

CITY OF BALTIMORE
WASTE WATER UTILITY FUND
FINANCIAL STATEMENTS
FOR THE YEARS ENDED
JUNE 30, 2012 and 2011
(WITH REPORT OF INDEPENDENT AUDITORS THEREON)

CITY OF BALTIMORE
WASTE WATER UTILITY FUND
FINANCIAL STATEMENTS
YEARS ENDED JUNE 30, 2012 and 2011

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CITY OF BALTIMORE
STEPHANIE RAWLINGS-BLAKE
Mayor

DEPARTMENT OF AUDITS
Room 321, City Hall
Baltimore, Maryland 21202



KPMG LLP
Suite 12000
1801 K Street, NW
Washington, DC 20006

Independent Auditors' Report

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

We have jointly audited the statement of net assets of the Waste Water Utility Fund of the City of Baltimore, Maryland (the City), as of June 30, 2012 and 2011 and the related statements of revenues, expenses, and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the City's management. Our responsibility is to express an opinion on these financial statements based on our audits.

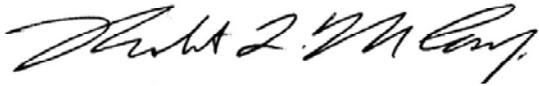
We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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 1, the financial statements present only the Waste Water 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, 2012 and 2011, its changes in financial position or its cash flows for the 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 Waste Water Utility Fund as of June 30, 2012 and 2011, and the changes in its financial position and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

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 principally 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.

In accordance with *Government Auditing Standards*, we have also issued our report dated August 19, 2013 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, which include the Waste Water Utility Fund. 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 the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.



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



Independent Auditors

August 19, 2013

City of Baltimore
Waste Water Utility Fund

Management's Discussion and Analysis

This section of the City of Baltimore, Maryland's Waste Water Utility Fund (Waste Water Utility) financial statements presents our discussion and analysis of the Waste Water Utility's financial performance during the years ended June 30, 2012 and 2011.

Background

The Waste Water Utility, through its system of sanitary sewers, interceptors, pumping stations, and waste water 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 waste water system presently receives waste water directly from Anne Arundel and Baltimore Counties, as well as the City. In addition, portions of Anne Arundel and Howard Counties discharge waste water into the system through Baltimore County.

Highlights

- For fiscal year 2012, total operating revenues were \$179.9 million, which represents a increase of 12.4% from the previous year's revenues. For fiscal year 2011, total operating revenues were \$160.1 million, which represents a decrease of 3.7% over the FY 2010 revenues.
- Total operating expenses for fiscal year 2012 were \$154.3 million, a increase of \$9.6 million over fiscal year 2011 operating expenses of \$144.7 million.
- Net assets increased in fiscal years 2012 and 2011 by \$83.1 million and \$50.7 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 Waste Water 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.

The Waste Water 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 Waste Water Utility are included in the statement of net assets.

Financial Analysis of the Waste Water Utility

Net Assets
Waste Water Utility Fund
(Expressed in Thousands)

	June 30,			Change 2012-2011	Change 2011-2010
	2012	2011	2010		
Current and other assets.....	\$ 293,520	\$ 307,670	\$ 223,316	\$ (14,150)	\$ 84,354
Capital assets.....	1,689,671	1,585,901	1,526,248	103,770	59,653
Total assets.....	<u>1,983,191</u>	<u>1,893,571</u>	<u>1,749,564</u>	<u>89,620</u>	<u>144,007</u>
Current liabilities.....	77,597	60,832	54,467	16,765	6,365
Noncurrent liabilities.....	734,131	744,371	657,475	(10,240)	86,896
Total liabilities.....	<u>811,728</u>	<u>805,203</u>	<u>711,942</u>	<u>6,525</u>	<u>93,261</u>
Net assets:					
Invested in capital assets, net of related debt.....	1,091,025	975,108	900,586	115,917	74,522
Restricted.....	69,019	64,970	67,560	4,049	(2,590)
Unrestricted.....	11,419	48,290	69,476	(36,871)	(21,186)
Total net assets.....	<u>\$1,171,463</u>	<u>\$1,088,368</u>	<u>\$1,037,622</u>	<u>\$ 83,095</u>	<u>\$ 50,746</u>

Analysis of Net Assets

Net assets may serve as a useful indicator of the Waste Water Utility's financial position. For the Waste Water Utility, assets exceeded liabilities by \$1,171.5 million, \$1,088.3 million, and \$1,037.6 million in fiscal years 2012, 2011, and 2010 respectively. The Waste Water Utility's net assets include its investment of \$1,091.0 million, \$975.1 million, and \$900.6 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 2012, 2011, and 2010, respectively. The Waste Water Utility uses these capital assets to provide waste water services to citizens; consequently, these assets are not available for future spending.

Although the Waste Water 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 Waste Water Utility through rates and charges, since the capital assets themselves cannot be liquidated for these liabilities. A portion of the Waste

Water Utility's net assets, \$69.0 million, represents restricted resources that are legally obligated for revenue bond repayment requirements for fiscal year 2012. The Waste Water Utility had unrestricted net assets of \$11.4 million, \$48.2 million, and \$69.5 million as of June 30, 2012, 2011, and 2010, respectively.

During fiscal years 2012, 2011, and 2010, the Waste Water Utility expended \$127.7 million, \$87.5 million, and \$90.6 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 \$3.7 million, \$103.8 million, and \$3.8 million, in fiscal years 2012, 2011, and 2010, respectively. Fitch Ratings, Moody's Investor Services, Inc., and Standard & Poor's Rating Services gave the Series 2012 Bonds insured ratings of AAA, Aaa, and AAA, respectively.

Revenues, Expenses, and Changes in Fund Net Assets
Waste Water Utility Fund
(Expressed in Thousands)

	Years Ended June 30,			Change	Change
	<u>2012</u>	<u>2011</u>	<u>2010</u>	<u>2012- 2011</u>	<u>2011- 2010</u>
Operating revenues.....	\$ 179,873	\$ 160,076	\$ 166,072	\$19,797	\$ (5,996)
Operating expenses:					
Salaries and wages	39,518	39,216	37,984	302	1,232
Other personnel costs	16,711	11,617	13,957	5,094	(2,340)
Contractual services	54,572	51,611	56,155	2,961	(4,544)
Material and supplies	8,069	7,517	7,556	552	(39)
Minor Equipment.....	486	170	110	316	60
Depreciation	34,903	34,595	31,440	308	3,155
Total operating expenses	<u>154,259</u>	<u>144,726</u>	<u>147,202</u>	9,533	(2,476)
Operating income.....	25,614	15,350	18,870	10,264	(3,520)
Non-operating (expense), net.....	(15,783)	(14,186)	(10,969)	(1,597)	(3,217)
Income before capital contributions.....	9,831	1,164	7,901	8,667	(6,737)
Capital contributions.....	73,264	49,582	23,619	23,682	25,963
Change in net assets.....	83,095	50,746	31,520	<u>\$ 32,349</u>	<u>\$19,226</u>
Beginning net assets	<u>1,088,368</u>	<u>1,037,622</u>	<u>1,006,102</u>		
Ending net assets	<u>\$1,171,463</u>	<u>\$1,088,368</u>	<u>\$1,037,622</u>		

Analysis of Revenues, Expenses, and Changes in Fund Net Assets

The overall increase in the Waste Water Utility's net assets amounted to \$83.1 million, and \$50.7 million, for fiscal years 2012, and 2011, respectively. These increases are due to improved operating margins that resulted from the implementation of a 9% waste water rate increase in fiscal years 2012 and 2011 to customers located in Baltimore City, offset by a decline in consumer consumption in 2011.

Capital Assets

The Waste Water Utility's capital assets as of June 30, 2012, 2011, and 2010 amounted to \$1,689.7 million, \$1,585.9 million, and \$1,526.2 million (net of accumulated depreciation), respectively. Capital assets include land, equipment, buildings, improvements, and construction in progress. Total increases in the Waste Water Utility's net capital assets for fiscal years 2012, and 2011, \$93.1 million, and \$59.7 million, respectively. These increases were funded primarily by issuance of revenue bonds. The following schedule presents the capital asset activities for fiscal years 2012, 2011, and 2010 (amounts expressed in thousands):

	Balance at June 30,			Change	Change
	2012	2011	2010	2012-2011	2011-2010
Land	\$ 8,931	\$ 8,931	\$ 8,931	—	—
Buildings and improvements	1,156,543	1,186,068	951,578	\$ (29,525)	\$ 234,490
Equipment	38,190	16,887	19,706	21,303	(2,819)
Construction in progress ...	443,186	374,015	546,033	69,171	(172,018)
Infrastructure.....	42,821	—	—	42,821	—
Total capital assets, net	<u>\$ 1,689,671</u>	<u>\$ 1,585,901</u>	<u>\$ 1,526,248</u>	<u>\$ 103,770</u>	<u>\$ 59,653</u>

As of June 30, 2012, the Waste Water Utility had commitments of \$272.9 million for the acquisition and construction of capital assets. See Note 5 for further information. During FY 2012, 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 2012, 2011, and 2010, the Waste Water Utility had long-term obligations of \$ 705.6 million, \$728.1 million, and \$644.2 million, respectively. These long-term obligations consisted primarily of revenue bonds, which are secured by revenue derived from the treatment of waste water. During fiscal years 2012, and 2011, the Waste Water Utility's debt decreased by \$22.5 million in 2012 and increased by \$83.6 million, in fiscal year 2011. See Note 6 for further information.

Economic Condition of the Waste Water Utility

The Waste Water 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 Waste Water Utility has ample long-term wastewater treatment capacity. The Waste Water Utility is currently under a consent decree with the U.S. Environmental Protection Agency to eliminate sanitary and combined sewer overflows. Although the Waste Water 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 2012, 2011 and 2010, 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
Waste Water Utility Fund
Statements of Fund Net Assets
June 30, 2012 and June 30, 2011
(Expressed in Thousands)

Assets:	2012	2011
Current assets:		
Cash and cash equivalents.....	\$ 49,771	\$ 70,756
Accounts receivable, net:		
Service billings.....	33,579	27,254
Other.....	296	217
Due from other governments.....	5,681	13,160
Inventories.....	283	272
Total current assets.....	89,610	111,659
Noncurrent assets:		
Restricted assets:		
Cash and cash equivalents.....	146,619	159,719
Accounts receivable.....	23,563	14,573
Capital assets not being depreciated.....	452,117	382,946
Capital assets, net of accumulated depreciation	1,237,554	1,202,955
Deferred outflow of resources - interest rate swaps.....	33,728	21,719
Total noncurrent assets.....	1,893,581	1,781,912
Total assets.....	1,983,191	1,893,571
Liabilities:		
Current liabilities:		
Accounts payable and accrued liabilities.....	18,096	7,192
Accrued interest payable.....	12,018	10,588
Due to other governments.....	12,663	10,863
Other liabilities.....	2,886	2,583
Revenue bonds payable.....	9,224	20,704
General long-term debt payable.....	22,691	41
Accounts payable from restricted assets.....	19	8,861
Total current liabilities.....	77,597	60,832
Noncurrent liabilities:		
Revenue bonds payable, net.....	682,922	707,370
Other liabilities.....	6,891	4,136
Unamortized bond premiums.....	10,464	10,924
General long-term debt payable.....	-	20
Derivative instrument liability.....	33,854	21,921
Total noncurrent liabilities.....	734,131	744,371
Total liabilities.....	811,728	805,203
Net assets:		
Invested in capital assets, net of related debt.....	1,091,025	975,108
Restricted for:		
Debt service.....	69,019	64,970
Unrestricted.....	11,419	48,290
Total net assets.....	\$ 1,171,463	\$ 1,088,368

The notes to the financial statements are an integral part of this statement.

CITY OF BALTIMORE
Waste Water Utility Fund
Statements of Revenues, Expenses, and Changes in Fund Net Assets
For the Years Ended June 30, 2012 and June 30, 2011
(Expressed in Thousands)

	<u>2012</u>	<u>2011</u>
Operating revenues:		
Charges for sewer services (net of bad debts of \$4,721 for fiscal year 2012 and \$2,480 for fiscal year 2011)	\$ 179,873	\$ 160,076
Operating expenses:		
Salaries and wages.....	39,518	39,216
Other personnel costs.....	16,711	11,617
Contractual services.....	54,572	51,611
Minor equipment.....	486	170
Materials , supplies, and minor equipment.....	8,069	7,517
Depreciation.....	34,903	34,595
Total operating expenses.....	<u>154,259</u>	<u>144,726</u>
Operating income	<u>25,614</u>	<u>15,350</u>
Nonoperating revenues (expenses):		
Gain on sale of investments	(105)	(61)
Interest income	1,115	1,308
Interest expense	(16,793)	(15,433)
Total nonoperating expenses, net	<u>(15,783)</u>	<u>(14,186)</u>
Income before capital contributions	9,831	1,164
Capital contributions.....	73,264	49,582
Changes in net assets.....	83,095	50,746
Total net assets - beginning.....	1,088,368	1,037,622
Total net assets - ending.....	<u>\$ 1,171,463</u>	<u>\$ 1,088,368</u>

The notes to the financial statements are an integral part of this statement.

CITY OF BALTIMORE
Waste Water Utility Fund
Statements of Cash Flows
For the Years Ended June 30, 2012 and June 30, 2011
(Expressed in Thousands)

	<u>2012</u>	<u>2011</u>
Cash flows from operating activities:		
Receipts from customers.....	\$ 171,958	\$ 147,920
Payments to employees.....	(56,229)	(50,833)
Payments to suppliers.....	(56,190)	(50,652)
Net cash provided by operating activities.....	<u>59,539</u>	<u>46,435</u>
Cash flows from capital and related financing activities:		
Proceeds from revenue bonds.....	-	103,865
Interest (expense), net	1,115	1,308
Interest expense	(18,258)	(15,445)
Principal paid on revenue bonds.....	(22,460)	(20,171)
Principal paid on General Long Term Debt	(42)	(464)
Acquisition and construction of capital assets.....	(127,703)	(87,516)
Capital contributions.....	73,264	49,582
Issuance costs.....	460	-
Net cash used by capital and related financing activities.....	<u>(93,624)</u>	<u>31,159</u>
Net increase (decrease) in cash and cash equivalents.....	(34,085)	77,594
Cash and cash equivalents, beginning of year.....	230,475	152,881
Cash and cash equivalents, end of year.....	<u>\$ 196,390</u>	<u>\$ 230,475</u>
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	<u>\$ 25,614</u>	<u>\$ 15,350</u>
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation expense.....	34,903	34,595
Changes in assets and liabilities:		
Accounts receivable.....	(6,404)	(16,028)
Due to/from other governments.....	7,479	3,872
Inventories.....	(11)	(41)
Restricted accounts receivable	(8,990)	-
Accounts payable and accrued liabilities.....	297	(3,757)
Other liabilities.....	3,058	(82)
Accrued interest payable.....	1,430	683
Restricted accounts payable.....	363	980
Due to other funds.....	1,800	10,863
Total adjustments.....	<u>33,925</u>	<u>31,085</u>
Net cash provided by operating activities.....	<u>\$ 59,539</u>	<u>\$ 46,435</u>

The notes to the financial statements are an integral part of this statement. -

CITY OF BALTIMORE
Waste Water Utility Fund
Notes to the Financial Statements
June 30, 2012 and 2011

1. Description of the Utility

The Waste Water Utility Fund is a separate utility in the Bureau of Water and Waste Water, 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 Waste Water 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 Waste Water 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 Waste Water 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.

The Waste Water Utility has elected not to follow Financial Accounting Standards Board pronouncements issued after November 30, 1989.

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 Waste Water Utility, and all other revenue is considered non-operating.

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 Waste Water Utility.

Investments

Investments are reported at fair value on the date of the Statement of Net Assets, 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.

CITY OF BALTIMORE
Waste Water Utility Fund
Notes to the Financial Statements
June 30, 2012 and 2011

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. It is the policy of the Waste Water Utility to not record the fair value of the swap arrangements. 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.

Inventories

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

Unbilled Waste Water Utility User Charges

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

Restricted Assets

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

Use of Restricted Net Assets

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

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

CITY OF BALTIMORE
Waste Water Utility Fund
Notes to the Financial Statements
June 30, 2012 and 2011

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.

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, 2012, it is estimated that accumulated non-vested sick leave for the Waste Water Utility approximated \$5,993,000. 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.

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, 2012 and 2011 is \$6,843,000 and \$6,780,000, respectively.

Due to Other Governments

Effective January 1, 2005, the State of Maryland implemented a Bay Restoration Fee to provide funding for the upgrade of waste water treatment facilities in the State. The fee is collected quarterly by the local government and remitted to the State. At June 30, 2012 and 2011, the Waste Water Utility held \$12,663,000 and \$10,863,000 respectively, in fees due to the State.

3. Deposits and Investments

The Waste Water Utility participates in the City's pooled cash account. At June 30, 2012 and 2011, the Waste Water Utility's share of the City's pooled cash account, including both restricted and unrestricted cash, was \$40,187,000 and \$72,399,000, respectively. All of the City's pooled cash deposits are either insured through the Federal Depository

CITY OF BALTIMORE
Waste Water Utility Fund
Notes to the Financial Statements
June 30, 2012 and 2011

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.

The Waste Water Utility's investments at June 30, 2012 and 2011 are presented in the following table. All investments are presented by investment type, and debt securities are presented by maturity (amounts expressed in thousands):

June 30, 2012 Investment Type	Fair Value	Investment Maturities (In Months)		
		Less than 6	6 to 12	Greater than 12
Debt Securities:				
U.S. Agencies	\$16,505	\$16,505	-	-
Money market mutual funds	126,011	126,011	-	-
Commercial paper	4,939	4,939	-	-
	147,455	\$147,455	-	-
Less: Cash equivalents	147,455			
Total investments	-			

CITY OF BALTIMORE
Waste Water Utility Fund
Notes to the Financial Statements
June 30, 2012 and 2011

June 30, 2011 Investment Type	Fair Value	Investment Maturities (In Months)		
		Less than 6	6 to 12	Greater than 12
Debt Securities:				
U.S. Agencies	\$ 2,167	\$ 2,167	-	-
U.S. Treasury	14,359	14,359	-	-
Money market mutual funds	136,272	136,272	-	-
Commercial paper	5,277	5,277	-	-
	158,075	\$158,075	-	-
Less: Cash equivalents	158,075			
Total investments	-			

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 percent 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 Waste Water Utility is in compliance with this policy.

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

CITY OF BALTIMORE
Waste Water Utility Fund
Notes to the Financial Statements
June 30, 2012 and 2011

As discussed above, the City's Board of Finance limits City investments to only the highest rated investments in the categories discussed above. The Waste Water Utility's portions of the City's rated debt investments as of June 30, 2012 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):

June 30, 2012 Investment Type	Fair Value	Quality Ratings	
		AAA	A1 - P1
Debt Securities:			
U.S. Agencies:			
Federal Home Loan Mortgage Association Note	\$ 16,505	\$ 16,505	–
Money market mutual funds:			
Wilmington US 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>

June 30, 2011 Investment Type	Fair Value	Quality Ratings	
		AAA	A1 - P1
Debt Securities:			
U.S. Agencies:			
Federal Home Loan Mortgage Corp Discount Note	\$ 14,359	\$ 14,359	–
Federal National Mortgage Assn.....	2,167	2,167	–
Money market mutual funds:			
M&T Bank US Government Money Market Fund	136,272	136,272	–
Commercial paper.....	5,277	–	5,277
Total rated debt investments.....	<u>\$ 158,075</u>	<u>\$152,798</u>	<u>\$ 5,277</u>

4. Allowance for Doubtful Accounts

Accounts receivable are shown net of an allowance of \$16,185,000 and \$10,914,000 as of June 30, 2012 and 2011, respectively.

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5. Capital Assets

Capital assets activity for the years ended June 30, 2012 and 2011 were as follows (expressed in thousands):

	Balance June 30, 2011	Increases	Decreases	Balance June 30, 2012
Capital assets, not being depreciated:				
Land	\$ 8,931	—	—	\$ 8,931
Construction in progress	374,015	\$ 134,768	\$ 65,597	443,186
Total capital assets, not being depreciated	382,946	134,768	65,597	452,117
Capital assets, being depreciated:				
Buildings and improvements	1,604,882	1,354	—	1,606,236
Equipment	98,841	24,893	—	123,734
Infrastructure.....	—	43,254	—	43,254
Total capital assets, being depreciated	1,703,723	69,501	—	1,773,224
Less: accumulated depreciation for:				
Buildings and improvements.....	418,814	30,879	—	449,693
Equipment	81,954	3,590	—	85,544
Infrastructure.....	—	433	—	433
Total accumulated depreciation	500,768	34,902	—	535,670
Total capital assets, being depreciated, net.....	1,202,955	34,599	—	1,237,554
Total capital assets, net.....	\$ 1,585,901	\$ 169,367	\$ 65,597	\$ 1,689,671
	Balance June 30, 2010	Increases	Decreases	Balance June 30, 2011
Capital assets, not being depreciated:				
Land	\$ 8,931	—	—	\$ 8,931
Construction in progress	546,033	\$ 93,964	\$ 265,982	374,015
Total capital assets, not being depreciated	554,964	93,964	265,982	382,946
Capital assets, being depreciated:				
Buildings and improvements	1,338,900	265,982	—	1,604,882
Equipment	98,557	284	—	98,841
Total capital assets, being depreciated	1,437,457	266,266	—	1,703,723
Less: accumulated depreciation for:				
Buildings and improvements.....	387,321	31,493	—	418,814
Equipment	78,852	3,102	—	81,954
Total accumulated depreciation	466,173	34,595	—	500,768
Total capital assets, being depreciated, net.....	971,284	231,671	—	1,202,955
Total capital assets, net.....	\$ 1,526,248	\$ 325,635	\$ 265,982	\$ 1,585,901

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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 2012 and 2011, interest cost of \$12,243,000 and \$11,581,000, respectively (net of interest earned of \$954,000 and \$1,298,000 respectively) was capitalized.

At June 30, 2012, the Waste Water Utility had outstanding commitments for construction of \$272.9 million.

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, 2012 and June 30, 2011 are as follows (amounts expressed in thousands):

	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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	Balance			Balance June 30, 2011	Amounts Due
	June 30, 2010	Additions	Reductions		Within One Year
General obligation bonds payable ^(a)	\$ 458	\$ 6	\$ 464	–	–
Long-term financing with State of Md. (b)	145	–	84	\$ 61	\$ 41
Total general long-term debt	\$ 603	\$ 6	\$ 548	\$ 61	\$ 41
Revenue bonds	\$ 647,282	\$ 103,865	\$ 20,171	\$ 730,976	–
Less: unamortized charges	3,042	–	140	2,902	–
Total Revenue bonds payable	\$ 644,240	\$ 103,865	\$ 20,031	\$ 728,074	\$ 20,704
Compensated absences	\$ 6,862	–	\$ (82)	\$ 6,780	\$ 2,583

- (a) These general obligation bonds bear interest rate ranging from 4.75% to 7.50% and mature serially through 2011.
- (b) 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 following is a schedule of the principal and interest payments required as of June 30, 2012 to service the above general long-term debt payable by the Waste Water Utility until maturity (amounts expressed in thousands):

	General Obligation Bonds		Long-Term Financing with State of Maryland	
	Principal	Interest	Principal	Interest
2013.....	–	–	\$ 19	\$ 1
Total.....	–	–	\$ 19	\$ 1

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

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	2012	2011
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.....	\$1,190	\$1,569
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.....	1,133	1,493
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.....	856	1,122
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.....	979	1,157
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.....	2,670	3,009
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.....	1,052	1,232
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.....	4,746	5,263
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.....	7,219	7,871
Serial bonds series 2002-A maturing in annual installments from \$1,145,000 to \$1,660,000 from July 1, 2012 through July 1, 2021, with variable interest through July 1, 2016 and a fixed rate of 4.85 – 5.0% thereafter, payable semiannually.....	13,660	15,480
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.....	3,511	3,826

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	2012	2011
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.....	9,157	12,487
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.....	10,654	11,520
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.....	11,988	13,043
Serial bonds series 2005-B maturing in annual installments from \$750,000 to \$1,480,000 from July 1, 2012 through July 1, 2025 with interest rates of 3.25% to 5.0%, payable semiannually.....	13,410	14,265
Serial bonds series 2005-C	-	730
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.....	18,674	22,770
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.....	4,763	5,106
Serial bonds series 2006-C maturing in annual installments from \$990,000 to \$2,090,000 from July 1, 2012 through July 1, 2026, with interest rates of 4.0% to 5.0%, payable semiannually.....	23,010	24,085
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.....	29,312	31,856
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.....	10,955	11,000

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	2012	2011
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.....	2,352	2,504
Serial bonds series 2007-D maturing in annual installments from \$1,890,000 to \$4,330,000 from July 1, 2012 through July 1, 2027, with interest rate at 5.0%, payable semiannually.....	49,265	51,250
Serial bonds series 2008-A maturing in annual installments from \$475,000 to \$1,005,000 from July 1, 2012 through July 1, 2028, with interest rates of 2.00% to 5.00%, payable semiannually.....	25,835	26,890
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%	7,245	7,671
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%....	1,558	1,732
Serial bonds series 2009-C maturing in annual installments from \$370,000 to \$570,000 from July 1, 2012 through July 1, 2022, with interest rates of 2.00% to 4.50% payable semiannually.....	7,430	7,430
Term bonds series 1993-A with interest at 5.6%, payable semiannually, due July 1, 2013.....	3,100	4,500
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.....	3,050	3,710
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

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	2012	2011
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
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.....	45,900	46,400
Auction rate notes series 2004-A, payable monthly, due July 1, 2034.....	17,500	17,500

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	2012	2011
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, 2012 through February 1, 2040, with an interest rate of 0.00%.....	750	750
Serial bonds series, 2011-A maturing in annual installments of \$915,000 to \$3,900,000 from July 1, 2012 through February 1, 2041, with interest rates from 2.00% to 5.00%.....	51,810	51,810
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%.....	3,707	-
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
	708,386	730,976
Less: unamortized charges.....	2,773	2,902
	\$705,613	\$728,074

At June 30, 2012 and 2011, the Waste Water Utility fund had \$88,700,000 and \$89,200,000 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 non-financial 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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Principal maturities and interest on revenue bonds, shown at gross, are as follows (amounts expressed in thousands):

Fiscal Year	Principal	Interest	Interest Rate Swap Net ^(a)
2013.....	\$ 22,691	\$ 24,804	\$ 3,969
2014.....	24,099	24,186	3,940
2015	24,743	23,518	3,900
2016.....	25,123	22,830	3,821
2017.....	25,847	22,163	3,700
2018–2022.....	133,885	99,794	16,398
2023–2027.....	124,624	80,961	11,758
2028–2032.....	134,254	58,752	5,714
2033–2037.....	122,995	31,705	418
2038–2042.....	64,120	8,408	–
2043.....	6,005	154	–
	\$708,386	\$ 397,276	\$ 53,618

(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, 2009, 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 Waste Water 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, 2012, the rate requirements were met, and management believes the Waste Water Utility is in compliance with all significant requirements of the indentures.

7. Pledged Revenue

The Waste Water Utility Fund has pledged future customer revenues to repay \$708,386,000 and \$730,976,000 of revenue bond debt at June 30, 2012 and 2011, respectively. Proceeds from these revenue bonds were used to build and improve various aspects of the City’s Waste Water Utility systems. The bonds are payable solely from the revenues of the Waste Water Utility Fund and are payable through 2043. Annual principal and interest payments on these revenue bonds are expected to require 23% of

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pledged revenues. Total principal and interest remaining to be paid on the revenue bonds for the Waste Water Utility Fund is \$1,159,280,000 and \$1,207,871,000 at June 30, 2012 and June 30, 2011, respectively. Principal and interest paid for the current year and current pledged revenue for the Waste Water Utility Fund were \$53,714,000 and \$179,873,000 respectively. While principal and interest and pledged revenue for FY 2010 were \$45,131,000 and \$160,076,000, respectively.

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 Waste Water Utility's financial statements. At June 30, 2012 and 2011, the Waste Water Utility had \$60,035,000 and \$60,035,000, respectively of debt outstanding that is considered defeased.

9. Interest Rate Swaps

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.

Terms, fair value, and credit risk – The terms, fair value, and credit risk rating of the outstanding swaps, as of June 30, 2012, 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.

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Hedged Derivative Instruments:

At June 30, 2012 and 2011, the Waste Water Utility Fund had deferred liabilities for various hedged derivative instruments with total fair values of these instruments in the amount of \$33,728,000 and \$21,719,000, respectively. The notional amounts for these hedged derivative instruments at June 30, 2012 and 2011 were \$97,150,000 and \$99,470,000, respectively. During fiscal years 2012 and 2011, the fair values of these instruments decreased \$2,320,000 and \$3,157,000, respectively. All hedges are cash flow hedges. The following schedule provides a detailed analysis of derivative instruments held at June 30, 2012 and 2011:

June 30, 2012

Outstanding Bonds	Effective Date	Termination Date	Interest Rate Paid by City	Interest Rate Received	Notional Amount	Fair Value	Counterparty Credit Rating
<i>Floating to Fixed Swaps:</i>							
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>	

June 30, 2011

Outstanding Bonds	Effective Date	Termination Date	Interest Rate Paid by City	Interest Rate Received	Notional Amount	Fair Value	Counterparty Credit Rating
<i>Floating to Fixed Swaps:</i>							
2002 Revenue Bonds	5/7/2002	7/1/2032	4.55%	67% LIBOR	\$ 71,700,000	\$ (16,937,935)	A/A2
2002 Revenue Bonds	5/7/2002	7/1/2011	4.10%	Bond Rate/CPI	1,820,000	26,336	A/A2
2002 Revenue Bonds	5/7/2002	7/1/2012	4.20%	Bond Rate/CPI	1,930,000	7,175	A/A2
2002 Revenue Bonds	5/7/2002	7/1/2013	4.30%	Bond Rate/CPI	1,960,000	(5,180)	A/A2
2002 Revenue Bonds	5/7/2002	7/1/2014	4.39%	Bond Rate/CPI	2,040,000	(14,647)	A/A2
2002 Revenue Bonds	5/7/2002	7/1/2015	4.50%	Bond Rate/CPI	1,240,000	(12,064)	A/A2
2002 Revenue Bonds	5/7/2002	7/1/2016	4.61%	Bond Rate/CPI	1,280,000	(13,557)	A/A2
2004 Revenue Bonds	6/1/2004	7/1/2034	5.21%	SIFMA	17,500,000	(4,769,626)	A/A2
Total Swaps Outstanding					<u>\$99,470,000</u>	<u>\$ (21,719,498)</u>	

Credit risk – As of June 30, 2012, the Waste Water Utility Fund is not exposed to credit one all but one 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

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would be exposed to credit risk in the amount of the derivatives' fair value¹. Should the counterparties to these transactions fail to perform according to the terms of the swap contracts, the Fund faces a maximum loss equivalent to the swap's \$3,850 fair value. However, because the swaps' counterparties are also party to other swaps, the Fund could use netting provisions to offset the potential loss.

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 all swaps is to be in the form of cash or United States Government securities held by the City. As of June 30, 2012, none of the City's swap agreements met this requirement.

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, 2012, the SIFMA rate for the prior 52-week period ranged from 0.07% to 0.26%, whereas the City's tax-exempt market rate ranged from 0.06% to 0.46%. 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, 2012, LIBOR for the prior 52-weeks ranged from 0.13% to 0.40%, whereas the City's taxable market rate ranged from 0.13% to 0.40%. 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.

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.

¹ For the one swap agreement that has positive fair value, the fund has credit exposure to the counterparty as of June 30, 2012.

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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, 2012 and 2011, classified by type and the changes in fair value of such derivative instruments for the year ended June 30, 2012 and 2011 are as follows:

June 30, 2012

Investment Derivative Instruments

	<u>Changes in Fair Value</u>		<u>Fair Value at June 30, 2012</u>		
	Classification	Amount	Classification	Amount	Notional
Fixed to					
Floating	Investment Revenue	<u>\$ 75,708</u>	Debt	<u>\$ (125,864)</u>	<u>\$(7,469,047)</u>

June 30, 2011

Investment Derivative Instruments

	<u>Changes in Fair Value</u>		<u>Fair Value at June 30, 2011</u>		
	Classification	Amount	Classification	Amount	Notional
Fixed to					
Floating	Investment Revenue	<u>\$ (56,720)</u>	Debt	<u>\$ (201,572)</u>	<u>\$(7,469,047)</u>

Credit Risk – At June 30, 2012 and 2011, 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 Waste Water Utility Fund would have exposure to credit risk. The counterparty’s credit rating at June 30, 2012, was AA/Aa2 for derivative instruments held by the Waste Water Utility Fund.

Interest rate risk – For those swaps for which the Waste Water Utility Fund pays a floating rate and receives fixed rate payments, the fund is exposed to interest rate risk. As floating rates increase, the Waste Water 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.

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10. Pension Plan

Classified employees of the Waste Water 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 Waste Water Utility's share of contributions to the plan was \$6,330,000 in 2012, \$3,455,000 in 2011 and \$3,979,000 in 2010. The Waste Water 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 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, 2012, there were 10,477 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 2012 and 2011, the City's total contributions to the Plan were \$142.4 and \$142.8 million, respectively, from its General Fund.

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12. Risk Management

The Waste Water 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 \$500,000 with a cap of \$500,000,000. 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 2012 and 2011, the Waste Water Utility's share of the City's cost was \$1,782,000 and \$1,947,000, respectively.

13. Commitments and Contingencies

The Waste Water 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 Waste Water Utility. As of June 30, 2012, the Waste Water Utility estimates that no material liabilities will result from such audits.

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 waste water 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 Waste Water Utility to deliver up to approximately 2,167 wet tons of sewerage sludge per month and to pay a

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tipping fee comparable to alternative methods of sludge disposal currently being used by the Waste Water Utility. The debt service on variable rate bonds is a component of the tipping fee. The Waste Water Utility's current tipping fee expense per wet ton for delivering sewerage sludge was \$84.36 and \$126.09 up to the guaranteed and excess tonnage amounts, respectively. Payments under the agreement in fiscal year 2011 were \$2.3 million. The maximum commitment by the City is 54,750 wet tons per year.

The Waste Water 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 Waste Water Treatment Plants. Under the agreements the Waste Water 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 Waste Water Utility's current monthly base tipping fee expense for delivering biosolids is \$274,664 and \$266,388 for the Back River and Patapsco Waste Water Treatment Plants, respectively. The service tipping fees were \$380.33 and \$390.35 per ton for the Back River and Patapsco Waste Water Treatment Plants, respectively. Payments under the agreements in fiscal year 2012 were \$21.006 million. The agreements extend to 2014 and 2017 for the Back River and Patapsco Waste Water 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 waste water revenue bonds in conjunction with all available State and Federal assistance.