AUDITED FINANCIAL STATEMENTS

Puerto Rico Aqueduct and Sewer Authority
(A Component Unit of the Commonwealth of Puerto Rico)
Years Ended June 30, 2011 and 2010
With Report of Independent Auditors

ERNST & YOUNG

Puerto Rico Aqueduct and Sewer Authority
(A Component Unit of the Commonwealth of Puerto Rico)

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Report of Independent Auditors

The Board of Directors
Puerto Rico Aqueduct and Sewer Authority

We have audited the accompanying balance sheets of the Puerto Rico Aqueduct and Sewer Authority, a component unit of the Commonwealth of Puerto Rico (the Authority), as of June 30, 2011 and 2010, 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 Authority'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 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. We were not engaged to perform an audit of the Authority's internal control over financial reporting. Our audit included 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 Authority's internal control over financial reporting. Accordingly, we express no such opinion. An audit also 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, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Puerto Rico Aqueduct and Sewer Authority at June 30, 2011 and 2010, and the changes in its financial position and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 11, 2011, on our consideration of the Puerto Rico Aqueduct and Sewer Authority'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 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 a*nd should be considered in assessing the results of our audit.

The management's discussion and analysis and schedule of funding progress for postemployment healthcare benefits on pages 3 through 20 and page 70 are not a required part of the basic financial statements but are supplementary information required by the *Governmental Accounting Standards Board*. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Ernst & Young LLP

November 11, 2011

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affixed to
original of
this report.

As management of Puerto Rico Aqueduct and Sewer Authority (the Authority), we offer readers of the Authority's annual financial report our discussion and analysis of the Authority's financial performance during the fiscal years ended on June 30, 2011, 2010 and 2009. Please read it in conjunction with the Authority's financial statements, which follow this section.

June 30, 2011 and 2010 Financial Highlights

- The Authority's net assets decreased by $112.2 million to $2,934.4 million, or 3.7%, primarily as the net result of an increase in operating revenues of $96.3 million, an increase in total operating expenses, including depreciation and amortization, of $77.6 million, an increase in nonoperating expenses of $26.7 million and a decrease of capital contributions of $935.1 million.
- Operating revenues increased by $96.3 million to $809.1 million, or 13.5%, due to a decrease in water and sewer revenues of $19.8 million, a decrease in the provision for bad debts of $31.2 million and an increase of $85.0 million from appropriations received from Central Government.
- Operating expenses, including depreciation and amortization, increased by $77.6 million to $848.7 million, or 10%, primarily as a result of a decrease in payroll and related expenses of $15.1 million, an increase of the service contract of the Superaqueduct of $5.7 million, an increase of professional and consulting services of $12.7 million, an increase in chemical expenses of $3.2 million, an increase in repairs and maintenance expenses of $5.4 million, an increase in electricity expenses of $16.5 million, and an increase in depreciation and amortization expense of $49.3 million.
- Capital contributions decreased by $935.1 million to $34.3 million. For fiscal year ended June 30, 2010, the Puerto Rico Infrastructure Authority (PRIFA) transferred to the Authority capital assets in the amount of $933.4 million. There were no capital assets transfers during the fiscal year ended June 30, 2011.
- Total assets increased by $174.5 million to $7,741.0 million or 2.3%, primarily due to an increase by $127.0 million in the Authority's capital assets. Total liabilities increased by $286.7 million to $4,806.6 or 6.3%, primarily as a result of an increase in long term debt of $312.1 million and a decrease in other liabilities of $25.4 million.

June 30, 2010 and 2009 Financial Highlights

- The Authority's net assets increased by $830.8 million to $3,046.6 million, or 37%, primarily as the net result of an increase in water and sewer revenues of $8.3 million, an increase in total operating expenses, including depreciation, of $2.9 million, a decreased in non operating expenses of $18.2 million and an increase of capital contributions of $947.2 million.
- Operating revenues increased by $8.3 million to $712.8 million, or 1%, due to an increase in water and sewer revenues of $3.4 million and a decrease in the provision for bad debts of $4.9 million.
- Operating expenses, including depreciation, increased by $2.9 million to $771.1 million, or 0.4%, primarily as a result of a decrease in payroll and related expenses of $13.5 million, a decrease of the service contract of the Superaqueduct of $2.6 million, an increase of professional and consulting services of $3.6 million, a decrease in chemical expenses of $1.0 million, an increase in repairs and maintenance expense of $7.9 million, an increase in electricity expense of $3.6 million and an increase in depreciation expense of $8.1 million.
- Capital contributions increased by $947.2 million to $969.4 million, primarily as a result of capital assets transferred by Puerto Rico Infrastructure Authority (PRIFA) for the amount of $933.4 million.
- Total assets increased by $1,082.8 million to $7,566.5 million or 17%, primarily due to an increase by $1,092.2 million in the Authority's capital assets transfer attributable to PRIFA. Total liabilities increased by $252.0 million to $4,519.9 million or 6%, primarily as a result of an increase in long term debt of $358.7 million and a decrease in other liabilities of $106.7 million.

Overview of the Financial Statements

This annual report includes the management's discussion and analysis report, the independent auditors' report, the basic financial statements and the required supplementary information of the Authority. The basic financial statements include notes that explain in more detail the information contained in the basic financial statements.

Financial Analysis of the Authority

The balance sheets and the statement of revenues, expenses, and changes in net assets report the net assets of the Authority and the changes therein. The Authority's net assets – the difference between assets and liabilities – can be used to measure its financial health or financial position. Increases or decreases in the Authority's net assets are one indicator of whether its financial health is improving or deteriorating. However, other nonfinancial factors need to be considered such as changes in economic conditions and new or changed government regulations.

Analysis of Financial Results

The following table provides a summary of the Authority's net assets as of June 30 of the years indicated (in thousands):

	June 30		
	2011	**2010**	**Change**
Current and other assets	**$ 529,006**	$ 481,507	$ 47,499
Capital assets, net	**7,212,020**	7,084,994	127,026
Total assets	**7,741,026**	7,566,501	174,525
Long-term debt outstanding	**4,264,882**	3,952,743	312,139
Other liabilities	**541,732**	567,128	(25,396)
Total liabilities	**4,806,614**	4,519,871	286,743
Net assets:			
Invested in capital assets, net of related debt	**3,374,252**	3,544,720	(170,468)
Restricted	**24,482**	17,642	6,840
Unrestricted deficit	**(464,322)**	(515,732)	51,410
Total net assets	**$ 2,934,412**	$ 3,046,630	$ (112,218)

Analysis of Financial Results (continued)

	June 30		
	2010	**2009**	**Change**
Current and other assets	$ 481,507	$ 490,941	$ (9,434)
Capital assets, net	7,084,994	5,992,747	1,092,247
Total assets	7,566,501	6,483,688	1,082,813
Long-term debt outstanding	3,952,743	3,594,067	358,676
Other liabilities	567,128	673,793	(106,665)
Total liabilities	4,519,871	4,267,860	252,011
Net assets:			
Invested in capital assets, net of related debt	3,544,720	2,963,993	580,727
Restricted	17,642	14,481	3,161
Unrestricted deficit	(515,732)	(762,646)	246,914
Total net assets	$ 3,046,630	$ 2,215,828	$ 830,802

Net Assets

June 30, 2011 and 2010

The Authority's net assets as of June 30, 2011 were approximately $2,934.4 million. This is a $112.2 million decrease from the net assets as of June 30, 2010 of $3,046.6 million. Total assets increased by $174.5 million during the fiscal year ended June 30, 2011. This is primarily a result of a net increase in capital assets of $127.0 million due to current year net additions of $328.0 million offset by current year depreciation and amortization of $201.0 million.

Unrestricted and restricted cash and cash equivalents as of June 30, 2011, increased by $49.9 million when compared with June 30, 2010. The increase is primarily due to deposits made to restricted accounts to pay debt service and reimbursement of funds requested for payment of capital projects. Accounts receivable, net, decreased by $29.1 million primarily due the net effect of a decrease of $1.7 million in accounts receivable from water and sewer services customers and an increase in the allowance for doubtful accounts of $27.4 million.

Net Assets (continued)

June 30, 2011 and 2010 (continued)

Total liabilities increased by $286.7 million. This is primarily due to an increase of $312.1 million in long-term debt outstanding, mainly representing the net effect of an (1) increase in lines of credit of $278.7 million, (2) an increase in notes payable of $34.7 million (3) a decrease in bonds payable of $1.2 million. A decrease of $25.4 million in other current and noncurrent liabilities is primarily due to an increase of $16 million in accounts payable, a decrease in accrued liabilities of $22.1 million, a decrease in accrued interest of $20.3 million, and an increase of $1 million in unearned revenues, accrued compensated absences and customer deposits.

June 30, 2010 and 2009

The Authority's net assets as of June 30, 2010 were approximately $3,046.6 million. This is an $830.8 million increase from the net assets as of June 30, 2009 of $2,215.8 million. Total assets increased by $1,082.8 million during the fiscal year ended June 30, 2010. This is primarily a result of a net increase in capital assets of $1,092.2 million due to current year net additions of $1,242.9 million offset by current year depreciation and amortization of $150.6 million. This increase in capital assets is mainly due to the assets transferred from PRIFA for the amount of $933.4 million.

Unrestricted and restricted cash and cash equivalents as of June 30, 2010, increased by $13.6 million when compared with June 30, 2009. The increase is primarily due to deposits made to restricted accounts to pay debt service and reimbursement of funds requested for payment of capital projects. Accounts receivable, net, decreased by approximately $22.8 million primarily due the net effect of an increase of $35.5 million in accounts receivable from water and sewer services customers and an increase in the allowance for doubtful accounts of $58.3 million.

Total liabilities increased by $252.0 million. This is primarily due to an increase of $358.7 million in long-term debt outstanding, mainly representing the net effect of an (1) increase in lines of credit of $292.9 million, (2) an increase in notes payable of $51.8 million (3) an increase in bonds payable of $14 million to finance the Authority's capital improvement program. A decrease of $106.7 million in other current and noncurrent liabilities is primarily due to a decrease of $111.3 million in accounts payable, accrued liabilities and accrued interest and an increase of $4.6 million customer's deposits and compensated absences and postemployment benefits.

Capital Assets

Capital assets as of June 30, 2011 and 2010 were as follows (in thousands):

	June 30		
	2011	**2010**	**Change**
Capital assets being depreciated	**$ 8,276,363**	$ 8,049,013	$ 227,350
Accumulated depreciation and amortization	**(2,843,090)**	(2,642,053)	(201,037)
	5,433,273	5,406,960	26,313
Land and other nondepreciable assets	**66,851**	61,765	5,086
Construction in progress	**1,711,896**	1,616,269	95,627
Capital assets, net	**$ 7,212,020**	$ 7,084,994	$ 127,026

	June 30		
	2010	**2009**	**Change**
Capital assets being depreciated	$ 8,049,013	$ 6,831,835	$ 1,217,178
Accumulated depreciation and amortization	(2,642,053)	(2,491,389)	(150,664)
	5,406,960	4,340,446	1,066,514
Land and other nondepreciable assets	61,765	60,323	1,442
Construction in progress	1,616,269	1,591,978	24,291
Capital assets, net	$ 7,084,994	$ 5,992,747	$ 1,092,247

June 30, 2011 and 2010

The net increase of $127.0 million in capital assets includes additions of $328.0 million, reduced by $201.0 million in depreciation and amortization. The $328.0 million in capital investment is broken down as follows:

- $277.9 million in the Authority's capital improvement program;
- $50.1 million in renewal and replacement projects;

The Authority has approximately $1,711.9 million in construction in progress as of June 30, 2011, and has construction commitments of approximately $50.9 million.

Capital Assets (continued)

June 30, 2011 and 2010 (continued)

On August 16, 2011, the Authority entered into an Asset Purchase Agreement (the Agreement) with the Puerto Rico Industrial, Tourism, Educational, Medical and Environmental Facilities Financing Authority (AFICA), a public corporation of the Commonwealth of Puerto Rico, to purchase certain assets that were being used to develop the Southern Gas Pipeline Project for a total purchase price of approximately $23.5 million and assumed the rights and obligations of PREPA under a Subordinated Loan Agreement between AFICA and PREPA and a Subordinated Note and Loan Agreement of approximately $31 million.

June 30, 2010 and 2009

The net increase of $1,092.2 million in capital assets includes additions of $1,242.8 million, reduced by $150.6 million in depreciation and amortization. The $1,242.8 million in capital investment is broken down as follows:

- $261.6 million in the Authority's capital improvement program;
- $47.8 million in renewal and replacement projects;
- $933.4 million for projects transferred from PRIFA, component unit of the Commonwealth.

The Authority has approximately $1,616.3 million in construction in progress as of June 30, 2010, and has construction commitments of approximately $155 million.

Debt Administration

Long-term debt for the years ended June 30, 2011 and 2010 was as follows (in thousands):

	June 30		
	2011	**2010**	**Change**
Bonds payable:			
2001 Series A Commonwealth Appropriation Bonds	**$ 8,985**	$ 17,600	$ (8,615)
Act 164 PFC Commonwealth Appropriation Bonds	**341,565**	341,565	–
2004 Series A Commonwealth Appropriation Bonds	**326,785**	326,785	–
Revenue Bonds:			
2008 Series A, Serial Bonds	**93,155**	93,155	–
2008 Series A, Convertible Capital Appreciation	**155,975**	146,843	9,132
2008 Series A Term Bonds	**1,095,125**	1,095,125	–
2008 Series B Serial Bonds	**22,445**	22,445	–
2008 Series A and B Revenue Refunding Term Bonds	**284,755**	284,755	–
Rural Development Serial Bonds	**306,030**	312,079	(6,049)
Add premium on bonds refunding	**34,609**	36,316	(1,707)
Less :			
Bond discount	**(15,805)**	(16,244)	439
Deferred loss from refunding	**(73,884)**	(79,445)	5,561
Total bonds	**$ 2,579,740**	$ 2,580,979	$ (1,239)

(Continued)

Debt Administration (continued)

	June 30		
	2011	**2010**	**Change**
Bonds payable	**$ 2,579,740**	$ 2,580,979	$ (1,239)
Notes payable:			
Water Pollution Control and Drinking Water Treatment Revolving Funds Loans	**413,449**	375,793	37,656
Notes with commercial banks	**241,744**	244,688	(2,944)
Total notes	**655,193**	620,481	34,712
Lines of credit	**1,029,949**	751,283	278,666
Long-term debt outstanding	**4,264,882**	3,952,743	312,139
Other long term liabilities:			
Accrued compensated absences	**46,442**	49,338	(2,896)
Net OPEB obligation	**17,148**	12,453	4,695
Early retirement obligation	**2,308**	3,639	(1,331)
Customer deposits	**80,098**	79,840	258
Total other liabilities	**145,996**	145,270	726
Total – long-term obligations	**4,410,878**	4,098,013	312,865
Current portion	**322,942**	48,631	–
Long-term obligations, less current portion	**$ 4,087,936**	$ 4,049,382	$ 312,865

The Authority's long-term debt increased by $312.1 million from $3,952.7 million as of June 30, 2010, to $4,264.9 million as of June 30, 2011.

Debt Administration (continued)

June 30, 2011

Bonds Payable

Bonds outstanding as of June 30, 2011 decreased by $1.2 million, mainly from the net effect of an increase in accreted value of 2008 Series A Revenue Bonds of $9.1 million, and a decrease of $14.6 million in payments of principal and an increase for the amortization of bonds discount, bonds premium, and bonds deferred lost from bonds refunding of $4.3 million.

On September 14, 2011, the Authority issued approximately $70.2 million of Series HH of USDA Rural Development Program Bonds, at a maximum interest of 4.25% of interest, payable semiannually and maturing in semiannual installments through July 1, 2051.

Notes Payable

The Authority finances the cost of design and construction of certain capital improvements projects with notes from the Puerto Rico Water Pollution Control Revolving Fund and the Puerto Rico Safe Drinking Water Treatment Revolving Loan Fund programs that bear interest at 2%. As of June 30, 2011, the Authority's loans outstanding under these programs amounted to approximately $413.4 million. These loans increased approximately $37.6 million due to the net effect of drawings of approximately $55.1 million for payment of capital improvements and payment of principal on loans outstanding of approximately $17.5 million.

On September 8, 2006, the Authority entered into a term loan agreement with various commercial banks amounting to $250 million to repay various lines of credit with Government Development Bank (GDB) and to pay the costs associated with the loan. As of June 30, 2011, the outstanding balance of the term loan was approximately $241.7 million. On August 17, 2011, the maturity date of this term loan was extended from September 1, 2011 to January 16, 2012. The Authority has plans to restructure its debt and is evaluating various alternatives.

Debt Administration (continued)

June 30, 2011 (continued)

Lines of Credit

During 2011, the Authority entered into revolving lines of credit with GDB for the purpose of financing the Authority's capital improvement program for approximately $21.7 million and $250.0 million. As of June 30, 2011, approximately $136.0 million under these lines of credit was outstanding.

The existing $250.0 million line of credit was increased by approximately $19.5 million to approximately $269.0 million to pay accrued interest.

The existing $269.0 million, $87.6 million, $125.0 million, $36.7 million, $150.0 million, $70.0 million, and $200.0 million capital improvement program revolving lines of credit with GDB had an outstanding balance as of June 30, 2011 of approximately $893.9 million.

The $150.0 million revolving line of credit with GDB for the purpose of financing the operating reserve, required by the Master Agreement of Trust securing its revenue bonds, had no outstanding balance as of June 30, 2011.

Detailed information regarding long-term debt activity is included in notes 9 through 13 to the financial statements.

June 30, 2010

Bonds Payable

Bonds outstanding as of June 30, 2010 increased by $13.9 million, mainly from the net effect of an increase in accreted value of 2008 Series A Revenue Bonds of $8.6 million, an increase of $15 million on issuance of Rural Development Bonds Series GG, a decrease of $14 million in payments of principal and an increase for the amortization of bonds discount, bonds premium, and bonds deferred lost from bonds refunding of $4.3 million.

Debt Administration (continued)

June 30, 2010 (continued)

Notes Payable

The Authority finances the cost of design and construction of certain capital improvements projects with notes from the Puerto Rico Water Pollution Control Revolving Fund and the Puerto Rico Safe Drinking Water Treatment Revolving Loan Fund programs that bear interest at 2%. As of June 30, 2010, the Authority's loans outstanding under these programs amounted to approximately $375.8 million. These loans increased approximately $54.6 million due to the net effect of drawings of approximately $69.5 million for payment of capital improvements and payment of principal on loans outstanding of $14.9 million.

On September 8, 2006, the Authority entered into a term loan agreement with various commercial banks amounting to $250 million to repay various lines of credit with Government Development Bank (GDB) and to pay the costs associated with the loan. As of June 30, 2010, the outstanding balance of the term loan was $244.7 million.

Lines of Credit

During 2010, the Authority entered into revolving lines of credit with GDB for the purpose of financing the Authority's capital improvement program for $125 million, $36.7 million, $150 million, $70 million and $113 million. As of June 30, 2010, approximately $413.7 million under these lines of credit was outstanding.

The existing $250 million and $87.6 million capital improvement program revolving lines of credit with GDB had an outstanding balance as of June 30, 2010 of $250 million and $87.6 million, respectively.

The $150 million revolving line of credit with GDB for the purpose of financing the operating reserve, required by the Master Agreement of Trust securing its revenue bonds, had no outstanding balance as of June 30, 2010.

Detailed information regarding long-term debt activity is included in notes 9 through 13 to the financial statements.

Summary of Revenues, Expenses, and Changes in Net Assets

The following table provides a summary of the Authority's changes in net assets for the years ended June 30, 2011 and 2010 (in thousands):

	Years Ended June 30		
	2011	**2010**	**Change**
Operating revenue:			
Revenues from water and sewer, net	**$ 724,108**	$ 712,788	$ 11,320
Central Government appropiations	**85,000**	–	85,000
Total operating revenues	**$ 809,108**	**$ 712,788**	**$ 96,320**
Operating expenses:			
Payroll and payroll related expenses	**250,968**	266,099	(15,131)
Service contract – Superaqueduct	**28,473**	22,800	5,673
Professional and consulting services	**34,138**	21,395	12,743
Chemicals	**29,453**	26,279	3,174
Materials and replacements	**16,110**	14,529	1,581
Repairs and maintenance of capital assets	**45,405**	39,990	5,415
Electricity	**156,583**	140,131	16,452
Insurance	**9,276**	9,443	(167)
Other operating expenses	**77,248**	78,685	(1,437)
Operating expenses (excluding depreciation and amortization)	**647,654**	619,351	28,303
Depreciation and amortization	**201,037**	151,767	49,270
Total operating expenses	**848,691**	771,118	77,573
Operating loss	**(39,583)**	(58,330)	18,747
Nonoperating expenses, net	**(106,910)**	(80,245)	(26,665)
Loss before capital contributions	**(146,493)**	(138,575)	(7,918)
Capital contributions	**34,275**	969,377	(935,102)
(Decrease) increase in net assets	**(112,218)**	830,802	(943,020)
Net assets at beginning of year	**3,046,630**	2,215,828	830,802
Net assets at end of year	**$ 2,934,412**	$ 3,046,630	$ (112,218)

Summary of Revenues, Expenses, and Changes in Net Assets (continued)

The following table provides a summary of the Authority's changes in net assets for the years ended June 30, 2010 and 2009 (in thousands):

	Years Ended June 30		
	2010	**2009**	**Change**
Operating revenue:			
Revenues from water and sewer, net	$ 712,788	$ 704,457	$ 8,331
Operating expenses:			
Payroll and payroll related expenses	266,099	279,606	(13,507)
Service contract – Superaqueduct	22,800	25,476	(2,676)
Professional and consulting services	21,395	17,796	3,599
Chemicals	26,279	27,310	(1,031)
Materials and replacements	14,529	15,454	(925)
Repairs and maintenance of capital assets	39,990	32,003	7,987
Electricity	140,131	136,497	3,634
Insurance	9,443	9,513	(70)
Other operating expenses	78,685	80,849	(2,164)
Operating expenses (excluding depreciation and amortization)	619,351	624,504	(5,153)
Depreciation and amortization	151,767	143,687	8,080
Total operating expenses	771,118	768,191	2,927
Operating loss	(58,330)	(63,734)	5,404
Nonoperating expenses, net	(80,245)	(98,439)	18,194
Loss before capital contributions	(138,575)	(162,173)	23,598
Capital contributions	969,377	22,133	947,244
Increase (decrease) in net assets	830,802	(140,040)	970,842
Net assets at beginning of year	2,215,828	2,355,868	(140,040)
Net assets at end of year	$ 3,046,630	$ 2,215,828	$ 830,802

Summary of Revenues, Expenses, and Changes in Net Assets (continued)

June 30, 2011 and 2010

Net assets decreased by $112.2 million, from $3,046.6 million in 2010 to $2,934.4 million in 2011, due to the results of current year operations.

Major fluctuations that resulted in a decrease in net assets are broken down as follows (in thousands):

Increase in operating revenues	$	96,320
Increase in operating expenses		(77,573)
Increase in nonoperating expenses		(26,665)
Decrease in capital contributions		(935,102)
Net change	$	(943,020)

Operating revenues increased as a result of a decrease in water and sewer billed of $19.8 million, a decrease in the provision for bad debt of $31.2 million and an increase of $85.0 million from appropriations received from the Commonwealth during the fiscal year ended June 30, 2011.

Operating expenses increased by $77.6 million primarily due to the net effect of the following:

- A decrease of $15.1 million in payroll and payroll related expenses.
- An increase of $16.5 million in electricity expenses.
- An increase of $5.7 million in Service Contract – Superaqueduct expenses.
- An increase of $3.2 million in chemical expenses.
- An increase of $49.3 million in depreciation and amortization expense.
- An increase of $5.4 million in repair and maintenance of capital assets.
- An increase of $12.7 million in professional and consulting services expenses

Service contract – Superaqueduct expenses pertain to a contract signed with Thames-Dick for the operation and maintenance of the North Coast Aqueduct (Superaqueduct).

On July 19, 2011, the Authority and Thames-Dick agreed to cancel the Master Agreement and transfer responsibility to the Authority of the operation and administration of the North Coast Aqueduct.

Summary of Revenues, Expenses, and Changes in Net Assets (continued)

June 30, 2011 and 2010 (continued)

Nonoperating expenses increased by $26.7 million when compared with previous fiscal year. This is primarily the net effect of an increase of $16.0 million in interest expense on bonds, notes and lines of credits, a decrease in Commonwealth contributions of $6.9 million for the payment of principal and interest on outstanding debt, and a decrease in other income of $4.1 million.

Capital contributions decreased by $935.1 million. This is primarily due to capital assets transferred from by PRIFA in the amount of $933.4 million during fiscal 2010.

June 30, 2010 and 2009

Net assets increased by $830.8 million, from $2,215.8 million in 2009 to $3,046.6 million in 2010, due to the results of current year operations.

Major fluctuations that resulted in an increase in net assets are broken down as follows (in thousands):

Increase in operating revenues	$	8,331
Increase in operating expenses		(2,927)
Decrease in nonoperating expenses		18,194
Increase in capital contributions		947,244
Net change	$	970,842

Operating revenues increased as a result of an increase in water and sewer billed of $3.4 million and a decrease in the provision for bad debt of $4.9 million during the fiscal year ended June 30, 2010.

Operating expenses increased by $2.9 million primarily due to the net effect of the following:

- A decrease of $13.5 million in payroll and payroll related expenses.
- A decrease of $2.6 million in Service Contract – Superaqueduct expenses.
- A decrease of $2.2 million in other operating expenses.
- An increase of $7.9 million in depreciation expense.

Summary of Revenues, Expenses, and Changes in Net Assets (continued)

June 30, 2010 and 2009 (continued)

- An increase of $8.0 million in repair and maintenance of capital assets.
- An increase of $3.6 million in electricity expenses.
- An increase of $3.5 million in professional and consulting services expenses.

The decrease in payroll expenses are the result of a reduction in the number of employees and changes in benefits granted.

Service contract – Superaqueduct expenses pertain to a contract signed with Thames-Dick for the operation and maintenance of the North Coast Aqueduct (Superaqueduct).

Non-operating revenue increased by $18.2 million when compared with previous fiscal year. This is primarily the net effect of an increase of $10.1 million in interest expense on bonds, notes and lines of credits and the increase in Commonwealth contributions of $27.2 million for the payment of principal and interest on outstanding debt.

Capital contributions increased by $947.2 million. This is primarily due to capital assets transferred from by PRIFA for the amount of $933.4 million.

Economic Factors and Next Year's Budgets and Rates

Puerto Rico's economy is currently in a recession that began in the fourth quarter of fiscal year 2006. Although Puerto Rico's economy is closely linked to the United States economy, for fiscal years 2007, 2008, 2009, and 2010, Puerto Rico's real gross national product decreased by 1.2%, 2.9%, 4.8%, and 3.8%, respectively, while the United States real gross domestic product grew at a rate of 1.9% and 2.0% during fiscal years 2007 and 2008, respectively, contracted during fiscal year 2009 at a rate of 2.8% and grew by 0.7% in fiscal year 2010. According to the Puerto Rico Planning Board's (the Planning Board) latest projections made in March 2011, which take into account the preliminary results of fiscal year 2010, the economic impact of the disbursement of funds from the American Recovery and Reinvestment Act of 2009 (ARRA) and other economic factors, the real gross national product for fiscal year 2011 is forecasted to contract by 1.0%. The gross national product for fiscal year 2012, however, is forecasted to grow by 0.7%.

Economic Factors and Next Year's Budgets and Rates (continued)

The economic situation impacted the Authority's collection rate. During fiscal year 2011, management has been focusing in minimize the financial impact of the current situation by the implementation of a revenue optimization program directed to, among other things, increase collections and replace meters to increase billed water consumption.

During June 2011, the Authority adopted a balanced operational budget for fiscal year 2012. In addition, the Authority's Capital Improvement Program for the fiscal year 2012 is estimated in $407 million.

The Authority's credit ratings are "Baa1" by Moody's Investors Service, "BBB-" by Standard and Poor's Ratings Services and "BBB" by Fitch Ratings.

Contacting the Authority's Financial Management

This financial report is designed to provide the Authority's customers and creditors and other interested persons with a general overview of its finances and to demonstrate the Authority's accountability for the funds it receives. If you have questions about this report, or need additional financial information, contact the Director of Finance at 604 Barbosa Avenue, Suite 406, San Juan, Puerto Rico 00917-4310 or (787) 620-3791.

Puerto Rico Aqueduct and Sewer Authority
(A Component Unit of the Commonwealth of Puerto Rico)

Balance Sheets

(In thousands)

	June 30 2011	June 30 2010
Assets		
Current assets:		
Cash and cash equivalents	**$ 62,630**	$ 12,713
Accounts receivable, net	**163,589**	192,703
Receivables from federal agencies	**3,344**	3,417
Materials and supplies inventory, net	**28,572**	24,163
Prepayments and other current assets	**6,130**	5,870
Total current assets	**264,265**	238,866
Noncurrent assets:		
Restricted cash and cash equivalents	**209,852**	185,425
Capital assets:		
Capital assets being depreciated	**8,276,363**	8,049,013
Accumulated depreciation and amortization	**(2,843,090)**	(2,642,053)
	5,433,273	5,406,960
Land and other nondepreciable assets	**66,851**	61,765
Construction in progress	**1,711,896**	1,616,269
Total capital assets, net	**7,212,020**	7,084,994
Other assets:		
Deferred debt issuance cost, net of accumulated amortization of $12,224 and $9,897 for 2011 and 2010, respectively	**54,889**	57,216
Total assets	**$ 7,741,026**	$ 7,566,501

(Continued)

Puerto Rico Aqueduct and Sewer Authority
(A Component Unit of the Commonwealth of Puerto Rico)

Balance Sheets (continued)

(In thousands)

	June 30	
	2011	**2010**
Liabilities and net assets		
Current liabilities:		
Bonds payable	**$ 7,815**	$ 7,316
Notes payable	**260,041**	19,448
Lines of credit	**27,770**	–
Accounts payable	**162,858**	146,862
Accrued liabilities	**151,747**	173,893
Accrued interest	**61,862**	82,141
Unearned revenue	**19,269**	18,962
Customers' deposits	**6,146**	5,766
Compensated absences and postemployment benefits	**21,170**	16,101
Total current liabilities	**718,678**	470,489
Noncurrent liabilities:		
Bonds payable	**2,571,925**	2,573,663
Notes payable	**395,152**	601,033
Lines of credit	**1,002,179**	751,283
Customers' deposits	**73,952**	74,074
Compensated absences and postemployment benefits	**44,728**	49,329
Total noncurrent liabilities	**4,087,936**	4,049,382
Total liabilities	**4,806,614**	4,519,871
Net assets:		
Invested in capital assets, net of related debt	**3,374,252**	3,544,720
Restricted for environmental compliance, capital activity and other	**24,482**	17,642
Unrestricted	**(464,322)**	(515,732)
Total net assets	**2,934,412**	3,046,630
Total net assets and liabilities	**$ 7,741,026**	$ 7,566,501

See accompanying notes.

Puerto Rico Aqueduct and Sewer Authority
(A Component Unit of the Commonwealth of Puerto Rico)

Statements of Revenues, Expenses, and Changes in Net Assets

(In thousands)

	Year Ended June 30	
	2011	**2010**
Operating revenues:		
Water	**$ 492,847**	$ 503,888
Sewer	**253,657**	262,447
Central Government appropiations	**85,000**	–
Bad debt expense	**(22,396)**	(53,547)
Total net operating revenues	**809,108**	712,788
Operating expenses:		
Payroll and payroll related	**250,968**	266,099
Service contract – Superaqueduct	**28,473**	22,800
Professional and consulting services	**34,138**	21,395
Chemicals	**29,453**	26,279
Materials and replacements	**16,110**	14,529
Repairs and maintenance of capital assets	**45,405**	39,990
Electricity	**156,583**	140,131
Insurance	**9,276**	9,443
Other operating expenses	**77,248**	78,685
Operating expenses (excluding depreciation and amortization)	**647,654**	619,351
Depreciation and amortization	**201,037**	**151,767**
Total operating expenses	**848,691**	**771,118**
Operating loss	**(39,583)**	**(58,330)**
Nonoperating revenues (expenses):		
Interest expense, net of amortization of debt issuance cost, bond premium and discount, and deferred refunding loss	**(153,068)**	(137,063)
Commonwealth contributions for principal payments on bonds and notes	**819**	8,275
Commonwealth contributions for interest payments on bonds and notes	**37,749**	37,190
Interest income	**4,578**	4,269
Other income	**3,012**	7,084
Total nonoperating expenses, net	**(106,910)**	(80,245)
Loss before capital contributions	**(146,493)**	**(138,575)**
Capital contributions:		
Federal grants and other contributions	**31,798**	26,498
Other Commonwealth contributions	**2,477**	942,879
Total capital contributions	**34,275**	969,377
Change in net assets	**(112,218)**	830,802
Net assets at beginning of year	**3,046,630**	2,215,828
Net assets at end of year	**$ 2,934,412**	$ 3,046,630

See accompanying notes.

Puerto Rico Aqueduct and Sewer Authority
(A Component Unit of the Commonwealth of Puerto Rico)

Statements of Cash Flows

(In thousands)

	Year Ended June 30	
	2011	**2010**
Cash flows from operating activities		
Cash received from customers	**$ 748,865**	$ 733,762
Cash received from Commonwealth	**85,000**	–
Cash paid to suppliers	**(380,937)**	(469,108)
Cash paid to employees	**(254,239)**	(271,787)
Net cash provided by (used in) operating activities	**198,689**	(7,133)
Cash flows from noncapital financing activities		
Payments of lines of credit	**–**	(150,000)
Payments of notes	**(2,944)**	(2,748)
Net cash from other income	**3,012**	7,084
Interest paid on notes and lines of credit	**(8,026)**	(8,121)
Net cash used in noncapital financing activities	**(7,958)**	(153,785)
Cash flows from capital and related financing activities		
Additions to utility plant and other capital assets	**(350,819)**	(322,914)
Proceeds from capital contributions	**39,196**	40,389
Proceeds from issuance of bonds	**–**	15,047
Proceeds from issuance of notes payable	**74,663**	69,452
Proceeds from borrowings from lines of credit	**297,069**	459,156
Payments of bonds and notes	**(31,328)**	(20,584)
Payment of lines of credit	**(37,926)**	(16,260)
Interest paid on bonds, notes and lines of credit	**(111,820)**	(54,039)
Net cash (used in) provided by capital and related financing activities	**(120,965)**	170,247
Cash flows from investing activities		
Interest received on investments	**4,578**	4,269
Net cash provided by investing activities	**4,578**	4,269
Net increase in cash and cash equivalents	**74,344**	13,598
Cash and cash equivalents at beginning of year	**198,138**	184,540
Cash and cash equivalents at end of year	**$ 272,482**	$ 198,138
For purposes of the statement of cash flows, cash and cash equivalents include:		
Unrestricted	**$ 62,630**	$ 12,713
Restricted	**209,852**	185,425
	$ 272,482	$ 198,138

(Continued)

Puerto Rico Aqueduct and Sewer Authority
(A Component Unit of the Commonwealth of Puerto Rico)

Statements of Cash Flows (continued)

(In thousands)

	Year Ended June 30 2011	2010
Reconciliation of operating loss to cash provided by (used in) operating activities		
Operating loss	**$ (39,583)**	$ (58,330)
Adjustments to reconcile operating loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	**201,037**	151,767
Provision for uncollectible accounts	**22,396**	53,547
Change in assets and liabilities:		
Decrease (increase) in accounts receivable	**1,796**	(35,205)
Decrease (increase) in accounts receivable from federal agencies	**73**	(247)
Increase in materials and supplies inventory	**(4,409)**	(1,732)
Increase in prepayments and other current assets	**(260)**	(70)
Increase (decrease) in accounts payable	**38,752**	(110,268)
Increase in unearned revenue	**307**	347
Increase in accrued compensated absences and early retirement obligation	**468**	2,191
Decrease in accrued liabilities	**(22,146)**	(11,418)
Increase in customers' deposits	**258**	2,285
Total adjustments	**238,272**	51,197
Net cash provided by (used in) operating activities	**$ 198,689**	$ (7,133)
Noncash noncapital financing activities		
Amortization of debt issuance cost	**$ 332**	$ 332
Noncash capital and related financing activities		
Net additions to utility plant and other capital assets	**22,757**	921,100
Write-off of capital contributions	**4,922**	4,411
Amortization of:		
Debt issuance cost	**1,996**	1,995
Bond premiums and discounts	**1,269**	1,269
Deferred refunding loss	**5,561**	5,561
Accretion of interest on capital appreciation bonds	**9,132**	8,598
Principal paid by the Commonwealth	**819**	8,275
Interest paid by the Commonwealth	**37,749**	37,190

See accompanying notes.

1. Reporting Entity and Summary of Significant Accounting Policies

The Puerto Rico Aqueduct and Sewer Authority (the Authority) is a component unit of the Commonwealth of Puerto Rico (the Commonwealth). The Authority was created in 1945 under Act No. 40 (the Act), as amended and reenacted, for the purpose of owning, operating, and developing all of the public aqueduct and sewer systems in Puerto Rico. The Authority provides water and wastewater services to the Commonwealth, businesses, and residents of Puerto Rico. As a public corporation and an instrumentality of the Commonwealth, the Authority is exempt from the payment of income, property and municipal taxes. Under the terms of the Act, the Authority has broad powers, including, among others, to borrow money and issue revenue bonds for any of its corporate purposes. The Authority receives, in addition to its funds derived from operating its water and wastewater systems, grants from various agencies of the federal government of the United States of America and donations in kind or in cash from developers and various governmental agencies and instrumentalities of the Commonwealth.

Summary of Significant Accounting Policies

The accounting and reporting policies of the Authority conform to the accounting rules prescribed by the Governmental Accounting Standards Board (GASB). Under GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting,* the Authority has elected not to apply Financial Accounting Standards Board pronouncements issued after November 30, 1989. The Authority functions as an enterprise fund and maintains its accounting records on the accrual basis of accounting in conformity with U.S. generally accepted accounting principles. The following describes the most significant accounting policies followed by the Authority.

Measurement Focus and Basis of Accounting

The Authority's operations are accounted for on a flow of economic resources measurement focus, using the accrual basis of accounting. Under this method, all assets and liabilities associated with operations are included on the balance sheet, and revenues are recorded when earned and expenses are recorded at the time liabilities are incurred.

Revenues are recorded when utility services are provided to customers. All customers are billed on a monthly basis. Revenues are presented net of estimated allowances for uncollectible accounts. The Authority recognizes revenue on unbilled utility services based on estimated consumption.

1. Reporting Entity and Summary of Significant Accounting Policies (continued)

Measurement Focus and Basis of Accounting (continued)

The Authority distinguishes operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with the Authority's principal ongoing operations. The principal operating revenues of the Authority are charges to customers for water and sewer related sales and services. Operating expenses of the Authority include the cost of sales and services, administrative expenses, and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.

Cash and Cash Equivalents

Cash equivalents include all highly liquid instruments with maturities of three months or less at the time of acquisition. If such instruments are included in restricted assets, they are considered cash equivalents for purposes of the statements of cash flows.

The Authority maintains some construction fund accounts related to past bond issuances invested in mutual funds. As of June 30, 2011 and 2010, the account balances amounted to approximately $17.9 million and $21.7 million, respectively. The accounts are held under the Puerto Rico Government Investment Trust Fund (the Trust Fund), a collective investment trust created by the Secretary of the Treasury of Puerto Rico as settler and the Government Development Bank of Puerto Rico as trustee. The Trust Fund seeks to maintain a constant net asset value per unit of $1 through investment in high-grade short term money market instruments with a dollar-weighted average portfolio maturity of less than 60 days, including, but not limited to, obligations of the U.S. Government, the Puerto Rico Government, their respective agencies and instrumentalities, repurchase agreements with respect to obligations of the U.S. Government, certificates of deposit, time deposits, bank notes and banker's acceptances issued by the U.S. or Puerto Rico regulated banks, commercial paper and corporate obligations. The Authority can invest, reinvest or redeem units acquired at any time without charge or penalty.

The Trust Fund values its investments on the basis of amortized cost. Although the Trust Fund's policies are designed to help maintain a stable net asset value per unit of $1, all money market instruments can change in value when interest rates or issuers' creditworthiness change, or if an issuer or guarantor of a security fails to pay interest or principal when due. As of June 30, 2011 and 2010 the net asset value per unit of the Trust Fund was $1.

1. Reporting Entity and Summary of Significant Accounting Policies (continued)

Restricted Assets

Funds set aside for construction or other specific purposes are classified as restricted assets since their use is limited for these purposes by the applicable agreements.

When both restricted and unrestricted resources are available for a specific use, it is the Authority's policy to use restricted resources first, then unrestricted resources as they are needed.

Receivables

Receivables are stated net of estimated allowances for uncollectible accounts, which allowances are determined based upon past collection experience and current economic conditions, among other factors.

Materials and Supplies Inventory

Materials and supplies inventory is stated at average cost, not to exceed market. Inventory is presented net of a reserve for obsolescence totaling approximately $3.8 million and $3.5 million as of June 30, 2011 and 2010 respectively.

Unamortized Debt Issuance Costs, Premiums, Discounts and Deferred Refunding Losses

Debt issuance costs, premiums and discounts are deferred and amortized to expense over the life of the related debt using the straight-line method, which approximates the effective interest method.

The excess of reacquisition costs over the carrying value of refunded long-term debt is deferred and amortized to expense using the straight-line method over the remaining term of the original debt, or the term of the new debt, whichever is shorter.

Bonds payable are reported net of applicable bond premium or discount and deferred refunding loss. Unamortized debt issuance costs are reported as an asset on the balance sheets.

Capital Assets

The Authority defines capital assets as tangible and intangible assets used in the Authority's operations with a useful live longer than a year, not held for sale and with an individual cost of over $1,000 for technology hardware and software and over $2,000 for all other capital assets.

1. Reporting Entity and Summary of Significant Accounting Policies (continued)

Capital Assets (continued)

Utility plant is carried at cost, which includes capitalized labor, materials, administrative costs, and interest on debt financed construction. Interest capitalized by the Authority for the years ended June 30, 2011 and 2010 amounted to approximately $67.2 million and $57 million, respectively.

Recurring maintenance and repair costs are charged to expense, whereas major repairs, improvements, and replacements are capitalized. When capital assets are disposed, the cost and applicable accumulated depreciation are removed from the respective accounts, and the resulting gain or loss is recorded in operations.

All utility plant and other capital assets are recorded at historical cost or estimated historical cost.

Depreciation and amortization expense is calculated using the straight-line method.

During fiscal year 2011, the Authority performed an assessment of the useful lives of all its depreciable capital assets by category. In evaluating useful lives, the Authority considered the industry averages for similar types of assets, the geological and hydrological conditions unique to Puerto Rico and engineering judgments of the Authority's historical maintenance and replacement trends. This assessment indicated that some assets will continue to be used for a longer period than previously anticipated and others whose periods were reduced or remained the same. As a result, effective July 1, 2011, the Authority revised the useful lives as follows:

Description	Former Useful Life	Revised Useful Life
Wells and tanks	Forty-eight (48) years	Fifty (50) years
Equipment and vehicles	Five (5) years	Five (5) years
Furniture and fixtures	Ten (10) years	Ten (10) years
Water and sewer plants, tanks and pump stations	Forty-eight (48) years	Thirty (30) years
Buried infrastructure	Forty-eight (48) years	Range from Fifty (50) to Seventy (70) years
Dams	Range from Fifty (50) to One-Hundred (100) years	Seventy (70) years
Buildings	Range from Twenty (20) to Fifty (50) years	Forty (40) years

Changes in estimates are accounted for on a prospective basis, by depreciating assets' current carrying values over their revised remaining useful lives. The effect of this change in estimate, compared to the original depreciation had an impact of approximately $18.5 million increasing the deprecation expense for fiscal year 2011.

1. Reporting Entity and Summary of Significant Accounting Policies (continued)

Capital Assets (continued)

Construction in progress represents the accumulated costs of various construction projects. If construction plans are abandoned, such costs are expensed.

Unearned Revenue

Unearned revenue arises from advances received from the Commonwealth and other governmental agencies in accordance with a consumption schedule for water and sewer services. Unearned revenue also arises from water and sewer services paid by residential, commercial or industrial customers over periodic billings that are adjusted.

Accounting for Compensated Absences

Employees earn vacation and sick leave based on a prescribed formula. The amount of vacation and sick leave earned and not used by the Authority's employees is accrued as a liability as the benefits are earned by the employees and if the employees' rights to receive compensation are attributable to services already rendered and it is probable that the Authority will compensate the employees for the benefits through paid time off or some other means, such as cash payments at termination or retirement. Accrued compensated absences include payroll related expenses.

The cost of compensated absences expected to be paid in the next twelve months is classified as a current liability while amounts expected to be paid after twelve months are classified as noncurrent liabilities.

Postemployment Health Benefits

The Authority provides certain healthcare benefits for retired employees. Substantially all of the Authority's employees may become eligible for these benefits if they meet the required years of service working for the Authority.

The Authority has the obligation to contribute a maximum of $125 monthly per retired employee for coverage under the medical plan. The Authority accounts for its postretirement healthcare benefits in accordance with GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions*.

1. Reporting Entity and Summary of Significant Accounting Policies (continued)

Postemployment Health Benefits (continued)

The Authority maintains an Early Retirement Program established during fiscal year 2002, which provides for a monthly payment to certain retired employees to cover healthcare premiums for a maximum of $280 per month, up to the age of seventy (70) years or for a maximum of ten (10) years, whichever occurs first. The present value of future healthcare benefit contributions for these early retired employees is accrued and reported as a liability in the accompanying balance sheets. As of June 30, 2011 and 2010, the accrued liability for early retirement amounted to approximately $1.9 million and $2.9 million, respectively.

The cost of healthcare benefits paid to retired employees amounted to approximately $3.6 million and $2.9 million for 2011 and 2010 respectively.

Pension Benefits

The Authority's employees participate in the Government of Puerto Rico Employees Retirement System (the Plan), a cost-sharing multiple-employer plan. The Authority recognizes annual pension expense equal to its required contribution to the Plan. The Commonwealth funds any past or future unfunded liability related to the Authority's employees.

Net Assets

Net assets are reported in three categories:

- ***Invested in Capital Assets, Net of Related Debt*** – These consists of capital assets, net of accumulated depreciation and amortization and reduced by outstanding balances for bonds, notes, and other debt that are attributed to the acquisition, construction, or improvement of those assets. Debt pertaining to significant unspent debt proceeds is not included in the calculation of invested in capital assets, net of related debt.
- ***Restricted Net Assets*** – These result when constraints, on the use of net assets are either externally imposed by creditors, grantors, contributors, and the like, or imposed by law through constitutional provisions or enabling legislation. At June 30, 2011 and 2010, the Authority had no assets restricted by enabling legislation.
- ***Unrestricted Net Assets*** – These consist of net assets, which do not meet the definition of the two preceding categories. Unrestricted net assets could be designated to indicate that management does not consider them to be available for general operations. Unrestricted net assets often have constraints on resources that are imposed by management, but can be removed or modified.

1. Reporting Entity and Summary of Significant Accounting Policies (continued)

Use of Estimates

Management of the Authority has made a number of estimates and assumptions relating to the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the basic financial statements and the reported amounts of revenue and expenses during the period. Actual results could differ from those estimates.

Future Adoption of Accounting Standards

GASB has issued the following accounting standards that the Authority has not yet adopted:

GASB Statement		Adoption required in fiscal year
57	OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans	2012
60	Accounting and Financial Reporting for Service Concession Arrangements	2012
61	Accounting and Financial Reporting Entity: Omnibus-an amendment of GASB Statements No. 14 and No. 34	2013
62	Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements	2013
63	Financial Reporting of Deferred Outflows of Resources, Deferred Inflows od Resources, and Net Position	2013
64	Derivative Instruments: Application of Hedge Accounting Termination Provisions - an amendment of GASB Statement No. 53	2012

The impact of these standards has not yet been determined.

Effects of New Pronouncements

In June 2010, GASB issued Statement No. 59, *Financial Instruments Omnibus*. The objective of this Statement is to update and improve existing standards regarding financial reporting and disclosure requirements of certain financial instruments and external investment pools for which significant issues have been identified in practice. The Authority adopted the provisions of GASB Statement No. 59 during the year ended June 30, 2011. The adoption of GASB Statement No. 59 had no impact on the Authority.

1. Reporting Entity and Summary of Significant Accounting Policies (continued)

Commonwealth Appropriations

The Authority receives appropriations from the Commonwealth. Appropriations are classified as operating revenues, non-operating revenues and capital contributions as specified in Joint Resolutions approved by the Puerto Rico Legislature. Appropriations to pay for operating expenses are classified as operating revenues. Appropriations to pay for debt service are classified as non-operating revenues and appropriations for capital projects are classified as capital contributions.

Reclassifications

Certain prior year amounts have been reclassified to conform to the current year's presentation.

2. Deposits

The carrying amount of deposits with financial institutions of the Authority consisted of the following (in thousands):

	June 30			
	2011		2010	
	Carrying amount	Bank balance	Carrying amount	Bank balance
Unrestricted deposits in commercial banks in Puerto Rico	**$ 62,630**	**$ 69,047**	$ 12,713	$ 30,184
Restricted deposits in commercial banks in Puerto Rico	**166,930**	**166,930**	144,825	144,825
Restricted deposits in governmental banks:				
GDB	**41,208**	**41,208**	39,351	39,351
EDB	**1,714**	**1,714**	1,249	1,249
Total	**$ 272,482**	**$ 278,899**	$ 198,138	$ 215,609

Cash and cash equivalents consist of demand deposits, interest-bearing accounts, certificates of deposit, and mutual funds, as described in Note 1.

2. Deposits (continued)

Custodial Credit Risks Related to Deposits

Pursuant to the laws of the Commonwealth, the Authority's cash is required to be held only in banks designated as depository institutions of public funds by the Commonwealth's Secretary of the Treasury. The Commonwealth requires that public funds deposited in commercial banks in Puerto Rico must be fully collateralized for the amount deposited in excess of federal depository insurance. All securities pledged as collateral are held by the Secretary of the Treasury of the Commonwealth.

Custodial credit risk is the risk that, in the event of a bank failure, the Authority's deposits might not be recovered. Deposits maintained at Government Development Bank for Puerto Rico (GDB) and Economic Development Bank for Puerto Rico (EDB) are exempt from the collateral requirements established by the Commonwealth and thus represent a custodial credit risk that in the event of GDBs or EDBs failure, the Authority may not be able to recover these deposits. GDB and EDB are component units of the Commonwealth.

The Authority was exposed to the following custodial credit risk arising from the balance of deposits maintained in governmental and commercial banks as follows (in thousands):

	June 30	
	2011	**2010**
Uninsured and uncollateralized:		
GDB	**$ 41,208**	$ 39,351
EDB	**1,714**	1,249
	$ 42,922	$ 40,600

3. Accounts Receivable

Accounts receivable are primarily for water and sewer services provided to residential, industrial, commercial and government customers, and consisted of the following (in thousands):

	June 30	
	2011	**2010**
Water and sewer services:		
Residential, industrial, and commercial	**$ 468,443**	$ 458,079
Government agencies and municipalities	**70,537**	88,886
	538,980	546,965
Other receivables:		
Government agencies and municipalities	**3,401**	3,374
Private entities	**26,195**	19,986
	29,596	23,360
	568,576	570,325
Less allowance for uncollectible accounts	**(404,987)**	(377,622)
Total	**$ 163,589**	$ 192,703

4. Receivables from Federal Agencies

The receivables from federal agencies of approximately $3.3 million and $3.4 million as of June 30, 2011 and 2010, respectively, consisted primarily of amounts pending to be received from the U.S. Department of Homeland Security (USDHS) as reimbursement for expenses incurred by the Authority's disaster recovery activities.

5. Materials and Supplies Inventory

As of June 30, 2011 and 2010, material and supplies inventory consisted of the basic materials needed for the operation and maintenance of the water and sewer system and for the replacement of water meters.

6. Capital Assets

Utility plant and other capital assets as of June 30, 2011 and 2010 and the changes therein for the years then ended are as follows (in thousands):

	June 30, 2011			
	Beginning Balance	Increases	Decreases	Ending Balance
Capital assets not being depreciated:				
Land	$ 53,897	$ 4,497	$ –	$ 58,394
Easement	7,868	589	–	8,457
Construction in progress	1,616,269	322,439	(226,812)	1,711,896
Total capital assets not being depreciated	1,678,034	327,525	(226,812)	1,778,747
Capital assets being depreciated:				
Infrastructure (water and sewer facilities)	7,392,677	187,537	–	7,580,214
Wells, tanks and meters	388,896	25,628	–	414,524
Buildings and improvements	70,078	439	–	70,517
Equipment, furniture, fixtures and vehicles	197,362	13,746	–	211,108
Total capital assets being depreciated	8,049,013	227,350	–	8,276,363
Less accumulated depreciation and amortization:				
Infrastructure (water and sewer facilities)	(2,328,335)	(173,946)	–	(2,502,281)
Wells, tanks and meters	(128,842)	(12,596)	–	(141,438)
Buildings and improvements	(28,338)	(1,576)	–	(29,914)
Equipment, furniture, fixtures and vehicles	(156,538)	(12,919)	–	(169,457)
Total accumulated depreciation and amortization	(2,642,053)	(201,037)	–	(2,843,090)
Total capital assets being depreciated, net	5,406,960	26,313	–	5,433,273
Total capital assets, net	$ 7,084,994	$ 353,838	$ (226,812)	$ 7,212,020

6. Capital Assets (continued)

	June 30, 2010			
	Beginning Balance	**Increases**	**Decreases**	**Ending Balance**
Capital assets not being depreciated:				
Land	$ 52,944	$ 953	$ –	$ 53,897
Easement	7,379	489	–	7,868
Construction in progress	1,591,978	1,243,851	(1,219,560)	1,616,269
Total capital assets not being depreciated	1,652,301	1,245,293	(1,219,560)	1,678,034
Capital assets being depreciated:				
Infrastructure (water and sewer facilities)	6,236,119	1,157,324	(766)	7,392,677
Wells, tanks and meters	345,899	43,168	(171)	388,896
Buildings and improvements	67,645	2,433	–	70,078
Equipment, furniture, fixtures and vehicles	182,172	15,190	–	197,362
Total capital assets being depreciated	6,831,835	1,218,115	(937)	8,049,013
Less accumulated depreciation and amortization:				
Infrastructure (water and sewer facilities)	(2,198,535)	(130,566)	766	(2,328,335)
Wells, tanks and meters	(121,460)	(7,408)	26	(128,842)
Buildings and improvements	(26,111)	(2,227)	–	(28,338)
Equipment, furniture, fixtures and vehicles	(145,283)	(11,255)	–	(156,538)
Total accumulated depreciation and amortization	(2,491,389)	(151,456)	792	(2,642,053)
Total capital assets being depreciated, net	4,340,446	1,066,659	(145)	5,406,960
Total capital assets, net	$ 5,992,747	$ 2,311,952	$ (1,219,705)	$ 7,084,994

7. Restricted Assets

Restricted assets at June 30, 2011 and 2010 consisted of the following:

Construction Funds – Amounts in construction funds represent unspent bond proceeds, which will be used to pay the cost of construction of infrastructure projects. Construction funds are held by the Authority and deposited in GDB.

Capital Activity Funds – Amounts in capital activity funds represent amounts deposited as a result of agreements between commonwealth agencies and municipalities for construction of infrastructure projects. Also includes fines and penalties assessed by EPA that will be used for construction of infrastructure projects to provide water services and to comply with environmental regulations.

Debt Service Funds – Amounts in debt service funds represent amounts deposited for the payment of principal and interest on bonds and notes. Also includes deposits required by the Master Agreement of Trust.

Restricted assets by category consist of:

	June 30	
	2011	**2010**
Construction funds	**$ 21,455**	$ 24,201
Capital activity funds	**13,494**	13,088
Debt service funds	**174,903**	148,136
	$ 209,852	$ 185,425

8. Accrued Liabilities

Accrued liabilities consisted of the following (in thousands):

	June 30	
	2011	**2010**
Payroll and related accruals	**$ 43,511**	$ 54,712
Legal, labor related and environmental contingencies	**68,554**	70,762
Contract retentions	**39,682**	48,419
	$ 151,747	$ 173,893

9. Long-Term Liabilities

Long-term debt activity for the years ended June 30, 2011 and 2010 was as follows (in thousands):

	June 30, 2011					
	Beginning Balance	Additions/ Amortization	Reductions	Ending Balance	Due Within One Year	Due Thereafter
Bonds payable:						
2001 Series A Commonwealth Appropriation Bonds	$ 17,600	$ –	$ (8,615)	$ 8,985	$ 8,985	$ –
Act 164 PFC Commonwealth Appropriation Bonds	341,565	–	–	341,565	–	341,565
2004 Series A Commonwealth Appropriation Bonds	326,785	–	–	326,785	–	326,785
2008 Series A Revenue Bonds	1,335,123	9,132	–	1,344,255	–	1,344,255
2008 Series B Revenue Bonds	22,445	–	–	22,445	–	22,445
2008 Series A Revenue Refunding Bonds	159,055	–	–	159,055	–	159,055
2008 Series B Revenue Refunding Bonds	125,700	–	–	125,700	–	125,700
Rural Development Serial Bonds	312,079	–	(6,049)	306,030	3,123	302,907
Add bond premium	36,316	–	(1,707)	34,609	1,707	32,902
Less bond discount	(16,244)	–	439	(15,805)	(439)	(15,366)
Less deferred loss on refunding	(79,445)	–	5,561	(73,884)	(5,561)	(68,323)
Total bonds	2,580,979	9,132	(10,371)	2,579,740	7,815	2,571,925
Notes payable:						
Water Pollution Control and Safe Drinking Water Treatment Revolving Funds Loans	375,793	55,139	(17,483)	413,449	18,297	395,152
Notes with commercial banks	244,688	–	(2,944)	241,744	241,744	–
Total notes	620,481	55,139	(20,427)	655,193	260,041	395,152
Lines of credit	751,283	316,592	(37,926)	1,029,949	27,770	1,002,179
Other long-term liabilities:						
Accrued compensated absences	49,338	10,226	(13,122)	46,442	12,738	33,704
Net OPEB obligation	12,453	7,010	(2,315)	17,148	7,010	10,138
Early retirement obligation	3,639	–	(1,331)	2,308	1,422	886
Customers' deposits	79,840	8,683	(8,425)	80,098	6,146	73,952
Total other liabilities	145,270	25,919	(25,193)	145,996	27,316	118,680
Total – long-term obligations	$ 4,098,013	$ 406,782	$ (93,917)	$ 4,410,878	$ 322,942	$ 4,087,936

9. Long-Term Liabilities (continued)

	June 30, 2010					
	Beginning Balance	Additions/ Amortization	Reductions	Ending Balance	Due Within One Year	Due Thereafter
Bonds payable:						
2001 Series A Commonwealth Appropriation Bonds	$ 25,875	$ –	$ (8,275)	$ 17,600	$ 8,615	$ 8,985
Act 164 PFC Commonwealth Appropriation Bonds	341,565	–	–	341,565	–	341,565
2004 Series A Commonwealth Appropriation Bonds	326,785	–	–	326,785	–	326,785
2008 Series A Revenue Bonds	1,326,525	8,598	–	1,335,123	–	1,335,123
2008 Series B Revenue Bonds	22,445	–	–	22,445	–	22,445
2008 Series A Revenue Refunding Bonds	159,055	–	–	159,055	–	159,055
2008 Series B Revenue Refunding Bonds	125,700	–	–	125,700	–	125,700
Rural Development Serial Bonds	302,742	15,047	(5,710)	312,079	2,992	309,087
Add bond premium	38,025	–	(1,709)	36,316	1,709	34,607
Less bond discount	(16,683)	–	439	(16,244)	(439)	(15,805)
Less deferred loss on refunding	(85,006)	–	5,561	(79,445)	(5,561)	(73,884)
Total bonds	2,567,028	23,645	(9,694)	2,580,979	7,316	2,573,663
Notes payable:						
Water Pollution Control and Safe Drinking Water Treatment Revolving Funds Loans	321,215	69,452	(14,874)	375,793	16,504	359,289
Notes with commercial banks	247,436	–	(2,748)	244,688	2,944	241,744
Total notes	568,651	69,452	(17,622)	620,481	19,448	601,033
Lines of credit	458,387	459,156	(166,260)	751,283	–	751,283
Other long-term liabilities:						
Accrued compensated absences	51,352	14,079	(16,093)	49,338	12,674	36,664
Net OPEB obligation	7,928	7,010	(2,485)	12,453	2,402	10,051
Early retirement obligation	3,960	–	(321)	3,639	1,025	2,614
Customers' deposits	77,555	8,285	(6,000)	79,840	5,766	74,074
Total other liabilities	140,795	29,374	(24,899)	145,270	21,867	123,403
Total – long-term obligations	$ 3,734,861	$ 581,627	$ (218,475)	$ 4,098,013	$ 48,631	$ 4,049,382

10. Bonds Payable

Bonds payable consisted of the following (in thousands):

	June 30 2011	June 30 2010
Commonwealth Appropriation Bonds:		
Series 2001:		
Series A, 4.00% – 5.50% due in semiannual interest payments through 2011 and annual principal installments from August 1, 2007 through 2011	**$ 8,985**	$ 17,600
Act 164 PFC, 4.00% – 6.15% due in semiannual interest and annual principal payments from July 15, 2004 through 2030	**341,565**	341,565
Series 2004:		
Series A, 1.25% – 5.75% due in semiannual interest payments through August 1, 2031 and annual principal installments from July 15, 2004 to 2031	**326,785**	326,785
Revenue Refunding Bonds:		
Series 2008:		
Series A and B, Term Bonds, 5.80% – 6.10% due in monthly interest payments through July 1, 2034 and annual principal payments from July 1, 2021 to 2034	**284,755**	284,755
Revenue bonds:		
Series 2008:		
Series A, Serial Bonds, 5.00%, due in semiannual interest payments through July 1, 2025 and annual principal payments from July 1, 2012 to July 1, 2025	**93,155**	93,155
Series A, Convertible Capital Appreciation Bonds, 6.125%, due in semiannual interest payments from January 1, 2012 through July 1, 2024 and annual principal payments from July 1, 2017 to 2024	**155,975**	146,843
Series A, Term Bonds, 5.00% – 6.00%, due semiannual interest payments through July 1, 2047 and annual principal payments from July 1, 2026 to 2047	**1,095,125**	1,095,125
Series B, Serial Bonds, 6.15% due in monthly interest payments through July 1, 2038 and one principal payment on July 1, 2038	**22,445**	22,445
Rural development serial bonds:		
Serial bonds, 4.25% – 5.00%, due semiannually through July 1, 2050	**306,030**	312,079
Subtotal	**2,634,820**	2,640,352
Bond premium	**34,609**	36,316
Bond discount	**(15,805)**	(16,244)
Deferred amount on refundings	**(73,884)**	(79,445)
Total	**$ 2,579,740**	$ 2,580,979

10. Bonds Payable (continued)

2001 Series A and B Bonds

Joint Resolution No. 523 (J.R. 523) of the Commonwealth, approved on August 24, 2000, authorized the Authority to restructure and refinance a line of credit with GDB in a principal amount not to exceed approximately $390 million. The funds from the line of credit were used to finance the construction of the north coast superaqueduct project (Superaqueduct). The line of credit was restructured and refinanced through the issuance by Puerto Rico Public Finance Corporation (PFC), a component unit of GDB, on August 1, 2001, of approximately $356.7 million of Series A Bonds at a premium of approximately $2.3 million and approximately $33.3 million of Series B Bonds. The net proceeds of the 2001 Series A and B Bonds of approximately $381.1 million, after payment of the cost of issuance of approximately $9.6 million and approximately $1.6 million, set aside to cover capitalized interest, were used by PFC to purchase the outstanding promissory note of the Authority from GDB.

The Authority's 2001 Series A and B Bonds are secured by promissory note payments made by the Commonwealth to PFC pursuant to a Debt Restructuring and Assignment Agreement, dated August 1, 2001, between the Authority and PFC. In accordance with J.R. 523, such payments shall be funded by Commonwealth appropriations approved annually up to a maximum of approximately $34.9 million per fiscal year for a term of 30 years ending in fiscal year 2031-2032. The Commonwealth is not legally bound to appropriate funds for such promissory payments. Payments of principal and interest on the bonds are due on or before July 15 of each fiscal year, commencing July 15, 2004.

Act 164 PFC Bonds

On December 17, 2001, Act No. 164 (Act 164) of the Commonwealth authorized departments, agencies, instrumentalities, and public corporations of the Commonwealth, including the Authority, to restructure their outstanding obligations with GDB, for which no repayment source existed, over a period not exceeding 30 years.

Pursuant to Act 164, on January 16, 2002, PFC issued approximately $771.3 million of Series C Bonds, approximately $40.7 million of Series D Bonds, and $1,091.0 million of Series E Bonds, for the purpose of funding the purchase by PFC of certain promissory notes held by GDB. The Authority's then outstanding debt with GDB of approximately $609.2 million was restructured with proceeds of approximately $712.1 million from these issuances which included capitalized interest and issuance cost and its note evidencing this debt was purchased by PFC from GDB.

10. Bonds Payable (continued)

Act 164 PFC Bonds (continued)

The 2001 Series C and E Bonds are secured by promissory note payments made by the Commonwealth to PFC pursuant to a Debt Restructuring and Assignment Agreement dated July 1, 2001, between the debtors, including the Authority, and PFC. In accordance with Act 164, such payments shall be funded by Commonwealth appropriations approved annually up to a maximum of approximately $225 million per fiscal year for a term of 30 years. The Commonwealth is not legally bound to appropriate funds for such promissory notes payments. Payments of principal and interest on bonds are due on or before July 15 of each fiscal year, commencing July 15, 2004.

On June 28, 2004, PFC issued approximately $1,206.1 million of Series A Refunding Bonds at a premium of approximately $89.4 million, and approximately $146.9 million of Series B Refunding Bonds, for the purpose of refunding a portion of certain of its outstanding bonds.

The net proceeds from the 2004 Series A and B Refunding Bonds amounting to approximately $1,395 million, after payment of the cost of issuance and bond premium of approximately $47.4 million, were used to advance refund a portion of PFC's previously issued bonds in order to obtain lower interest rates. The Authority's allocable share of the total refunded debt was approximately $734 million at the issuance date including the unrefunded original PFC debt and the refunded debt through 2004 Series A and B. This refunding resulted in the Authority's recognition of net debt issuance cost of approximately $11.7 million, a net premium of approximately $44.4 million, and deferred refunding loss of approximately $67.2 million, all of which is being amortized over the term of the new debt, which is through 2031.

The 2004 Series A and B Bonds are secured by promissory notes payments made by the Commonwealth to PFC pursuant to Supplemental Debt Restructuring and Assignment Agreements, between the debtors, including the Authority, and PFC. In accordance with various Appropriation Acts, principal and interest payments on such notes shall be funded by Commonwealth appropriations approved annually for the number of fiscal years specified in such Appropriation Acts. The Commonwealth is not legally bound to appropriate funds for such repayments. Until the fiscal year beginning July 1, 2005, the Authority's promissory note payments were made by Commonwealth appropriations authorized by J.R. 523 and Act 164. Payments of principal and interest on bonds are due on or before July 15 of each fiscal year.

10. Bonds Payable (continued)

Act 164 PFC Bonds (continued)

On July 31, 2007, December 20, 2007 and June 26, 2008, the Puerto Rico Sales Tax Financing Corporation (known as COFINA for its Spanish acronym), a component unit of the Commonwealth, issued its Sales Tax Revenue Bonds Series 2007A and B, Series 2007C and Series 2009A, respectively, to refinance certain of the Act 164 PFC Bonds outstanding and the corresponding notes issued by PFC by certain of the Commonwealth's agencies and component units, (including the Authority). The Series 2009A and B proceeds were deposited in escrow with The Bank of New York/Mellon as master escrow agent. As a result, approximately $180.2 million of the Authority's share of the Act 164 PFC Bonds were considered legally defeased. The proceeds of the Series 2007C Bonds were used, in part, to purchase and cancel approximately $61.4 million of the Authority's share of the Act 164 PFC Bonds. The proceeds of the Series 2009A Bonds were used to purchase and cancel approximately $127.4 million of the Authority's share of the Act 164 PFC Bonds.

As of June 30, 2007, the Authority's share of the Act 164 PFC Bonds was approximately $721.3 million. After the COFINA debt refunding, the balance was reduced to approximately $341.6 million.

2004 Series A Refunding Bonds

The 2004 Series A Refunding Bonds mentioned above, also refinanced outstanding debt related to the Superaqueduct. The 2004 Series A balance related to the Superaqueduct was approximately $326.8 million as of the refunding date, with maturity dates ranging from August 1, 2013 to August 1, 2031.

2008 Revenue Bonds Series A and B

On March 18, 2008, the Authority issued approximately $1,338.6 million of Revenue Bonds, Series A and B (the 2008 Revenue Bonds). The 2008 Revenue Bonds Series A consist of (1) $93.2 million of serial bonds bearing interest at 5% per annum with maturity dates ranging from July 1, 2012 to July 1, 2025, (2) $127.9 million of capital appreciation term bonds bearing interest at 6 1/8% per annum and with maturity dates ranging from July 1, 2017 to July 1, 2024, and (3) $1,095.1 million of term bonds bearing interest at rates ranging from 5% to 6% per annum with maturity dates ranging from July 1, 2026 to July 1, 2047.

10. Bonds Payable (continued)

2008 Revenue Bonds Series A and B (continued)

As of June 30, 2011 and 2010, the outstanding balance for the 2008 Revenue Bonds Series A was approximately $1,344.2 million and $1,335.1 million, respectively, which included approximately $28.0 million and $18.9 million, respectively, of accreted value. The 2008 Revenue Bonds Series B consist of an approximately $22.4 million term bond bearing interest at 6.15% per annum and maturing on July 1, 2038. The 2008 Revenue Bonds were issued, to raise funds to be used by the Authority to repay certain outstanding bond anticipation notes and lines of credit and to pay a portion of the cost of the Authority's capital improvement program. The 2008 Revenue Bonds are considered senior debt.

2008 Revenue Refunding Bonds Series A and B

On March 18, 2008, the Authority issued approximately $284.8 million of Revenue Refunding Bonds, Series A and B (the 2008 Revenue Refunding Bonds), (guaranteed by the Commonwealth) to refund the Authority's outstanding Revenue Refunding Bonds, Series 1995 (guaranteed by the Commonwealth) in the amount of approximately $262.8 million. The 2008 Revenue Refunding Bonds bear interest at rates ranging from 5.80% to 6.10% per annum with maturity dates ranging from July 1, 2021 to July 1, 2034. The Revenue Refunding Bonds, Series A and B net proceeds of approximately $279.5 million (after payment of approximately $5.3 million in underwriters' discount, insurance, and other issuance costs) and other funds made available from sinking funds and investment accounts from the refunded bonds, were deposited in an irrevocable trust with an escrow agent to pay all future principal and interest payments of the Series 1995 Bonds to their respective dates of redemption or maturity. As a result, the 1995 Series Bonds are considered to be legally defeased and the liability for those bonds has been removed from the Authority's balance sheets.

The defeasance of the 1995 Series Bonds increased the Authority's total debt service payments over the next 25 years by approximately $292.8 million and resulted in an economic loss (difference between the present values of the old and new debt service payments) of approximately $12.7 million. The advance refunding resulted in a difference between the reacquisition price and the net carrying amount of the old debt of approximately $35.9 million. This difference, reported in the accompanying financial statements as a deduction from bonds payable, is being charged to operations through the year 2019 following a method substantially equivalent to the effective interest method.

10. Bonds Payable (continued)

2008 Revenue Refunding Bonds Series A and B (continued)

The 2008 Revenue Refunding Bonds are guaranteed by the Commonwealth and the Authority's net revenue, as defined in the corresponding trust indenture, is pledged toward the payment of debt service on these bonds. The 2008 Revenue Refunding Bonds are subordinated to all senior and senior subordinated debt.

Rural Development Serial Bonds

United States Department of Agriculture (USDA) Rural Development Program assists the Authority in the financing and construction of aqueduct and sewer facilities in rural areas by purchasing revenue bonds from the Authority, the proceeds of which are used by the Authority to finance such projects. GDB provides interim financing for these projects through short-term lines of credit. As of June 30, 2011 and 2010, the USDA Rural Development Program Serial Bonds consisted of twenty-four (24) separate series, issued from 1983 through 2009, bearing interest from 4.25% to 5% due in semiannual installments through 2050. The outstanding balance of the USDA Rural Development Program Serial Bonds as of June 30, 2011 and 2010 was approximately $306.0 million and $312.1 million, respectively.

The USDA Rural Development Program Serial Bonds are guaranteed by the Commonwealth, pursuant to Law No. 140 of 2000 as amended and the Authority's net revenue is pledged toward the payment of debt service on the USDA Rural Development Program Serial Bonds. The USDA Rural Development Program Serial Bonds are subordinate to all senior and senior subordinated.

10. Bonds Payable (continued)

Debt Service Payments

Future principal and interest payments on all bonds payable outstanding at June 30, 2011 are as follows (in thousands):

	Principal	Interest	Total
Fiscal year:			
2012	$ 12,108	$ 134,783	$ 146,891
2013	18,693	136,162	154,855
2014	33,406	135,516	168,922
2015	34,970	134,035	169,005
2016	38,369	132,106	170,475
2017 – 2021	224,773	627,203	851,976
2022 – 2026	359,258	553,336	912,594
2027 – 2031	650,802	437,740	1,088,542
2032 – 2036	382,825	292,852	675,677
2037 – 2041	311,945	201,343	513,288
2042 – 2046	387,453	101,459	488,912
2047 – 2051	180,218	9,398	189,616
Total	2,634,820	$ 2,895,933	$ 5,530,753
Plus unamortized premium	34,609		
Less:			
Unamortized discount	(15,805)		
Deferred loss on debt refunding	(73,884)		
Bonds payable, net	$ 2,579,740		

11. Notes Payable

Notes payable consisted of the following (in thousands):

	June 30	
	2011	**2010**
Puerto Rico Water Pollution Control Revolving Fund	**$ 266,964**	$ 249,687
Puerto Rico Safe Drinking Water Treatment Revolving Loan Fund	**146,485**	126,106
Notes with commercial banks	**241,744**	244,688
	$ 655,193	$ 620,481

The Puerto Rico Water Pollution Control Revolving Fund and Puerto Rico Safe Drinking Water Treatment Revolving Loan Fund (the Revolving Funds) were created by Act. No. 44 of June 21, 1988 and Act No. 32 of July 7, 1997, respectively, of the Commonwealth. The Puerto Rico Water Pollution Control Revolving Fund is administered, pursuant to Act No. 44 and Act No. 9 of June 21, 1988 and June 18, 1970, respectively, as amended, by Puerto Rico Environmental Quality Board (EQB). The Puerto Rico Safe Drinking Water Treatment Revolving Loan Fund is administered, pursuant to Act No. 5 of July 21, 1977, as amended, by Puerto Rico Department of Health (DOH).

Pursuant to these laws, EQB and DOH, on behalf of the Commonwealth, are authorized to enter into operating agreements and capitalization grant agreements with the U.S. Environmental Protection Agency (EPA). Puerto Rico Infrastructure Financing Authority (PRIFA), a component unit of the Commonwealth, the Authority, and GDB entered into a memorandum of understanding under which each party has agreed to assume specific responsibilities in connection with the operations of the Revolving Funds.

The Authority has entered into revolving loan agreements with PRIFA to finance certain capital improvements to the system. As of June 30, 2011 and 2010, the Authority had outstanding approximately $413.4 million and $375.8 million, respectively, under these loan agreements.

The PRIFA loan agreements are evidenced by promissory notes, which bear interest at a 2% annual rate payable semiannually. Construction loans are required to be paid in full within 20 years of the project completion date. The Authority has pledged its net revenues on a basis subordinate in all respects to the Authority's bonds outstanding. If the Authority's pledged revenues are not sufficient for the payment of principal and interest, the payments are guaranteed by the Commonwealth under the Act No. 45 of July 28, 1994, as amended, which obligates the Commonwealth to pay principal and interest on the notes.

11. Notes Payable (continued)

On September 8, 2006, the Authority entered into a $250 million term loan agreement with various commercial banks. The proceeds were used to repay various lines of credit with GDB and pay costs and fees associated with the term loan. During fiscal year 2011 and 2010, the loan bored interest at 3.25%. The loan is payable in quarterly installments commencing on September 1, 2008 and due on September 1, 2011. The outstanding balance as of June 30, 2011 and 2010 was approximately $241.7 million and $244.7 million respectively. The net revenue of the Authority, as defined in the Term Loan Agreement, is pledged toward payment of debt service on this term loan. The notes are considered senior subordinated debt and are subordinated to the senior debt.

The combined future aggregate amount of debt service for these loans as of June 30, 2011 was as follows (in thousands):

	Principal	Interest	Total
2012	$ 260,041	$ 7,694	$ 267,735
2013	18,081	5,322	23,403
2014	18,444	4,958	23,402
2015	18,757	4,588	23,345
2016	18,292	4,213	22,505
2017 – 2021	82,808	15,838	98,646
2022 – 2026	73,722	8,097	81,819
2027 – 2031	40,485	1,587	42,072
	530,630	$ 52,297	$ 582,927
Interim construction loans:			
Puerto Rico Water Pollution Control Revolving Fund	73,632		
Puerto Rico Safe Drinking Water Treatment Revolving Loan Fund	50,931		
Total	$ 655,193		

12. Lines of Credit

On October 19, 2000, the Authority entered into a line of credit agreement with GDB. This agreement provides the Authority with an available maximum amount of approximately $103.9 million. On October 29, 2004, the maximum available amount was increased to approximately $276 million to assist the Authority in financing the construction of aqueduct and sewer facilities in rural areas. As of June 30, 2009, the Authority had an outstanding balance of approximately $14.6 million. During fiscal year 2010 the line of credit was repaid and a new line of credit of $37.6 million was established for construction of rural projects.

On November 13, 2006, the Authority entered into a line of credit agreement with GDB. This agreement provides the Authority with an available maximum amount of $190 million to be used to provide funding for the capital improvement program of the Authority. On February, 2010, an increase of $60 million for a maximum amount of $250 million was approved. On November, 2010 the line was increased by $19.5 million to $269.5 million to capitalize unpaid accrued interest payable. As of June 30, 2011 and 2010, the Authority had an outstanding balance of $269.5 million and $250 million, respectively.

On March 18, 2008, the Authority entered into a revolving line of credit agreement with GDB. This agreement provides the Authority with an available maximum amount of $150 million to be used to satisfy the Operating Reserve Requirement pursuant to the Master Agreement of Trust dated as of March 1, 2008 between the Authority and the bond trustee related to the 2009 Revenue Bonds. This line of credit is due on June 30, 2013. There was no outstanding balance as of June 30, 2011 and 2010.

On May 4, 2009, the Authority entered into a revolving line of credit agreement with GDB. This agreement provides the Authority with an available maximum amount of $87.6 million to be used to provide funding for the capital improvement program of the Authority. As of June 30, 2011 and 2010, the Authority had an outstanding balance of approximately $87.6 million.

On November 12, 2009, the Authority entered into a revolving line of credit agreement with GDB. This agreement provides the Authority with an available maximum amount of $125 million to be used to provide funding for the capital improvement program of the Authority. As of June 2011 and 2010, the Authority had an outstanding balance of $125 million.

12. Lines of Credit (continued)

On December 8, 2009, the Authority entered into a line of credit agreement with GDB. This agreement provides the Authority with an available maximum amount of approximately $37.6 million for the purpose of providing interim financing for the construction of aqueduct and sewer facilities in rural areas. As of June 30, 2011 and 2010, the Authority had an outstanding balance of approximately $13.4 million and $8.5 million respectively.

On December 30, 2009, the Authority entered into a line of credit agreement with GDB. This agreement provides the Authority with an available maximum amount of $150 million to be used to provide funding for the capital improvement program of the Authority. As of June, 2011 and 2010, the Authority had an outstanding balance of $150 million, respectively.

On March 10, 2010, the Authority entered into a revolving line of credit agreement with GDB. This agreement provides the Authority with an available maximum amount of $70 million to be used to provide funding for the capital improvement program of the Authority. The proceeds will be applied only to projects approved and to be funded by the State Revolving Funds pursuant to federal regulations under the Clean Water Act, the Safe Drinking Water Act, and the American Recovery Act (“ARRA”). The Authority will pay this interim financing with moneys received from State Revolving Funds, as reimbursements on payments done by the Authority for the projects. As of June 30, 2011 and 2010, the Authority had an outstanding balance of approximately $48.3 million and $16.8 million on this line of credit, respectively.

On April 16, 2010, the Authority entered into a revolving line of credit agreement with GDB. This agreement provides the Authority with an available maximum amount of $50 million to be used to provide funding for the capital improvement program of the Authority. On June 7, 2010, the maximum available amount was increased to approximately $113.9 million. On August 3, 2010 the maximum available amount was increased to approximately $200 million. As of June, 2011 and 2010, the Authority had an outstanding balance of $200 million and $113.9 million, respectively.

On November 30, 2010, the Authority entered into a line of credit agreement with GDB. This agreement provides the Authority with an available maximum amount of approximately $21.7 million for the purpose of providing interim financing for the construction of aqueduct and sewer facilities in rural areas. As of June 30, 2011, the Authority had an outstanding balance of approximately $10.5 million under this line of credit agreement.

12. Lines of Credit (continued)

On March 8, 2011, the Authority entered into a line of credit agreement with GDB. This agreement provides the Authority with an available maximum amount of $250 million to be used to provide funding for the capital improvement program of the Authority. As of June, 2011, the Authority had an outstanding balance of approximately $125.5 million.

Future amounts required to pay principal balances at June 30, 2011 are as follows (in thousands):

Fiscal year:	
2012	$ 27,770
2013	1,002,179
	$ 1,029,949

13. Financial Covenants

The Master Agreement of Trust (the MAT) governing the 2008 Revenue Bonds and the Term Loan Agreement governing the notes with commercial banks, each contain distinct financial covenants requiring the maintenance of certain financial ratios.

The MAT contains a rate covenant requiring the Authority to fix, charge, collect and revises rates, fees and other charges for the use of and the services furnished by its systems so as to meet in each fiscal year, the following annual debt service requirements: (i) net revenues shall be at least equal to 120% of the annual debt service with respect to the senior indebtedness for such fiscal year; (ii) net revenues shall be at least equal to 110% of the annual debt service with respect to senior indebtedness and senior subordinated indebtedness for such fiscal year; and (iii) net revenues shall be sufficient to pay annual debt service on its indebtedness and to fund other amounts that may be due under the MAT. Indebtedness, as defined in the MAT, includes Commonwealth Guaranteed Indebtedness and Commonwealth Supported Obligations.

As of June 30, 2011 and 2010, the Authority was in compliance with the senior indebtedness and the senior and senior subordinated indebtedness annual debt service coverage requirements.

The Term Loan Agreement requires the Authority to maintain, for each fiscal year, a senior and senior subordinated debt service coverage ratio equal to at least 1.20. As of June 30, 2011 and 2010, the Authority was in compliance with the senior and senior subordinated debt service coverage ratio under the Term Loan Agreement.

14. Capital Contributions

Capital contributions for the fiscal years ended June 30, 2011 and 2010 were as follow (in thousands):

	June 30	
	2011	**2010**
Appropriations from Commonwealth	**$ 212**	$ 560
Other contributions from Commonwealth	**2,265**	942,280
Contributions from governmental agencies and municipalities	**3,947**	3,841
Federal grants:		
USDA Rural Development Program	**3,235**	8,044
Federal Emergency Management Agency	**1,247**	4,325
American Recovery and Reinvestment Act Funds	**19,698**	3,066
Developer contributions	**2,477**	1,976
Other contributions	**1,194**	5,285
	$ 34,275	$ 969,377

15. Related Party Transactions

Operating revenues for services provided to the Commonwealth and its component units amounted to approximately $79.7 million and $84.5 million during the years ended June 30, 2011 and 2010, respectively. Further, operating, administrative, and general expenses during the fiscal years ended June 30, 2011 and 2010 included approximately $156.6 million and $140.1 million, respectively, of charges from Puerto Rico Electric Power Authority (PREPA), a component unit of the Commonwealth.

As of June 30, 2011 and 2010, the Authority had approximately $46.6 million and $65 million, respectively, of receivables from the Commonwealth and its component units, which were reported in accounts receivable in the accompanying basic financial statements.

The Authority had approximately $1.6 million and $1.1 million of excess of collections over billings from the Commonwealth, recorded as unearned revenue in the basic financial statements as of June 30, 2011 and 2010, respectively.

Over the years, GDB, as fiscal agent and bank of the Commonwealth, had extended lines of credit to the Authority in order to finance capital improvement projects and operational deficits. As of June 30, 2011 and 2010, the Authority had an outstanding balance of approximately $1,029.9 million and $751.3 million, respectively, under these lines of credit.

15. Related Party Transactions (continued)

On July 2, 2010, Joint Resolution No. 68 was approved by the Puerto Rico Legislature. This Resolution assigned to the Authority the amount of $85 million to subsidize operating expenses and payment of debt service, as needed.

16. Pension Plan

The Government of Puerto Rico Employees Retirement System (ERS) is a cost-sharing multiple-employer defined benefit pension plan sponsored by, and reported as a component unit of, the Commonwealth. All regular employees of the Authority under the age of 55 at the date of employment become members of the ERS as a consequence of their employment.

The ERS provides retirement, death, and disability benefits pursuant to Act 447, approved on May 15, 1951, as amended, which became effective on January 1, 1952. Disability retirement benefits for occupational and nonoccupational disabilities are available to members enrolled in the plan before January 1, 2000. Benefits vest after ten years of plan participation.

The amount of the annuity shall be one and one half percent (1.5%) of the average compensation multiplied by the number of years of creditable service up to twenty (20) years, plus two percent (2%) of the average compensation multiplied by the number of years of creditable service in excess of twenty years. In no case shall the annuity be less than $200 per month.

Participants who have completed at least thirty years of creditable service are entitled to receive a Merit Annuity. Such participants who have not attained fifty-five years of age will receive 65% of the average compensation or if they have attained fifty-five years of age will receive 75% of the average compensation. Disability retirement benefits are available to members for occupational and nonoccupational disability. However, for nonoccupational disability a member must have at least ten years of service. No benefits are payable if participants receive a refund of their accumulated contributions.

Commonwealth legislation requires that employees hired before April 1, 1990 contribute 5.775% of the first $550 of their monthly gross salary and 8.275% of their gross monthly salary in excess of $550. Employees hired after April 1, 1990 contribute 8.275% of their gross monthly salary. The Authority's contributions are 9.275% of the gross monthly salary.

Total employer contributions during years ended June 30, 2011, 2010, and 2009 amounted to approximately $8.5 million, $10 million, and $10.7 million, respectively, which represented 100% of required contributions.

16. Pension Plan (continued)

On September 24, 1999, an amendment to Act No. 447 of May 15, 1951, which created the ERS, was enacted for the purpose of establishing a new pension program (System 2000). System 2000 became effective on January 1, 2000. Employees participating in the ERS as of December 31, 1999 had the option to stay in the defined benefit plan or transfer to System 2000. Employees joining the Authority on or after January 1, 2000 are only allowed to become members of System 2000.

System 2000 is a defined contribution plan, also known as a cash balance plan. Under this new plan, there is a pool of pension assets, which are invested by the ERS, together with those of the current defined benefit plan. Benefits at retirement age are not guaranteed by the Commonwealth. The annuity is based on a formula that assumes that each year the employee's contribution (with a minimum of 8.275% of the employee's salary up to a maximum of 10%) is invested in an account, which will either: (1) earn a fixed rate based on the two-year Constant Maturity Treasury Note or (2) earn a rate equal to 75% of the return of the ERS' investment portfolio (net of management fees), or (3) earn a combination of both alternatives. Participants receive periodic account statements similar to those of defined contribution plans showing their accrued balances.

System 2000 reduces the retirement age from 65 years to 60 for those employees who joined the ERS on or after April 1, 1990. Disability pensions are not granted under System 2000. The employers' contributions (9.275% of the employee's salary) are used to fund the defined benefit plan.

Total employer contributions during the fiscal years ended June 30, 2011, 2010 and 2009, amounted to approximately $3.9 million, $4 million, and $4 million, respectively, which represented 100% of required contributions.

Additional information on the ERS is provided in its financial statements for the years ended June 30, 2011 and 2010, a copy of which can be obtained from the Administrator of the Retirement System: P.O. Box 42003, San Juan, Puerto Rico 00940.

17. Other Postemployment Benefits

Plan Description

The Authority provides retirement healthcare benefits under the Healthcare Benefit Plan to Retirees (the Plan) pursuant to collective bargain agreements. The Plan is administered by the Authority. Benefits consist of a fixed maximum monthly payment (annuity) to cover medical expenses. Based on the Plan's features and functionality, and for the purpose of the actuarial valuation, it has been identified as a single-employer defined benefit healthcare plan. Participants groups covered are employees under Collective Labor Agreement with "Union Independiente Autentica" (UIA), employees under Collective Labor Agreement with "Hermandad Independiente de Empleados Profesionales de la Autoridad de Acueductos y Alcantarillados" (HIEPAAA) and employees under Managers' Regulation, all of which are Authority employees. All employees with more than 20 years of rendered service within the Authority are eligible for the healthcare benefit upon retirement age. Normal retirement age is as follows:

- For those employees employed by the Authority before March 30, 1990, normal retirement age would be at:
  - 30 years of service;
  - 10 to 24 years of service and 58 years old; or
  - 25 years of service and 55 years old.
- For employees employed by the Authority after March 30, 1990, normal retirement age would be at:
  - 10 years of service and 65 years old; or
  - 25 years of service and 55 years old.

The obligation ends in case of death before retirement and in case of total or permanent disability before retirement. The obligation also ends in case of death after retirement.

Funding Policy

The contribution requirements of the Authority are established and may be amended, by each collective bargain agreement. The benefits are paid directly by the Authority to the retirees at a rate of a maximum of $125 per month per retiree. The Plan is financed on a pay-as-you-go basis and the amount contributed during the year ended June 30, 2011 and 2010 was approximately $2.5 million, which is in accordance with the funding policy. There is no contribution requirement for plan members.

17. Other Postemployment Benefits (continued)

Annual OPEB costs and Net OPEB obligation

The Annual Pension Cost (APC) and the Annual Required Contribution (ARC) were computed as part of an actuarial valuation performed as of June 30, 2011, in accordance with parameters of GASB Statement No. 45 based on current years' demographic data. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal cost each year and amortize any unfunded actuarial accrued liabilities (UAAL) over a period of 12 years.

The annual required contribution estimated for the years ended June 30, 2011 and 2010 amounted to (in thousands):

	2011	2010
Annual Required Contribution (ARC):		
Normal costs	**$ 1,715**	$ 1,715
Amortization of initial UAAL	**4,100**	4,100
Amortization of loss	**1,738**	1,738
GASB Statement No. 45 Annual Required Contribution	**$ 7,553**	$ 7,553

OPEB costs components for the years ended June 30, 2011 and 2010 are as follows (in thousands):

	2011	2010
Annual OPEB Costs		
ARC for fiscal year	**$ 7,553**	$ 7,553
Interest on Net OPEB Obligation	**278**	278
ARC Amortization Adjustment	**(821)**	(821)
Total Annual OPEB Costs	**$ 7,010**	$ 7,010

17. Other Postemployment Benefits (continued)

Annual OPEB costs and Net OPEB obligation (continued)

The net OPEB obligation change for the years ended June 30, 2011 and 2010 is as follows (in thousands):

	2011	2010
Change in net OPEB obligation		
Net OPEB obligation	**$ 12,453**	$ 7,928
Total annual OPEB costs	**7,010**	7,010
Actual benefit payments	**(2,315)**	(2,485)
Net OPEB obligation	**$ 17,148**	$ 12,453

The net OPEB obligation is recorded as a component of compensated absences and postemployment benefits in the accompanying balance sheet as of June 30, 2011 and 2010.

Funded Status

Funded status of the plan as of July 1, 2009, the most recent actuarial valuation date, is as follows (in thousands):

	2011	2010
Unfunded Actuarial Accrued Liability (UAAL):		
Active employees	**$ 23,721**	$ 23,721
Retirees	**32,693**	32,693
Actuarial accrued liability	**56,414**	56,414
Actuarial value of assets	**–**	–
UAAL	**$ 56,414**	$ 56,414

The schedule of funding progress included as required supplementary information presents multiyear trend information about whether the actuarial value of plan assets is increasing or decreasing over time relative to the actuarial accrued liability for benefits.

17. Other Postemployment Benefits (continued)

Actuarial Assumptions

Actuarial valuations of an ongoing plan involve estimates of the value of reported amounts and assumptions about the probability of occurrence of events far into the future. Examples include assumptions about future employment, mortality, and the healthcare cost trend. Amounts determined regarding the funded status of the plan and the ARC of the employer are subject to continuous revision as actual results are compared with past expectations and new estimates are made about the future.

Economic Assumptions

Discount Rate

The discount rate considered for years ended June 30, 2011 and 2010 was 3.5%. For fiscal year 2010, U.S. Treasury Bond 10-year term investments represents the Authority's expected long-term return on internal assets used to finance the payment of plan benefits.

Medical Increase Rate

As the retirement healthcare benefit is fixed, such that it will not increase the obligation under the plan (regardless of the claim experience) without negotiation of a new contract with the unions or an express Board of Directors' approval, the medical increase rate was zero for the years ended June 30, 2011 and 2010. If the fixed benefit level does indeed increase sometime in the future (by negotiation or plan amendment), the higher obligation will be recognized when the new contract or amendment is adopted.

Turnover

For the years ended June 30, 2011 and 2010, the turnover table used for the valuation was the Standard Hewitt Withdrawal Table for Hourly Union Employees – 5 years of service select period.

Healthy Mortality

The RP-2000 Combined Healthy Mortality Table projected to 2009 by Scale AA was used for the valuation of the benefit granted by the plan.

17. Other Postemployment Benefits (continued)

Disability Table

The Hunter disability table was used for the valuation.

Actuarial Cost Method

The actuarial cost method used for by the Authority is Projected Unit Credit (Attribution from date of hire to expected retirement ages).

Amortization of Initial UAAL

Period

The initial UAAL will be amortized in a 12-year period based on the average future years of service of the active population, starting on fiscal year ended June 30, 2008. The years of service projection considers multiple decrement tables and the latest age of retirement, considered to be 65 years. The open amortization criteria were used for the valuation.

Method

The amortization of the UAAL is calculated under the level dollar method based on the fact that there is no payroll component on the benefit.

18. Labor Union Contracts

The collective bargaining agreement with the HIEPAAA union, which covers approximately 170 professional employees, was signed effective June 1, 2005 until May 31, 2009. After that date, the agreement has been renewed on a yearly basis for certain clauses. As of June 30, 2011, the labor agreement is under negotiation for economic clauses.

The collective bargaining agreement with the UIA union, which covers approximately 3,800 blue-collar and clerical employees, expired on June 30, 2003. During the year ended June 30, 2005, the UIA employees went on strike for eighty-four (84) days. At the conclusion of the strike, the UIA and the Authority reached an agreement as to a new labor contract. As of June 30, 2011, the contract was in process of being formalized and signed by the parties.

19. Agreement for Operation, and Management, of the Water and Sewer System

During fiscal year 2001, Thames-Dick Superaqueduct Partners and the Authority signed a contract for the operation and maintenance of the water intakes and the interconnections tanks with the Authority distribution system, along the PR North Coast route, from Arecibo to Bayamon (Superaqueduct). The contract also includes the operation of a filter plant. Thames-Dick is responsible for the operation, maintenance, security, and for the environmental and regulatory compliance (water quality) for all the operations under the contract. All costs associated with the contract ($28.5 million and $22.8 million for the years ended June 30, 2011 and 2010, respectively) are reported under the caption of *Service contract – Superaqueduct* in the accompanying statements of revenues, expenses, and changes in net assets.

20. Commitments and Contingencies

Environmental Matters

Facilities and operations of the Authority's water and sewer system are subject to regulations under numerous federal and Commonwealth environmental laws. Under agreements with the United States government, acting on behalf of EPA, the Authority and the Commonwealth are subject to consent decrees to enforce compliance with environmental laws. Accordingly, the Authority could be assessed stipulated noncompliance penalties.

- On July 1, 2003, the Authority entered into an agreement (Civil Action No. 01-1709) with EPA to attain compliance with the Clean Water Act in relation to the Authority's wastewater pump stations (WWPSs) in response to a significant number of sanitary sewer bypasses from these locations. The Clean Water Act prohibits discharges of sewage from any point in the collection and treatment system other than the authorized point at the treatment facility. The Authority completed all improvement projects required by EPA for these WWPSs on or before the established completion dates in the Agreement. This agreement also required the Authority to invest $1 million in the development and implementation of a Supplemental Environmental Project (SEP). This project consisted of the connection of three NON-PRASA communities to the Authority's drinking water system. The connection has been completed and is awaiting completion of adjacent systems to fully integrate these systems to PRASA's service. The agreement also required the implementation of the Preventive Maintenance Program (PMP) for all of PRASA's WWPSs. This was fully completed in December of 2010, after a three phase, EPA-approved implementation schedule.

20. Commitments and Contingencies (continued)

Environmental Matters (continued)

As part of the agreement, PRASA pays stipulated penalties for pump station bypass events on a quarterly basis. The penalty calculations are based on the pumping capacity of the pump station and the time taken to correct the deficiency causing the bypass event. The amount paid during fiscal year 2010 and 2011 was approximately $.4 million.

- On June 22, 2006, the Authority entered into a consent decree (Civil Action No. 06-1624) with EPA that requires the Authority to implement system-wide remedial measures at all of the wastewater treatment plants operated by the Authority. The decree establishes deadlines for the compliance with the conditions set forth in the agreement and stipulates penalties for violation of any of those deadlines. The Authority was assessed a stipulated civil penalty of $1 million which was paid during fiscal year 2008. This penalty was assessed by the Court as payment for the discharge permit violations of several treatment facilities to the Clean Water Act.

  The agreement also required the Authority to deposit in an escrow account with the GDB an additional civil penalty in the amount of $3 million. These funds are to be used for providing sewer service to a community that has not been connected to the Authority's sanitary sewer system. PRASA is currently engaged in discussion with EPA as to the specific community that will benefit from this project.

  As part of the agreement, PRASA pays stipulated penalties on a yearly basis for exceedances to each of PRASA's facilities to their individual discharge permits. The penalty calculations are based on frequency of the exceedances as well as the percentage of the exceedances with its respective limit. The amount paid during fiscal years 2010 and 2011 was approximately $.5 million. These penalty payments are deposited into an escrow account from which a fraction of the deposited amount can be reimbursed to PRASA based on completion of specific projects and initiatives.

20. Commitments and Contingencies (continued)

Environmental Matters (continued)

- On May 25, 2006, the Authority entered into a plea agreement with the U. S. Department of Justice related to violations of the Clean Water Act, as amended, Title 33, USC, Sections 11311(a) and 1319(c)(2)(A). As part of the agreement (Criminal Case No. 06-CR-00202-001), the Authority paid a $9 million fine. This penalty was assessed by the Court as payment for the discharge permit violations of several treatment facilities to the Clean Water Act. In addition, the agreement required the Authority to comply with several special conditions, such as: (i) upgrade the collection and wastewater treatment system in the Ponce de León Avenue area of San Juan for a cost of not less than $10 million to prevent direct discharges to the Martin Peña Channel, (ii) upgrade nine waste water treatment plants for a cost not less than $109 million, and (iii) comply with the consent decree signed by the Authority with the U.S. Government on June 22, 2006. The plea agreement also established stipulated penalties for violation of any of the deadlines or performance standards set forth in the agreement. As of today, the Authority is in compliance with the deadlines and requirements of this Consent Order and no penalties have been paid.

- On December 15, 2006, an agreement (Civil Case No. KPE 2006-0858) was signed between the Authority and the Department of Health of the Commonwealth related to violations of the Safe Drinking Water Act (SDWA), as amended. The agreement was preliminarily approved by the supervising court on March 15, 2007 and it was amended and finally approved by that court on June 20, 2008. The Authority agreed to implement a work plan to remediate the violations, establish a preventive and mitigation measures, and execute a preventive maintenance program for the purpose of meeting the requirements of the SDWA. This Act requires the compliance with parameters of water quality and treatment techniques in the Authority's water systems. As part of the agreement, the Authority paid a penalty of $1 million during fiscal year ended June 30, 2007. The civil penalty was stipulated by the court for alleged non-compliance issues to the Safe Drinking Water Act attended in this decree. In this Consent Decree, the Authority shall pay stipulated penalties for failing to comply with remedial measures deadlines, fail to submit deliverables or exceedances to maximum contaminant levels.

20. Commitments and Contingencies (continued)

Environmental Matters (continued)

During fiscal year ended June 30, 2008 and based on the amendment and final approval of the agreement, the Authority accrued approximately $2.7 million for penalties for noncompliance as stipulated by the final agreement, which were paid during fiscal year 2009. Also, as part of the penalties for noncompliance with the remedial measures of the agreement with the Department of Health during fiscal year 2009, $1.3 million were deposited in a GDB escrow account to be used for a SEP. This SEP included three projects: (1) a chemical monitoring of 67 Non-PRASA systems, (2) the installation of a disinfection system in six Non- PRASA systems, and (3) the connection of schools that have their own deficient water systems, to the Authority's water system.

During fiscal year ended June 30, 2010, the Authority paid the amount of $.1 million, part paid in penalties and part deposited in an escrow account. The penalties deposited in the escrow account, for parameters exceedances, will be used for compliance project of the Authority with the approval of the Department of Health. In fiscal year ended June 30, 2011 the amount paid by this consent decree was approximately $.2 million.

- On November 2007, the Authority entered into negotiation of a consent decree (Civil Action No. 10-1365) with EPA that requires the Authority to implement system wide remedial measures at all of the sludge treatment systems at the water treatment plants owned and operated by the Authority. The consent decree was lodged on May 3, 2010 and its entry date was August 24, 2010. This consent order closed previous Consent Orders known as PRASA II (Civil Action No. 92-1511) and PRASA III (Civil Action No. 00-2554). This consent order establishes deadlines for the compliance with the conditions set forth in the proposed agreement and stipulates penalties for violation of any of those deadlines.

20. Commitments and Contingencies (continued)

Environmental Matters (continued)

The Authority was assessed a penalty of approximately $3.2 million which was paid during fiscal year 2011. In accordance with this consent decree, from the amount of $3.2 million, the Authority paid a civil penalty of approximately $1 million to the Treasurer of the United States of America. The civil penalty was established by EPA and US Department of Justice for the alleged non-compliance issues attended in this consent decree associated with the Clean Water Act. The other amount of approximately $2.2 million was deposited in an escrow account with GDB for the design and construction of a SEP. As part of this consent decree, the SEP Project that will be executed by the Authority is the installation of an aeration system in the Toa Vaca Lake. The aeration system is under construction.

The total amount of penalties paid under this agreement during the fiscal year 2011 was approximately $.1 million. Stipulated penalties must be paid by the Authority for failing to comply with remedial measures deadlines, fail to submit deliverables or DMR's monthly reports or permit limit exceedances.

The Authority is a defendant in other environmental minor lawsuits, pending trial or final judgment. The Authority intends to vigorously defend itself against all of the allegations. Management, based on the advice of legal counsel, is of the opinion that any liability that may result from such lawsuits would not have a material adverse effect on the Authority's financial position as of June 30, 2011.

20. Commitments and Contingencies (continued)

Risk Management

The Authority has acquired commercial insurance to mitigate its exposure to certain losses involving real and personal property (including windstorm, flood and earthquake damages) and comprehensive general and automobile claims. Each commercial insurance policy maintained by the Authority contains specific policy limits and deductibles. A summary of the commercial insurance maintained by the Authority is as follows:

Coverage	Deductible	Policy Limit
Real and personal property:		
Windstorm	$25 million plus a 2% additional deductible up to a maximum of $7.5 million per location	$150 million
Flood	$25 million plus a 2% additional deductible up to a maximum of $3 million per location	$300 million
Earthquake	$25 million plus a 5% additional deductible up to a maximum of $7.5 million per location	$300 million
All other	$25 million plus $150 thousand occurrence	$150 million
Comprehensive general liability:		
General liability	$100 thousand per occurrence	$2 million
First excess liability	—	In excess of $2 million up to $20 million
Second excess liability	—	In excess of $20 million up to $40 million
Automobile	—	$1 million

Settled claims resulting from these risks have not exceeded commercial insurance coverage in any of the past three fiscal years.

20. Commitments and Contingencies (continued)

Construction Projects

The Authority enters in construction projects for the replacements or expansion of its facilities. As of June 30, 2011 and 2010, there were outstanding commitments for projects in process for approximately $50.9 million and $155 million, respectively.

Operating Leases

Certain commercial offices and warehouse facilities of the Authority are leased under operating lease agreements. During the years ended June 30, 2011 and 2010, the Authority incurred approximately $5 million and $3.8 million, respectively, in rent expense.

Future minimum noncancelable lease payments on existing operating leases at June 30, 2011, which have an initial term of one year or more, are as follows (in thousands):

2012	$ 2,184
2013	1,986
2014	1,113
2015	812
2016	761
2017 – 2021	2,734
2022 – 2026	687
2027 – 2031	601
2032 – 2036	60
	$ 10,938

Litigation

The Authority is the defendant in various lawsuits filed by customers alleging that the Authority has over billed them due to the methodology used to estimate consumption. There are two cases in which plaintiffs requested a certification of the suit as a class action and seek recovery of damages in the total amount of approximately $386 million, plus legal costs of around $100 million (25%) and interests and an injunction enjoining the Authority from continuing to bill using the current methodology. Those cases are: (1) Fernando Toro, et als v. Autoridad de Acueductos y Alcantarillados and (2) Joaquín Gautier, et als v. Autoridad de Acueductos y Alcantarillados.

20. Commitments and Contingencies (continued)

Litigation (continued)

In Toro, the Class Certification Hearings took place in the month of June 2011. The parties presented their evidence and the case is currently submitted for the consideration of the Judge for a determination of certification the class. At the present time, a Judgment has not been entered by the Court. However, after evaluating the evidence presented in the Class Certification Hearings, the Authority's potential exposure from this lawsuit is unlikely and, as such, no liability is being reported on the financial statements.

In Gautier, because the parties are involved in the discovery process, the Authority's potential exposure from this lawsuit cannot be presently determined and, as such, no liability is being reported on the financial statements.

The Authority is the defendant or codefendant in various other lawsuits. The ultimate outcome of the lawsuits cannot presently be determined. However, management, based on the advice of legal counsels, is of the opinion that these lawsuits will not have a material impact on the basic financial statements.

21. Subsequent Events

Issuance of Debt

On September 14, 2011, the Authority issued approximately $70.2 million of Series HH of USDA Rural Development Program Bonds, at a maximum interest of 4.25% of interest, payable semiannually and maturing in semiannual installments through July 1, 2051. The funds raised by this issuance were used to partially repay the outstanding balance of USDA Rural Development Program lines of credit for construction projects from GDB. The payment of principal and interest on these bonds is guaranteed by the Commonwealth.

21. Subsequent Events (continued)

Thames Dick Corporation – Master Agreement Termination

On January 31, 1996, the Authority and Thames Dick Superaqueduct Partners, Inc (TDSP) executed an agreement entitled Master Agreement for the North Coast Superaqueduct Project to plan, design, construct, operate and maintain North Coast Superaqueduct Project (NCSP). The Authority and TDSP have agreed to cancel the Master Agreement and transfer responsibility to the Authority for the operation and administration of the NCSP as of July 19, 2011. The amount of $2.1 million was deposited in an Escrow account to guarantee the Authority claims that may arise after cut-off date. TDSP is not responsible for retained liabilities exceeding the amount in escrow. Retained liabilities are claims by or against the Authority arising out of 1996 Master Agreement through the cut-off date. The Authority requested certain remedial maintenance services to be paid by TSDP and completed by the Authority after cut-off date for the amount of $1.8 million. This remedial maintenance services included (a) reservoir cleaning and (2) the repairing of three main pumps. TDSP transferred to the Authority the control of NCSP and ownership of vehicles, laboratory equipment, office equipment, and others.

Assets Transfer

On August 16, 2011, the Authority entered into an Asset Purchase Agreement (the Agreement) with the Puerto Rico Industrial, Tourism, Educational, Medical and Environmental Facilities Financing Authority (AFICA), a public corporation of the Commonwealth of Puerto Rico to purchase certain assets that were being used to develop the Southern Gas Pipeline Project for the total purchase price of approximately $23.5 million and assumed the rights and obligations of PREPA under a Subordinated Loan Agreement between AFICA and PREPA and a Subordinated Note and Loan Agreement of approximately $31 million.

Extension of Maturity Date – Term Loan Agreement

On September 8, 2006, the Authority entered into a $250 million term loan agreement with Banco Popular de Puerto Rico, as Administrative Agent, and a syndicate of banks. On August 17, 2011, the maturity date of this term loan was extended from September 1, 2011 to January 16, 2012. The Authority will be required to make quarterly principal payments of $736,000 on September 1, 2011 and December 1, 2011.

Required Supplementary Information

Puerto Rico Aqueduct and Sewer Authority
(A Component Unit of the Commonwealth of Puerto Rico)

Required Supplementary Information
Schedule of Funding Progress for Postemployment Healthcare Benefits

(In thousands)

Valuation Date	Actuarial Value of Assets	Actuarial Accrued Liability	Unfunded Actuarial Liability	Funded Ratio	Annual Covered Payroll	Percentage of Covered Payroll
July 1, 2009	$ –	$ 56,414	$ 56,414	—%	$ 147,432	35%

See accompanying independent auditors' report.

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