376 | 89,610 |
| Noncurrent assets: | | |
| Restricted assets: | | |
| Cash and cash equivalents | 97,942 | 146,619 |
| Accounts receivable | 48,115 | 23,563 |
| Capital assets, net of accumulated depreciation | 1,309,917 | 1,237,554 |
| Capital assets not being depreciated | 511,527 | 452,117 |
| Total noncurrent assets | 1,967,501 | 1,859,853 |
| Total assets | 2,088,877 | 1,949,463 |
| Deferred outflows of resources: | | |
| Interest rate swaps | 24,601 | 33,728 |
| Liabilities: | | |
| Current liabilities: | | |
| Accounts payable and accrued liabilities | \$6,444 | \$18,096 |
| Accrued interest payable | 12,408 | 12,018 |
| Due to other governments | 17,804 | 12,663 |
| Compensated Absences | 2,906 | 2,886 |
| Revenue bonds payable | 24,099 | 22,691 |
| General long-term debt payable | — | 19 |
| Accounts payable from restricted assets | 35,018 | 9,224 |
| Total current liabilities | 98,679 | 77,597 |
| Noncurrent liabilities: | | |
| Revenue bonds payable, net | 690,818 | 682,922 |
| Other liabilities | 6,530 | 6,891 |
| Unamortized bond premiums | 10,005 | 10,464 |
| Derivative instrument liability | 24,756 | 33,854 |
| Total noncurrent liabilities | 732,109 | 734,131 |
| Total liabilities | 830,788 | 811,728 |
| Net position: | | |
| Net investment in capital assets | 1,187,466 | 1,091,025 |
| Restricted for: | | |
| Debt service | 69,857 | 69,019 |
| Unrestricted | 25,367 | 11,419 |
| Total net position | \$1,282,690 | \$1,171,463 |

See accompanying notes to financial statements.

**CITY OF BALTIMORE
WASTEWATER UTILITY FUND**

Statements of Revenues, Expenses, and Changes in Net Position

Years ended June 30, 2013 and 2012

(Expressed in thousands)

| | 2013 | 2012 |
|-------------------------------------|-------------|-------------|
| Operating revenues: | | |
| Charges for sewer services, net | \$183,521 | \$179,873 |
| Operating expenses: | | |
| Salaries and wages | 38,760 | 39,518 |
| Other personnel costs | 17,354 | 16,711 |
| Contractual services | 59,877 | 54,572 |
| Minor equipment | 745 | 486 |
| Materials and supplies | 8,479 | 8,069 |
| Depreciation | 36,794 | 34,903 |
| Total operating expenses | 162,009 | 154,259 |
| Operating income | 21,512 | 25,614 |
| Nonoperating revenues (expenses): | | |
| Gain (loss) on sale of investments | (47) | (105) |
| Interest income | 951 | 1,115 |
| Interest expense | (15,514) | (16,793) |
| Total nonoperating expenses, net | (14,610) | (15,783) |
| Income before capital contributions | 6,902 | 9,831 |
| Capital contributions | 104,325 | 73,264 |
| Changes in net position | 111,227 | 83,095 |
| Total net position – beginning | 1,171,463 | 1,088,368 |
| Total net position – ending | \$1,282,690 | \$1,171,463 |

See accompanying notes to financial statements.

**CITY OF BALTIMORE
WASTEWATER UTILITY FUND**

Statements of Cash Flows

Years ended June 30, 2013 and 2012

(Expressed in thousands)

| | 2013 | 2012 |
|---|-----------|-----------|
| Cash flows from operating activities: | | |
| Receipts from customers | \$126,187 | \$171,958 |
| Payments to employees | (56,114) | (56,229) |
| Payments to suppliers | (49,771) | (56,190) |
| Net cash provided by operating activities | 20,302 | 59,539 |
| Cash flows from capital and related financing activities: | | |
| Proceeds from water quality loans | 4,766 | — |
| Interest income | 951 | 1,115 |
| Interest expense | (14,571) | (18,258) |
| Principal paid on revenue bonds | (22,676) | (22,460) |
| Principal paid on general long term debt | (19) | (42) |
| Acquisition and construction of capital assets | (142,773) | (127,703) |
| Capital contributions | 104,325 | 73,264 |
| Issuance costs | — | 460 |
| Net cash used by capital and related financing activities | (69,997) | (93,624) |
| Net decrease in cash and cash equivalents | (49,695) | (34,085) |
| Cash and cash equivalents, beginning of year | 196,390 | 230,475 |
| Cash and cash equivalents, end of year | \$146,695 | \$196,390 |
| Reconciliation of operating income to net cash provided by operating activities: | | |
| Operating income | \$21,512 | \$25,614 |
| Adjustments to reconcile operating income to net cash provided by operating activities: | | |
| Depreciation expense | 36,794 | 34,903 |
| Changes in assets and liabilities: | | |
| Accounts receivable | (5,704) | (6,404) |
| Due to/from other governments | (27,078) | 7,479 |
| Inventories | (2) | (11) |
| Restricted accounts receivable | (24,552) | (8,990) |
| Accounts payable and accrued liabilities | (11,652) | 297 |
| Other liabilities | (341) | 3,058 |
| Accrued interest payable | 390 | 1,430 |
| Restricted accounts payable | 25,794 | 363 |
| Due to other governments | 5,141 | 1,800 |
| Total adjustments | (1,210) | 33,925 |
| Net cash provided by operating activities | \$20,302 | \$59,539 |

See accompanying notes to financial statements.

**CITY OF BALTIMORE
WASTEWATER UTILITY FUND**

Notes to Financial Statements

June 30, 2013 and 2012

(1) Description of the Utility

The Wastewater Utility Fund is a separate utility in the Bureau of Water and Wastewater, one of the three bureaus in the City of Baltimore, Maryland's Department of Public Works. In November 1978, the voters approved a Charter Amendment establishing the Wastewater Utility as a separate enterprise and requiring it to be financially self-sustaining and operated without profit or loss to the other funds or programs of Baltimore City (City).

These financial statements are only of the Wastewater Utility and are not intended to present the financial position, changes in financial position, or, where applicable, cash flows of the City.

(2) Summary of Significant Accounting Policies

The accounting and financial reporting policies of the Wastewater Utility conform to accounting principles generally accepted in the United States and reporting standards as promulgated by the Governmental Accounting Standards Board for enterprise funds.

(a) Basis of Accounting

The financial statements have been prepared on the accrual basis of accounting whereby revenues are recorded when earned and expenses are recorded at the time liabilities are incurred, regardless of when the related cash flows take place. Operating revenues result from the services provided by the Wastewater Utility, and all other revenue is considered nonoperating.

(b) Cash and Cash Equivalents

Cash and cash equivalents include demand deposits, as well as short-term investments with a maturity date within three months of the date acquired by the Wastewater Utility.

(c) Investments

Investments are reported at fair value on the date of the statement of net position, based on market prices. Investments with maturities of less than one year from purchase date are reported at cost, which approximates fair value. Securities traded on national exchanges are valued at the last reported sales price.

(d) Swaps

Interest Rate Swaps are entered into to take advantage of lower cost interest rates, through conversion of variable rate to fixed rates and fixed rate to variable rates. Swap related transactions are recorded as payments are received and made. Note 9 provides more information on the various rewards and risks typical to these types of financing arrangements.

(e) Inventories

Inventories are stated at cost, using the moving average cost method.

**CITY OF BALTIMORE
WASTEWATER UTILITY FUND**

Notes to Financial Statements

June 30, 2013 and 2012

(f) *Unbilled Wastewater Utility User Charges*

Unbilled Wastewater user charges are estimated and accrued at year-end.

(g) *Restricted Assets*

The proceeds of the Wastewater Utility revenue bonds, Federal and State grants, and restricted accounts receivable are restricted for the purpose of the construction of Wastewater facilities and revenue bond repayment requirements.

(h) *Use of Restricted Net Position*

When an expense is incurred for which restricted and unrestricted resources are available to pay the expense, it is the Wastewater Utility's policy to apply the expense first to restricted resources, then to unrestricted resources.

(i) *Capital Assets*

Purchased or constructed capital assets are reported at historical cost. Capitalization thresholds are \$50,000 for buildings and improvements; and \$5,000 for equipment.

Capital assets are depreciated using the straight-line method over the estimated useful lives, as follows:

| | |
|------------------|---------------|
| Buildings | 50 years |
| Improvements | 20 – 50 years |
| Equipment | 2 – 25 years |
| Mobile equipment | 5 – 10 years |

(j) *Gains and Losses on Extinguishment of Debt from Refundings*

Gains and losses on the early extinguishment of debt are amortized over the shorter of the life of the new or old debt.

(k) *Sick, Vacation, and Personal Leave*

Employees earn one day of sick leave for each completed month of service; there is no limitation on the number of sick leave days that may be accumulated. A portion of unused sick leave earned annually during each twelve month base period may be converted to cash for a maximum of three days, computed on an attendance formula.

Upon retirement with pension benefits, or termination of employment after completion of twenty or more years of service without pension benefits, employees receive one day's pay for every four sick leave days accumulated and unused as of the date of separation; under any other conditions of separation, unused sick leave is forfeited. At June 30, 2013, it is estimated that accumulated nonvested sick leave for the Wastewater Utility approximated \$6.003 million. Sick leave benefit expenses are recorded as a percent of conversion value based on years of service, with a maximum of 100% for employees with twenty years or more of service.

**CITY OF BALTIMORE
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Notes to Financial Statements

June 30, 2013 and 2012

Employees can accumulate a maximum of 224 vacation and personal leave days depending upon length of service, which may be taken either through time off or carried until paid upon termination or retirement. Accumulated vacation and personal leave expenses are recorded when leave is earned.

The total vacation, personal leave, and conversion value of unused sick leave recorded as a liability for compensated absences at June 30, 2013 and 2012 is \$6.808 million and \$6.843 million, respectively.

(1) Due to Other Governments

Effective January 1, 2005, the State of Maryland implemented a Bay Restoration Fee to provide funding for the upgrade of Wastewater treatment facilities in the State. The fee is collected quarterly by the local government and remitted to the State. At June 30, 2013 and 2012, the Wastewater Utility held \$17.804 million and \$12.663 million respectively, in fees due to the State.

(3) Deposits and Investments

The Wastewater Utility participates in the City's pooled cash account. At June 30, 2013 and 2012, the Wastewater Utility's share of the City's pooled cash account, including both restricted and unrestricted cash, was \$38.810 and \$40.187, million, respectively. All of the City's pooled cash deposits are either insured through the Federal Depository Insurance Corporation or collateralized by securities held in the name of the City by the City's agent.

For other than pension funds, the City is authorized by state law to invest in direct or indirect obligations of the United States Government, repurchase agreements that are secured by direct or indirect obligations of the United States Government, certificates of deposit, commercial paper with highest letter and numerical rating, and mutual funds registered with the Securities and Exchange Commission. The City's investment policy limits the percentage of certain types of securities, with the exception of obligations for which the United States Government has pledged its full faith and credit. For investments held by the City in trust and/or to secure certain debt obligations, the City complies with the terms of the trust agreements. The City's Board of Finance has formally adopted the above policies and reviews and approves all security transactions.

**CITY OF BALTIMORE
WASTEWATER UTILITY FUND**

Notes to Financial Statements

June 30, 2013 and 2012

The Wastewater Utility's investments at June 30, 2013 and 2012 are presented in the following table. All investments are presented by investment type, and debt securities are presented by maturity (amounts expressed in thousands):

| | <u>Fair value</u> | <u>Investment maturities (in months)</u> | | |
|--------------------------------|-------------------|--|----------------|------------------------|
| | | <u>Less than 6</u> | <u>6 to 12</u> | <u>Greater than 12</u> |
| June 30, 2013 Investment type: | | | | |
| Debt securities: | | | | |
| U.S. Treasury | \$280 | \$280 | — | — |
| U.S. Agencies | 7,793 | 7,793 | — | — |
| Money market mutual funds | 94,479 | 94,479 | — | — |
| Commercial paper | 5,332 | 5,332 | — | — |
| | <u>\$107,884</u> | <u>\$107,884</u> | <u>—</u> | <u>—</u> |
| Less: cash equivalents | <u>107,884</u> | | | |
| Total investments | <u>—</u> | | | |

| | <u>Fair value</u> | <u>Investment maturities (in months)</u> | | |
|--------------------------------|-------------------|--|----------------|------------------------|
| | | <u>Less than 6</u> | <u>6 to 12</u> | <u>Greater than 12</u> |
| June 30, 2012 Investment type: | | | | |
| Debt securities: | | | | |
| U.S. Agencies | \$16,505 | \$16,505 | — | — |
| Money market mutual funds | 126,011 | 126,011 | — | — |
| Commercial paper | 4,939 | 4,939 | — | — |
| | <u>147,455</u> | <u>\$147,455</u> | <u>—</u> | <u>—</u> |
| Less: cash equivalents | <u>147,455</u> | | | |
| Total investments | <u>—</u> | | | |

Interest rate risk – Interest rate risk is the risk that changes in interest rates of debt investments will adversely affect the fair value of the investments.

The City limits its interest rate risk in accordance with the City's Board of Finance policy by maintaining a minimum of 20% of the City's investment in funds in liquid investments, to include United States Government securities, overnight repurchase agreements, and by limiting the par value of the portfolio invested for a period greater than one year at or below \$100 million. The Wastewater Utility is in compliance with this policy.

**CITY OF BALTIMORE
WASTEWATER UTILITY FUND**

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Credit risk of debt securities – Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligation.

As discussed above, the City's Board of Finance limits City investments to only the highest rated investments in the categories discussed above. The Wastewater Utility's portions of the City's rated debt investments as of June 30, 2013 were rated by a nationally recognized statistical rating agency, and are presented below using the Standard and Poor's rating scale (amounts expressed in thousands):

| Investment type | Fair value | June 30, 2013 | |
|--|------------------|-----------------|-----------------|
| | | Quality ratings | |
| | | AA+ | A1 |
| Debt securities: | | | |
| U.S. Agencies: | | | |
| Federal home loan mortgage association note | \$7,793 | \$7,793 | — |
| Money market mutual funds: | | | |
| Wilmington U.S. government money market fund | 94,479 | — | \$94,479 |
| Commercial paper | 5,332 | — | 5,332 |
| Total rated debt investments | <u>\$107,604</u> | <u>\$7,793</u> | <u>\$99,811</u> |

| Investment type | Fair value | June 30, 2012 | |
|--|------------------|------------------|----------------|
| | | Quality ratings | |
| | | AA+ | A1 |
| Debt securities: | | | |
| U.S. Agencies: | | | |
| Federal home loan mortgage association note | \$16,505 | \$16,505 | — |
| Money market mutual funds: | | | |
| Wilmington U.S. government money market fund | 126,011 | 126,011 | — |
| Commercial paper | 4,939 | — | \$4,939 |
| Total rated debt investments | <u>\$147,455</u> | <u>\$142,516</u> | <u>\$4,939</u> |

(4) Allowance for Doubtful Accounts

Accounts receivable are shown net of an allowance of \$16.141 million and \$16.185 million as of June 30, 2013 and 2012, respectively.

**CITY OF BALTIMORE
WASTEWATER UTILITY FUND**

Notes to Financial Statements

June 30, 2013 and 2012

(5) Capital Assets

Capital assets activity for the years ended June 30, 2013 and 2012 were as follows (expressed in thousands):

| | Balance June 30, 2012 | Increases | Decreases | Balance June 30, 2013 |
|--|-----------------------------|------------------|------------------|-----------------------------|
| Capital assets, not being depreciated: | | | | |
| Land | \$8,931 | — | — | \$8,931 |
| Construction in progress | 443,186 | \$167,173 | \$107,763 | 502,596 |
| Total capital assets, not being depreciated | 452,117 | 167,173 | 107,763 | 511,527 |
| Capital assets, being depreciated: | | | | |
| Buildings and improvements | 1,606,236 | 42,356 | 255 | 1,648,337 |
| Equipment | 123,734 | 1,536 | 35 | 125,235 |
| Infrastructure | 43,254 | 65,528 | — | 108,782 |
| Total capital assets, being depreciated | 1,773,224 | 109,420 | 290 | 1,882,354 |
| Less accumulated depreciation for: | | | | |
| Buildings and improvements | 449,693 | 31,291 | — | 480,984 |
| Equipment | 85,544 | 3,983 | 27 | 89,500 |
| Infrastructure | 433 | 1,520 | — | 1,953 |
| Total accumulated depreciation | 535,670 | 36,794 | 27 | 572,437 |
| Total capital assets, being depreciated, net | 1,237,554 | 72,626 | 263 | 1,309,917 |
| Total capital assets, net | <u>\$1,689,671</u> | <u>\$239,799</u> | <u>\$108,026</u> | <u>\$1,821,444</u> |

Interest is capitalized on assets acquired with tax-exempt debt. The amount of interest to be capitalized is calculated by offsetting interest costs incurred from the date of borrowing until completion of the project, with interest earned on invested proceeds over the same period. During fiscal years 2013 and 2012, interest cost of \$13.708 million and \$12.243 million, respectively (net of interest earned of \$1.127 million and \$954 thousand respectively), was capitalized.

At June 30, 2013, the Wastewater Utility had outstanding commitments for construction of \$321.3 million.

**CITY OF BALTIMORE
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Notes to Financial Statements

June 30, 2013 and 2012

(6) Long-Term Obligations

The City does not have a debt limit; however, the Constitution of Maryland requires a three-step procedure for the creation of debt by the City of Baltimore:

- Act of the General Assembly of Maryland or resolution of the majority of Baltimore City delegates
- Ordinance of the Mayor and City Council of Baltimore
- Ratification by the voters of the City of Baltimore

Changes in long-term obligations for the years ended June 30, 2013 and June 30, 2012 are as follows (amounts expressed in thousands):

| | Balance June 30, 2012 | Additions | Reductions | Balance June 30, 2013 | Amounts due within one year |
|--|-----------------------------|-----------|------------|-----------------------------|--------------------------------------|
| Long-term financing with State of Md. ^(a) | \$20 | — | \$20 | — | — |
| Total general long-term debt | 20 | — | 20 | — | — |
| Revenue bonds | 708,386 | 31,844 | 22,675 | 717,555 | 24,099 |
| Less: unamortized charges | 2,773 | — | 135 | 2,638 | — |
| Total revenue bonds payable | \$705,613 | \$31,844 | \$22,540 | \$714,917 | \$24,099 |
| Compensated absences | \$6,834 | — | \$26 | \$6,808 | \$2,906 |
| | | | | | |
| | Balance June 30, 2011 | Additions | Reductions | Balance June 30, 2012 | Amounts due within one year |
| Long-term financing with State of Md. ^(a) | \$61 | — | \$41 | \$20 | \$20 |
| Total general long-term debt | \$61 | — | \$41 | \$20 | \$20 |
| Revenue bonds | 730,976 | 3,707 | 26,297 | 708,386 | 22,691 |
| Less unamortized charges | 2,902 | — | 129 | 2,773 | — |
| Total revenue bonds payable | \$728,074 | \$3,707 | \$26,168 | \$705,613 | \$22,691 |
| Compensated absences | \$6,780 | \$54 | — | \$6,834 | \$2,909 |

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- (a) Under the provisions of Chapter 445, Laws of Maryland, 1968, and Chapter 286, Laws of Maryland, 1974, loans were made available to counties and municipalities charged with providing sewerage facilities to assist in the construction of such facilities. These loans bear interest ranging from 6.10% to 8.19%, and interest of \$1,000 will be due thereon in future years.

The City has issued revenue bonds, the proceeds of which were used to provide funds for capital improvements to Wastewater facilities. Certain assets and revenues of the Wastewater Utility are pledged as collateral for the bonds and notes. Bonds and notes outstanding as of June 30 consist of (amounts expressed in thousands):

| | <u>2013</u> | <u>2012</u> |
|--|-------------|-------------|
| Serial bonds series 1994-B maturing in annual installments from \$332,000 to \$406,000 through February 1, 2015, with interest rate at 2.25%, payable semiannually | \$802 | \$1,190 |
| Serial bonds series 1994-C maturing in annual installments from \$310,000 to \$387,000 through February 1, 2015, with interest rate at 2.5%, payable semi-annually | 765 | 1,133 |
| Serial bonds series 1994-D maturing in annual installments from \$215,000 to \$296,000 through February 1, 2015, with interest rate at 3.6%, payable semiannually | 581 | 856 |
| Serial bonds series 1996-B maturing in annual installments from \$148,000 to \$208,000 through February 1, 2017, with interest rate at 3.17%, payable semiannually | 795 | 979 |
| Serial bonds series 1998-A maturing in annual installments from \$287,000 to \$414,000 through February 1, 2019, with interest rate at 2.87%, payable semiannually | 2,320 | 2,670 |
| Serial bonds series 1999-A maturing in annual installments from \$122,000 to \$167,000 through February 1, 2019, with interest rate at 2.52%, payable semiannually | 915 | 1,052 |
| Serial bonds series 1999-B maturing in annual installments from \$433,000 to \$652,000 through February 1, 2021, with interest rate at 2.61%, payable semiannually | 4,215 | 4,746 |
| Serial bonds series 2001-A maturing in annual installments from \$569,000 to \$819,000 through February 1, 2022, with interest rate at 2.3%, payable semiannually | 6,552 | 7,219 |

**CITY OF BALTIMORE
WASTEWATER UTILITY FUND**

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| | <u>2013</u> | <u>2012</u> |
|---|-------------|-------------|
| Serial bonds series 2002-A maturing in annual installments from \$1,145,000 to \$1,660,000 from July 1, 2013 through July 1, 2021, with variable interest through July 1, 2016 and a fixed rate of 4.85 – 5.0% thereafter, payable semiannually | 11,730 | 13,660 |
| Serial bonds series 2003-A maturing in annual installments from \$1,930,000 to \$2,095,000 from July 1, 2023 through July 1, 2025, with interest ranging from 4.125% to 4.2% payable semiannually | 6,035 | 6,035 |
| Serial bonds series 2003-B maturing in annual installments from \$308,000 to \$984,000 through February 1, 2024, with interest rate at 0.40%, payable semiannually | 3,194 | 3,511 |
| Serial bonds series 2004-B maturing in annual installments from \$917,000 to \$984,000 through February 1, 2024, with interest rate at 0.45%, payable semiannually | 8,216 | 9,157 |
| Serial bonds series 2004-C maturing in annual installments from \$846,000 to \$984,000 through February 1, 2024 with interest rate at 0.25%, payable semiannually | 9,786 | 10,654 |
| Serial bonds series 2005-A maturing in annual installments from \$984,000 to \$1,030,000 through February 1, 2024 with interest rate at 0.25%, payable semiannually | 10,929 | 11,988 |
| Serial bonds series 2005-B maturing in annual installments from \$750,000 to \$1,480,000 from July 1, 2013 through July 1, 2025 with interest rates of 3.25% to 5.0%, payable semiannually | 12,530 | 13,410 |
| Serial bonds series 2006-A maturing in annual installments from \$1,380,000 to \$1,561,000 through February 1, 2026 with interest rate at 0.40%, payable semiannually | 17,191 | 18,674 |
| Serial bonds series 2006-B maturing in annual installments from \$338,000 to \$362,000 through February 1, 2026 with interest rate at 0.40%, payable semiannually | 4,420 | 4,763 |
| Serial bonds series 2006-C maturing in annual installments from \$990,000 to \$2,090,000 from July 1, 2013 through July 1, 2026, with interest rates of 4.0% to 5.0%, payable semiannually | 21,895 | 23,010 |
| Serial bonds series 2007-A maturing in annual installments from \$1,833,000 to \$2,184,000 through February 1, 2026, with interest rate at 0.4%, payable semiannually | 27,239 | 29,312 |
| Serial bonds series 2007-C maturing in annual installments from \$35,000 to \$3,935,000 from July 1, 2012 through July 1, 2027, with interest rates of 3.6% to 4.5%, payable semiannually | 10,910 | 10,955 |
| Serial bonds series 2007-B maturing in annual installments from \$134,000 to \$161,000 through February 1, 2027, with interest rate at 0.4%, payable semiannually | 2,200 | 2,352 |

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WASTEWATER UTILITY FUND**

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June 30, 2013 and 2012

| | <u>2013</u> | <u>2012</u> |
|--|-------------|-------------|
| Serial bonds series 2007-D maturing in annual installments from \$1,890,000 to \$4,330,000 from July 1, 2013 through July 1, 2027, with interest rate at 5.0%, payable semiannually | 47,180 | 49,265 |
| Serial bonds series 2008-A maturing in annual installments from \$475,000 to \$1,005,000 from July 1, 2013 through July 1, 2028, with interest rates of 2.00% to 5.00%, payable semiannually | 24,750 | 25,835 |
| Serial bonds series 2009-A maturing in annual installments of \$426,167 from February 1, 2013 through February 1, 2029 with interest rate at 0% | 6,819 | 7,245 |
| Serial bonds series 2009-B maturing in annual installment of \$95,391 from February 1, 2013 through February 1, 2030, with interest rate at 0.0% | 1,466 | 1,558 |
| Serial bonds series 2009-C maturing in annual installments from \$370,000 to \$570,000 from July 1, 2013 through July 1, 2022, with interest rates of 2.00% to 4.50% payable semiannually | 6,860 | 7,430 |
| Term bonds series 1993-A with interest at 5.6%, payable semiannually, due July 1, 2013 | 1,600 | 3,100 |
| Term bonds series 1993-A with interest at 5.65%, payable semiannually, due July 1, 2020 | 14,000 | 14,000 |
| Term bonds series 1994-A with interest at 6.0%, payable semiannually, due July 1, 2015 | 2,355 | 3,050 |
| Term bonds series 1994-A with interest at 5.0%, payable semiannually, due July 1, 2022 | 7,115 | 7,115 |
| Term bonds series 2002-A with interest at 5.0%, payable semiannually, due July 1, 2023 | 2,470 | 2,470 |
| Term bonds series 2002-A with interest at 5.0%, payable semiannually, due July 1, 2027 | 6,070 | 6,070 |
| Term bonds series 2002-A with interest at 5.2%, payable semiannually, due July 1, 2032 | 9,480 | 9,480 |
| Term bonds series 2002-A with interest at 5.125%, payable semiannually, due July 1, 2042 | 31,630 | 31,630 |
| Term bonds series 2006-C with interest at 5.0%, payable semiannually, due July 1, 2029 | 6,920 | 6,920 |
| Term bonds series 2007-C with interest at 4.5%, payable semiannually, due July 1, 2032 | 29,795 | 29,795 |
| Term bonds series 2007-C with interest at 4.5%, payable semiannually, due July 1, 2036 | 19,255 | 19,255 |

**CITY OF BALTIMORE
WASTEWATER UTILITY FUND**

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June 30, 2013 and 2012

| | <u>2013</u> | <u>2012</u> |
|---|-------------|-------------|
| Term bonds series 2007-D with interest at 5.0%, payable semiannually, due July 1, 2032 | 25,120 | 25,120 |
| Term bonds series 2007-D with interest at 5.0%, payable semiannually, due July 1, 2037 | 32,050 | 32,050 |
| Term bond series 2008-A with interest at 5.0%, payable semiannually, due July 1, 2033 | 12,205 | 12,205 |
| Term bond series 2008-A with interest at 5.0%, payable semiannually, due July 1, 2038 | 15,575 | 15,575 |
| Term bonds series 2009-C with interest at 5.00%, payable semiannually, due July 1, 2024 | 1,720 | 1,720 |
| Term bonds series 2009-C with interest at 5.00%, payable semiannually, due July 1, 2029 | 5,115 | 5,115 |
| Term bonds series 2009-C with interest at 5.125% payable semiannually, due July 1, 2034 | 6,545 | 6,545 |
| Term bonds series 2009-C with interest at 5.625% payable semiannually, due July 1, 2039 | 8,490 | 8,490 |
| Auction rate notes series 2002-B, payable monthly, due July 1, 2032 | 25,300 | 25,300 |
| Auction rate notes series 2002-C, payable monthly, due July 1, 2032 | 45,300 | 45,900 |
| Auction rate notes series 2004-A, payable monthly, due July 1, 2034 | 17,500 | 17,500 |
| Serial bonds series 2009-E maturing in annual installments of \$157,842 from February 1, 2015 through February 1, 2032, with an interest rate of 0.00% | 3,000 | 3,000 |
| Serial bonds series 2010-A maturing in annual installments from \$15,764 to \$37,150 from February 1, 2014 through February 1, 2040, with an interest rate of 0.00% | 750 | 750 |
| Serial bonds series, 2011-A maturing in annual installments of \$1,515,000 to \$3,940,000 from July 1, 2013 through February 1, 2031, with interest rates from 3.00% to 5.00% | 50,295 | 51,810 |

**CITY OF BALTIMORE
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June 30, 2013 and 2012

| | 2013 | 2012 |
|---|-------------|-------------|
| Serial bonds series, 2011-B maturing in annual installments of \$168,332 to \$203,363 from July 1, 2014 through February 1, 2033, with interest rates from 1.00% | 3,706 | 3,707 |
| Term bond series 2011-A with interest at 5.00%, payable semiannually, due July 1, 2036 | 22,870 | 22,870 |
| Term bond series 2011-A with interest at 5.00%, payable semiannually, due July 1, 2041 | 29,185 | 29,185 |
| Serial bonds series, 2013-A maturing in annual installments of \$1,558,483 to \$1,798,836 from February 2, 2016 through February 1, 2034, with interest rate of 0.80%, payable semiannually | 31,844 | — |
| | 717,555 | 708,386 |
| Less unamortized charges | 2,638 | 2,773 |
| | \$ 714,917 | 705,613 |

At June 30, 2013 and 2012, the Wastewater Utility fund had \$88.100 million and \$88.700 million of auction rate notes, respectively. Interest rates for these notes are determined every 7 to 35 days depending on the date of issue. In the event of a failed auction, the auction agent assesses the failed auction rate to the issuers of the notes. Interest paid under these conditions is currently limited to 150% to 175% of the nonfinancial commercial paper rate depending on the rating of the insurance provider on each note issue. The failed auction interest rate on these notes was in the 1% range or less.

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June 30, 2013 and 2012

Principal maturities and interest on revenue bonds, shown at gross, are as follows (amounts expressed in thousands):

| Fiscal year: | <u>Principal</u> | <u>Interest</u> | <u>Interest rate swap net^(a)</u> |
|--------------|------------------|------------------|---|
| 2014 | \$24,099 | \$24,128 | \$3,890 |
| 2015 | 24,743 | 23,594 | 3,880 |
| 2016 | 26,682 | 22,945 | 3,826 |
| 2017 | 27,417 | 22,295 | 3,726 |
| 2018 | 27,590 | 21,597 | 3,609 |
| 2019 – 2023 | 141,474 | 96,632 | 15,754 |
| 2024 – 2028 | 132,343 | 77,274 | 10,774 |
| 2029 – 2033 | 148,056 | 53,823 | 4,379 |
| 2034 – 2038 | 115,140 | 26,176 | 134 |
| 2039 – 2043 | 50,011 | 5,514 | — |
| | <u>\$717,555</u> | <u>\$373,978</u> | <u>\$49,972</u> |

(a) Interest rate swap net payments represent estimated payments for additional interest resulting from swap agreements to counterparties. The additional payments were computed using rates as of June 30, 2013, assuming current interest rates remain the same for the entire term of the bonds. As rates vary, variable rate bond interest payments and net swap payments will vary.

The Wastewater Utility has various revenue bond covenants that generally require the Utility to maintain rates sufficient to meet the operating requirements of the Utility and an operating reserve as defined in the revenue bond indentures. As of June 30, 2013, the rate requirements were met, and management believes the Wastewater Utility is in compliance with all significant requirements of the indentures.

(7) Pledged Revenue

The Wastewater Utility Fund has pledged future customer revenues to repay \$717.555 million and \$708.386 million of revenue bond debt at June 30, 2013 and 2012, respectively. Proceeds from these revenue bonds were used to build and improve various aspects of the City's Wastewater Utility systems. The bonds are payable solely from the revenues of the Wastewater Utility Fund and are payable through 2043. Annual principal and interest payments on these revenue bonds are expected to require 23% of pledged revenues. Total principal and interest remaining to be paid on the revenue bonds for the Wastewater Utility Fund is \$1,141.505 million and \$1,159.280 million at June 30, 2013 and June 30, 2012, respectively. Principal and interest paid for the current year and current pledged revenue for the Wastewater Utility Fund were \$51.586 million and \$183.521 million respectively. While principal and interest and pledged revenue for FY 2012 were \$53.714 million and \$179.873 million, respectively.

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WASTEWATER UTILITY FUND**

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June 30, 2013 and 2012

(8) Prior-Year Defeasance of Debt

In prior years, the City defeased certain revenue bonds by placing the proceeds of new debt issues in an irrevocable trust to provide for all future debt service payments on the old debt. Accordingly, the trust account assets and the liability for the defeased debt are not included in the Wastewater Utility's financial statements. At June 30, 2013 and 2012, the Wastewater Utility had \$60.035 million and \$60.035 million, respectively of debt outstanding that is considered defeased.

(9) Interest Rate Swaps

(a) Objectives of the Swaps

The City has entered into swaps for three reasons: First, the majority of its swaps have been used to create synthetic fixed rate financings (by issuing floating-rate bonds and swapping them to fixed) as a way to provide lower-cost fixed rate financing to meet the City's capital needs. Second, the City has used swaps from fixed to floating to help the City manage its balance sheet for an appropriate mix of fixed and floating rate exposure. And, third, the City has used basis swaps to amend the floating rate on certain of its existing synthetic fixed rate swaps in order to provide a better hedge on the underlying floating rate bonds.

(b) Terms, Fair Value, and Credit Risk

The terms, fair value, and credit risk rating of the outstanding swaps, as of June 30, 2013, were as follows. The notional amounts of the swaps match the principal amount of the associated debt. The City's swap agreements contain scheduled reductions to outstanding notional amounts that are designed to track the scheduled or anticipated reductions in the associated "bonds payable" category.

**CITY OF BALTIMORE
WASTEWATER UTILITY FUND**

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June 30, 2013 and 2012

Hedged Derivative Instruments

At June 30, 2013 and 2012, the Wastewater Utility Fund had liabilities for various hedged derivative instruments with total fair values of these instruments in the amount of (\$24.601) million and (\$33.728) million, respectively. The notional amounts for these hedged derivative instruments at June 30, 2013 and 2012 were \$94.020 million and \$97.150 million, respectively. During fiscal years 2013 and 2012, the fair values of these instruments increased \$9.127 million and decreased \$12.008 million, respectively. All hedges are cash flow hedges. The following schedule provides a detailed analysis of derivative instruments held at June 30, 2013 and 2012:

| Outstanding bonds | Effective date | Termination date | Interest rate paid by city | June 30, 2013 | | Counterparty credit rating | |
|--------------------------|----------------|------------------|----------------------------|------------------------|---------------------|----------------------------|---------|
| | | | | Interest rate received | Notional amount | | |
| Floating to fixed swaps: | | | | | | | |
| 2002 revenue bonds | 5/7/2002 | 7/1/2032 | 4.56% | 67% LIBOR | \$70,000,000 | (\$19,016,865) | A-/Baa1 |
| 2002 revenue bonds | 5/7/2002 | 7/1/2013 | 4.30 | Bond rate/CPI | 1,960,000 | (18,052) | A-/Baa1 |
| 2002 revenue bonds | 5/7/2002 | 7/1/2014 | 4.39 | Bond rate/CPI | 2,040,000 | (45,482) | A-/Baa1 |
| 2002 revenue bonds | 5/7/2002 | 7/1/2015 | 4.50 | Bond rate/CPI | 1,240,000 | (39,799) | A-/Baa1 |
| 2002 revenue bonds | 5/7/2002 | 7/1/2016 | 4.61 | Bond rate/CPI | 1,280,000 | (51,956) | A-/Baa1 |
| 2004 revenue bonds | 6/1/2004 | 7/1/2034 | 5.21 | SIFMA | 17,500,000 | (5,428,873) | A-/Baa1 |
| Total swaps outstanding | | | | | <u>\$94,020,000</u> | <u>(\$24,601,027)</u> | |

| Outstanding bonds | Effective date | Termination date | Interest rate paid by city | June 30, 2012 | | Counterparty credit rating | |
|--------------------------|----------------|------------------|----------------------------|------------------------|---------------------|----------------------------|---------|
| | | | | Interest rate received | Notional amount | | |
| Floating to fixed swaps: | | | | | | | |
| 2002 revenue bonds | 5/7/2002 | 7/1/2032 | 4.55% | 67% LIBOR | \$71,200,000 | (\$26,139,287) | A-/Baa1 |
| 2002 revenue bonds | 5/7/2002 | 7/1/2012 | 4.20 | Bond rate/CPI | 1,930,000 | 3,850 | A-/Baa1 |
| 2002 revenue bonds | 5/7/2002 | 7/1/2013 | 4.30 | Bond rate/CPI | 1,960,000 | (31,233) | A-/Baa1 |
| 2002 revenue bonds | 5/7/2002 | 7/1/2014 | 4.39 | Bond rate/CPI | 2,040,000 | (55,172) | A-/Baa1 |
| 2002 revenue bonds | 5/7/2002 | 7/1/2015 | 4.50 | Bond rate/CPI | 1,240,000 | (43,397) | A-/Baa1 |
| 2002 revenue bonds | 5/7/2002 | 7/1/2016 | 4.61 | Bond rate/CPI | 1,280,000 | (51,223) | A-/Baa1 |
| 2004 revenue bonds | 6/1/2004 | 7/1/2034 | 5.21 | SIFMA | 17,500,000 | (7,411,316) | A-/Baa1 |
| Total swaps outstanding | | | | | <u>\$97,150,000</u> | <u>(\$33,727,778)</u> | |

(c) **Credit Risk**

As of June 30, 2013, the Wastewater Utility Fund is not exposed to credit risk on any of the outstanding swaps because the swaps have negative fair values. All fair values were calculated using the mark-to-market or par value method. However, should interest rates change and the fair values of the swaps become positive, the Fund would be exposed to credit risk in the amount of the derivatives' fair value.

The swap agreements contain varying collateral agreements with counterparties. In general, these agreements require full collateralization of the fair value of the swap should the counterparty's credit rating fall below Baa as issued by Moody's or BBB as issued by Standard and Poor's. Collateral on

**CITY OF BALTIMORE
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all swaps is to be in the form of cash or United States Government securities held by the City. As of June 30, 2013, none of the City's swap agreements met this requirement.

(d) Basis Risk

The City's variable rate bonds are of three types: remarketed variable rate demand bonds (VRDBs), auction rate bonds (ARBs), and CPI index bonds. For those swaps associated with VRDBs and ARBs, the City receives a floating rate based on either the SIFMA Index or the one-month LIBOR. For the SIFMA based swaps, the City is exposed to basis risk should the spread between the SIFMA and the VRDBs or ARBs rate change. If a change occurs that results in the spread widening, the expected cost savings may not be realized. As of June 30, 2013, the SIFMA rate for the prior 52-week period ranged from 0.06% to 0.23%, whereas the City's tax-exempt market rate ranged from 0.04% to 0.38%. For one of the swaps, the City will receive a percent of LIBOR or a percent of LIBOR plus a basis points spread, each rate was chosen to closely approximate the City's tax-exempt variable rate bond payments. Because this swap is LIBOR-based, there is an additional degree of basis risk. As of June 30, 2013, LIBOR for the prior 52-weeks ranged from 0.13% to 0.40%, whereas the City's taxable market rate ranged from 0.19% to 0.24%. For those swaps associated with CPI index bonds, there is no basis risk, because the floating rate on the swaps is identical to the floating rate on the bonds.

(e) Interest Rate Risk

For those swaps for which the City pays a floating rate and receives fixed rate payments, the City is exposed to interest rate risk. As floating rates increase, the City's expected savings could decrease. The City would, however, benefit from offsetting increases in its earnings on short-term investments, whose return would be expected to go up in a higher interest rate environment.

(f) Termination Risk

The City or the counterparty may terminate the swap if the other party fails to perform under the terms of the contract. If at the time of termination the swap contract has a negative fair value, the City would be liable to the counterparty for that payment.

Investment Derivative Instruments

The fair value balance and notional amounts of derivative instruments outstanding at June 30, 2013 and 2012, classified by type and the changes in fair value of such derivative instruments for the year ended June 30, 2013 and 2012 are as follows:

| | Investment derivative instruments | | | | |
|-------------------|-----------------------------------|------------|-----------------------------|-------------|---------------|
| | Changes in fair value | | Fair value at June 30, 2013 | | |
| | Classification | Amount | Classification | Amount | Notional |
| Fixed to floating | Investment revenue | (\$29,195) | Debt | (\$155,059) | (\$7,469,047) |

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| | <u>fair value</u> | | <u>Fair value at June 30, 2012</u> | | |
|-------------------|-----------------------|-----------------|------------------------------------|--------------------|----------------------|
| | <u>Classification</u> | <u>Amount</u> | <u>Classification</u> | <u>Amount</u> | <u>Notional</u> |
| Fixed to floating | Investment revenue | <u>\$75,708</u> | Debt | <u>(\$125,864)</u> | <u>(\$7,469,047)</u> |

(g) Credit Risk

At June 30, 2013 and 2012, the government is not exposed to credit risk on the interest rate swaps, because they are in a negative fair value or liability position. However, if interest rates change and the fair values become positive, the Wastewater Utility Fund would have exposure to credit risk. The counterparty's credit rating at June 30, 2013, was AA/Aa2 for derivative instruments held by the Wastewater Utility Fund.

(h) Interest Rate Risk

For those swaps for which the Wastewater Utility Fund pays a floating rate and receives fixed rate payments, the fund is exposed to interest rate risk. As floating rates increase, the Wastewater Utility Fund's expected savings could decrease. The fund would, however, benefit from offsetting increases in its earnings on short term investments, whose return would be expected to go up in a higher interest environment.

(10) Pension Plan

Classified employees of the Wastewater Utility are required to join the City of Baltimore's Employees' Retirement System (ERS). The ERS is a cost-sharing multiple – employer defined benefit pension plan which provides retirement, disability, and death benefits to plan members and beneficiaries. The plan is managed by a Board of Trustees in accordance with Article 22 of the Baltimore City Code. Plan provisions may be amended only by the City Council. The Wastewater Utility's share of contributions to the plan was \$7.524 million in 2013, \$6.330 million in 2012 and \$3.455 million in 2011. The Wastewater Utility contributed 100% of the required contribution each of the three years. The ERS issues a publicly available financial report that may be obtained by writing to the Baltimore City Retirement Systems, 7 East Redwood Street, 12th Floor, Baltimore, MD 21202-3470.

(11) Other Postemployment Benefits

Baltimore City administrative policy provides that other postemployment benefits, other than pension benefits, be provided to all employees of the City. These benefits include certain healthcare and life insurance benefits. All employees who retire are eligible to receive these benefits. The City of Baltimore provides other postemployment benefits (OPEB) to all qualified City employees. The OPEB Plan (Plan) is a contributory, single employer defined benefit plan. The benefit and contribution provisions of the Plan are established and may be amended by the City. The Plan provides postemployment healthcare, prescription and life insurance benefits to retirees and their beneficiaries. In order to effectively manage the Plan, the City established an OPEB Trust Fund. All retiree and City contributions are deposited into the Trust Fund and all retiree related health and life insurance benefits are paid from the Trust Fund. The City

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also contracted with the Board of Trustees of the Employee's Retirement System to act as investment manager for the Trust Fund. BNY Mellon Bank Asset Servicing is the Trust Fund's asset custodian. The Plan does not issue stand alone financial statements; however, the OPEB Trust Fund is included in the City's financial statements as a Trust and Agency Fund.

At June 30, 2013, there were 10,238 City retirees eligible for these benefits. The City's policy is to fund benefits on a pay as you go basis plus make additional contributions comprising the federal retiree drug subsidy payments and additional annual appropriation. Retirees are required to contribute at various rates ranging from approximately \$58 to \$1,331 on a monthly basis, depending on the health plan and level of coverage elected and whether Medicare supplemental coverage is present.

For fiscal year 2013 and 2012, the City's total contributions to the Plan were \$125.9 million and \$157.1 million, respectively, from its General Fund.

(12) Risk Management

The Wastewater Utility participates in the City's risk management program. The City is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. During fiscal year 1987, the City established the Risk Management Fund (an internal service fund) to account for and finance its uninsured risks. The City's risk financing techniques include a combination of risk retention through self-insurance and risk transfer through the purchase of commercial insurance. The Risk Management Fund services all claims for risk of loss, including general liability, property and casualty, workers' compensation, unemployment compensation, automobile physical damage and bodily injury, and sundry other risks. Commercial insurance coverage is provided for each property damage claim in excess of \$500 thousand with a cap of \$500 million. Settled claims have not exceeded this commercial coverage in any of the past three years. The City also provides medical insurance coverage for all employees and retirees. Employees are required to pay a percentage of the annual cost of medical plans, and the remaining costs are paid by the City's internal service fund.

All funds of the City participate and make payments to the Risk Management Fund based on actuarial estimates and historical cost information of the amounts needed to pay prior and current year claims. During fiscal years 2013 and 2012, the Wastewater Utility's share of the City's cost was \$1.829 million and \$1.782 million, respectively.

(13) Commitments and Contingencies

The Wastewater Utility has received Federal grants and State grants. Entitlement to grant resources is generally conditioned upon compliance with terms and conditions of the grant agreements and applicable Federal and State regulations, including the expenditure of the resources for eligible purposes. Substantially all grants are subject to financial and compliance audits in accordance with grantors' requirements. Any disallowances as a result of these audits become a liability of the Wastewater Utility. As of June 30, 2013, the Wastewater Utility estimates that no material liabilities will result from such audits.

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The Northeast Maryland Waste Disposal Authority Act, was enacted by the Maryland General Assembly to assist in the provision of waste disposal facilities for the Northeast Maryland area, including the facilities for the disposal of Wastewater treatment residue. The City agreed to perform the obligations of the Authority. The current agreement, approved in March 2008 provided that the Authority and Mayor and City Council of Baltimore (the City) entered into a service agreement, through June 30, 2013, with Veolia Water North America-Central, LLC, a Delaware limited liability company, which now owns and operates the Facility. The agreement allows the Wastewater Utility to deliver up to approximately 2,167 wet tons of sewerage sludge per month and to pay a tipping fee comparable to alternative methods of sludge disposal currently being used by the Wastewater Utility. The debt service on variable rate bonds is a component of the tipping fee. The Wastewater Utility's current tipping fee expense per wet ton for delivering sewerage sludge was \$86.47 and \$42.67 up to the guaranteed and excess tonnage amounts, respectively. Payments under the agreement in fiscal year 2013 were \$2.329 million. The maximum commitment by the City is 54,750 wet tons per year. The agreement has been extended to June 30, 2018.

The Wastewater Utility also has an agreement with Synagro-Baltimore, L.L.C. a wholly owned subsidiary of Synagro Technologies for processing biosolids at the City's Back River and Patapsco Wastewater Treatment Plants. Under the agreements the Wastewater Utility delivers approximately 20,000 dry tons of biosolids per year at each facility and pays base and service tipping fee. The debt service on the bonds is a component of the tipping fee. The Wastewater Utility's current monthly base tipping fee expense for delivering biosolids is \$274 thousand and \$265 thousand for the Back River and Patapsco Wastewater Treatment Plants, respectively. The service tipping fees were \$385.37 and \$388.66 per ton for the Back River and Patapsco Wastewater Treatment Plants, respectively. Payments under the agreements in fiscal year 2013 were \$21.651 million. The agreements extend to 2014 and 2017 for the Back River and Patapsco Wastewater Treatment Plants, respectively.

The City has voluntarily entered into a Consent Decree to rehabilitate its aging sewer infrastructure and correct historical overflow mechanisms. The Consent Decree is one of many that the U.S. Department of Justice has currently negotiated with major east coast cities with aged sewer and storm water infrastructures. The City is proactively negotiating to increase its remedial efforts to address discharge and overflow concerns of the State and Federal regulatory agencies. These efforts are ambitious and the costs of the construction and maintenance are estimated to be greater than \$1 billion. The City has committed to financing these remedial efforts through a combination of water and Wastewater revenue bonds in conjunction with all available State and Federal assistance.

(14) Subsequent Event

On December 3, 2013, the City issued Wastewater Project and Refunding Revenue Bonds, Series 2013 in the amount of \$251 million, of which \$131.6 million is applicable to bond refunding. The bonds will fund capital projects and refund certain outstanding auction and fixed rate bonds. The majority savings was used to terminate outstanding swaps associated with the refunded auction bonds. The interest rates range from 3.00% to 5.00%, and interest is payable semiannually on July 1 and January 1 of each year beginning on July 1, 2014.

