



**PUERTO RICO AQUEDUCT AND SEWER AUTHORITY**  
(A Component Unit of the Commonwealth of Puerto Rico)

Basic Financial Statements

June 30, 2008 and 2007

(With Independent Auditors' Report Thereon)

**PUERTO RICO AQUEDUCT AND SEWER AUTHORITY**  
(A Component Unit of the Commonwealth of Puerto Rico)

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## Independent Auditors' Report

The Board of Directors  
Puerto Rico Aqueduct and Sewer Authority:

We have audited the accompanying basic financial statements of the Puerto Rico Aqueduct and Sewer Authority, a component unit of the Commonwealth of Puerto Rico, (the Authority) as of and for the years ended June 30, 2008 and 2007, as listed in the table of contents. 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 of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes 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, as well as 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, a component unit of the Commonwealth of Puerto Rico, as of June 30, 2008 and 2007, 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.

As described in note 1(p) to the basic financial statements, the Authority adopted the provisions of Governmental Accounting Standards Board Statement No. 45 *Accounting and Financial Reporting by Employers for Postemployment Benefits other than Pensions*, during the year ended June 30, 2008.



The management's discussion and analysis and schedule of funding progress on pages 3 through 16 and page 56 are not a required part of the basic financial statements but are supplementary information required by U.S. generally accepted accounting principles. We have applied certain limited procedures, which consisted principally of inquires 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.

KPMG LLP

October 27, 2008

Stamp No. 2376030 of the Puerto Rico  
Society of Certified Public Accountants  
was affixed to the record copy of this report

**PUERTO RICO AQUEDUCT AND SEWER AUTHORITY**  
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Management's Discussion and Analysis

June 30, 2008 and 2007

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, 2008 and 2007. Please read it in conjunction with the Authority's financial statements, which follow this section.

***June 30, 2008 and 2007 Financial Highlights***

- The Authority's net assets increased by \$132.9 million to \$2,370.9 million, or 5.9%, primarily as the net result of a contribution from the Puerto Rico Sales Tax Financing Corporation (known as COFINA for its spanish acronym), a component unit of the Commonwealth of Puerto Rico (the Commonwealth) to repay certain outstanding bonds, a decrease in water and sewer revenue, an increase in operating expenses and a payment made in 2008 related to the termination of forward interest rate swap agreements.
- Operating revenues decreased by \$59.8 million to \$695.7 million, or 7.9%, primarily due to an increase in the provision for bad debt of \$8.7 million and a decrease in service revenue of \$51.1 million. The decrease in service revenue was mainly due to a decrease in water consumption during fiscal year ended June 30, 2008.
- Capital contributions increased by \$9.7 million to \$34.0 million, or 39.7%, primarily as a result of an increase in federal grants and other contributions.
- Total assets increased by \$474.9 million to \$6,168.6 million or 8.3% primarily due to an increase by \$429.4 million in the Authority's capital assets, and an increase in deferred issuance costs due to new debt issued during the fiscal year ended on June 30, 2008.

***June 30, 2007 and 2006 Financial Highlights***

- The Authority's net assets decreased by \$29.6 million to \$2,238.0 million, or 1.3%, primarily as result of a decrease in contributions from the Puerto Rico Infrastructure Financing Authority (PRIFA), a component unit of the Commonwealth.
- Operating revenues increased by \$252.3 million to \$755.5 million, or 50.1%, primarily due to increased revenue from residential, industrial, commercial, and governmental customers attributable to the second of a two-step rate increase effective on July 2006.
- Capital contributions decreased by \$53.6 million to \$24.4 million, or 68.7%, primarily as a result of a decrease in contributions and capital assets donated by PRIFA.
- Total assets increased by \$481.2 million to \$5,693.7 million or 9.2% primarily due to an increase in capital assets of \$318.0 million, an increase in unrestricted and restricted cash and cash equivalents of \$98.1 million and an increase in accounts receivable of \$67.4 million.

***Operational Highlights***

During fiscal year 2008, the Authority went back to the bond market after 20 years and issued \$1,338.6 million of Revenue Bonds, Series A and B. The Series A Bonds were issued, in part, to raise funds to repay certain outstanding bond anticipation notes and lines of credit and to pay a portion of the costs of the Authority's capital improvement program. The Series B Bonds were issued in the local market to repay outstanding balances on lines of credit. In addition, the Authority issued \$284.8 million of Revenue Refunding Bonds, Series A and B

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(guaranteed by the Commonwealth) to refinance the Authority's outstanding Revenue Refunding Bonds, Series 1995. The 2008 Revenue Bonds, Series A and B, and the 2008 Revenue Refunding Bonds, Series A and B were rated "BBB-", "Baa3" and "BBB-" by Fitch Ratings, Moody's Investors Service and Standard and Poor's Ratings Services, respectively.

During fiscal year 2008, the Authority received contributions from COFINA for approximately \$369.0 million to repay and defease or cancel the Authority's share of certain series of debt (the Act 164 PFC Bonds) issued by Puerto Rico Public Finance Corporation (PFC), a component unit of the Government Development Bank (GDB) which itself is a component unit of the Commonwealth.

**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.

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*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		
	2008	2007	Change
Current and other assets	\$ 491,426	445,940	45,486
Capital assets, net	5,677,167	5,247,768	429,399
Total assets	<u>6,168,593</u>	<u>5,693,708</u>	<u>474,885</u>
Long-term debt outstanding	3,220,643	2,986,518	234,125
Other liabilities	577,077	469,206	107,871
Total liabilities	<u>3,797,720</u>	<u>3,455,724</u>	<u>341,996</u>
Net assets:			
Invested in capital assets, net of related debt	2,955,388	2,987,685	(32,297)
Restricted	12,024	19,798	(7,774)
Unrestricted deficit	(596,539)	(769,499)	172,960
Total net assets	<u>\$ 2,370,873</u>	<u>2,237,984</u>	<u>132,889</u>

	June 30		
	2007	2006	Change
Current and other assets	\$ 445,940	282,658	163,282
Capital assets, net	5,247,768	4,929,813	317,955
Total assets	<u>5,693,708</u>	<u>5,212,471</u>	<u>481,237</u>
Long-term debt outstanding	2,986,518	2,457,522	528,996
Other liabilities	469,206	487,348	(18,142)
Total liabilities	<u>3,455,724</u>	<u>2,944,870</u>	<u>510,854</u>
Net assets:			
Invested in capital assets, net of related debt	2,987,685	3,010,266	(22,581)
Restricted	19,798	9,295	10,503
Unrestricted	(769,499)	(751,960)	(17,539)
Total net assets	<u>\$ 2,237,984</u>	<u>2,267,601</u>	<u>(29,617)</u>

*Net Assets*

*June 30, 2008 and 2007*

The Authority's net assets as of June 30, 2008 were approximately \$2,370.9 million. This is a \$132.9 million increase from the net assets as of June 30, 2007 of \$2,238.0 million. Total assets increased by \$474.9 million

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June 30, 2008 and 2007

during the fiscal year ended June 30, 2008. This is primarily a result of a net increase in capital assets of \$429.4 million due to current year net additions of \$563.4 million offset by current year depreciation and amortization of \$134.0 million.

Unrestricted and restricted cash and cash equivalents as of June 30, 2008 increased by \$25.0 million when compared with June 30, 2007. The increase is primarily due to proceeds from the issuance of 2008 Series Bonds. Accounts receivable, net, decreased by approximately \$19.3 million primarily due the net effect of an increase of \$40.3 million in accounts receivable, mainly from water and sewer services customers and an increase in the allowance for doubtful accounts of \$59.6 million.

Total liabilities increased by \$342.0 million primarily due to an increase of \$234.1 million in long-term debt outstanding, mainly representing the net effect of (1) the issuance of 2008 Revenue Bonds, Series A and B in the amount of \$1,338.6 million, (2) the repayment of Bond Anticipation Notes of \$850 million with proceeds from the 2008 Revenue Bonds, (3) the issuance of 2008 Revenue Refunding Bonds Series A and B, in the amount of \$284.8 million, (4) the defeasance of the total outstanding balance of Series 1995 Bonds by \$262.8 million with the proceeds from the 2008 Revenue Refunding Bonds, (5) the defeasance or cancellation of the Authority's share of the Act 164 PFC Bonds in the amount of \$369.0 million, and (6) the increase of notes payable to finance the Authority's capital improvement program by \$64.1 million; and an increase by \$107.9 million in other current and noncurrent liabilities, primarily due to an increase of \$85.0 million in accounts payable and accrued liabilities.

*June 30, 2007 and 2006*

The Authority's net assets as of June 30, 2007 were approximately \$2,238.0 million. This is a \$29.6 million decrease from the net assets as of June 30, 2006 of \$2,267.6 million. Total assets increased by \$481.2 million during the fiscal year ended June 30, 2007. This is primarily a result of (1) an increase in capital assets of \$318.0 million due to current year net additions of \$453.3 million offset by current year depreciation and amortization of \$135.3 million, (2) a net increase in unrestricted and restricted cash and cash equivalents of \$98.1 million, and (3) an increase in accounts receivable of \$67.4 million.

Unrestricted and restricted cash and cash equivalents as of June 30, 2007 increased by \$98.1 million when compared with June 30, 2006. The increase is primarily due to proceeds from the issuance of bond anticipation notes and additional drawings on lines of credit. Accounts receivable, net, increased by approximately \$67.4 million primarily due the net effect of an increase of \$102.8 million in accounts receivable from water and sewer services customers and an increase in the allowance for doubtful accounts of \$40.6 million, both corresponding to the rate increase, and an increase in other receivables of \$5.2 million. Accounts receivable from federal agencies decreased \$4.6 million corresponding primarily to amounts received from the U.S. Department of Homeland Security (USDHS) to cover the expenses incurred by the Authority to establish security features required by the USDHS.

Total liabilities increased by \$510.9 million primarily due to the effect of an increase in long-term liabilities of \$529.0 million as a result of drawings on lines of credit with GDB, and bond anticipation notes, net of a decrease in other current and noncurrent liabilities of approximately \$18.1 million primarily due to a decrease of \$20.6 million in accrued interest.



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June 30, 2008 and 2007

**Capital Assets**

Capital assets as of June 30, 2008 and 2007 were as follows (in thousands):

	June 30		Change
	2008	2007	
Capital assets being depreciated	\$ 6,578,154	6,421,760	156,394
Accumulated depreciation and amortization	(2,347,871)	(2,213,899)	(133,972)
	4,230,283	4,207,861	22,422
Land	58,414	50,999	7,415
Construction in progress	1,388,470	988,908	399,562
Capital assets, net	<u>\$ 5,677,167</u>	<u>5,247,768</u>	<u>429,399</u>

	June 30		Change
	2007	2006	
Capital assets being depreciated	\$ 6,421,760	6,349,502	72,258
Accumulated depreciation and amortization	(2,213,899)	(2,078,606)	(135,293)
	4,207,861	4,270,896	(63,035)
Land	50,999	43,131	7,868
Construction in progress	988,908	615,786	373,122
Capital assets, net	<u>\$ 5,247,768</u>	<u>4,929,813</u>	<u>317,955</u>

*June 30, 2008 and 2007*

The net increase of \$429.4 million in capital assets includes an investment of \$563.4 million, reduced by \$134.0 million in depreciation and amortization. The \$563.4 million in capital investment is broken down as follows:

- \$483.8 million in the Authority's capital improvement program;
- \$57.5 million in renewal and replacement projects;
- \$18.5 million for emergency projects and consent decree projects; and
- \$3.6 million for other capital projects.

The Authority has approximately \$1,388.5 million in construction in progress as of June 30, 2008, and has construction commitments of approximately \$393.9 million.

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June 30, 2008 and 2007

*June 30, 2007 and 2006*

The net increase of \$318.0 million in capital assets includes an investment of \$453.3 million, reduced by \$135.3 million in depreciation and amortization. The \$453.3 million in capital investment is broken down as follows:

- \$311.7 million in the Authority's capital improvement program;
- \$96.9 million in renewal and replacement projects;
- \$32.9 million for emergency projects and consent decree projects; and
- \$11.8 million for other capital projects.

The Authority had approximately \$988.9 million in construction in progress as of June 30, 2007, and had construction commitments of approximately \$404 million.

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**Debt Administration**

Long-term debt for the years ended June 30, 2008 and 2007 was as follows (in thousands):

	June 30		Change
	2008	2007	
Bonds payable:			
1995 Serial Bonds	\$ —	73,725	(73,725)
1995 Term Bonds	—	152,900	(152,900)
1995 Periodic Auction Reset Bonds	—	18,100	(18,100)
1995 Inverse Floating Rate Bonds	—	18,100	(18,100)
2001 Series A Commonwealth Appropriation Bonds	33,825	35,280	(1,455)
2001 Series B Commonwealth Appropriation Bonds	—	6,250	(6,250)
Act 164 PFC Commonwealth Appropriation Bonds	341,565	721,293	(379,728)
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	130,152	—	130,152
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	308,030	204,706	103,324
Add premium on bonds refunding	39,733	41,441	(1,708)
Less :			
Bond discount	(17,122)	—	(17,122)
Deferred loss from refunding	(90,567)	(80,759)	(9,808)
Total bonds	<u>2,567,881</u>	<u>1,517,821</u>	<u>1,050,060</u>

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Authority's outstanding Revenue Refunding Bonds, Series 1995 (guaranteed by the Commonwealth) in the principal amount of \$262.8 million, and (3) Series EE and FF of the Rural Development Serial Bonds amounting to \$109.4 million for the purpose of financing a portion of the costs of the Authority's capital improvement projects and to repay an interim line of credit with GDB.

On July 31, 2007, December 20, 2007 and June 26, 2008, COFINA issued Sales Tax Revenue Bonds Series 2007A and B, Series 2007C and Series 2008A, respectively, to refinance certain series of Act 164 PFC Bonds outstanding and retire various notes issued to PFC by certain of the Commonwealth's agencies and component units (including the Authority). Proceeds were used to purchase and cancel or deposit in an escrow to advance refund the Authority's share of the Act 164 PFC Bonds amounting to \$369.0 million. This liability was considered legally defeased or cancelled and removed from the Authority's balance sheet as of June 30, 2008.

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, 2008, the Authority's loans outstanding under these programs amounted to \$293.3 million. These loans increased \$64.1 million due to the net effect of drawings of \$73.6 million for payment of capital improvements and payment of principal on loans outstanding of \$9.5 million.

Lines of Credit

During 2008, the Authority entered into a new \$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. As of June 30, 2008, there was no outstanding balance. In addition, the existing \$190 million capital improvement program revolving line of credit with GDB was renewed on June 4, 2008. As of June 30, 2008, \$100.7 million under this line of credit was outstanding.

Detailed information regarding long-term debt activity is included in notes 9 through 14 to the basic financial statements.

*June 30, 2007*

Bond Anticipation Notes

In December 2006 and January 2007, the Authority issued \$619.9 million and \$50 million of Series 2006A and Series 2007A Bond Anticipation Notes, respectively. The proceeds were used to repay various lines of credit with GDB and fees associated with the bond anticipation notes and to finance capital improvement projects.

On May 24, 2007, the Authority issued \$850 million of Series 2007B Bond Anticipation Notes. The proceeds were used for the purpose of refunding the Bond Anticipation Notes Series 2006A and 2007A and paying the costs of various capital improvements of the Authority.

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Notes Payable

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 GDB and to pay the costs associated with the loan. As of June 30, 2008 and 2007, the outstanding balance of the term loan was \$250 million.

Lines of Credit

During 2007, the Authority also obtained lines of credit from GDB to finance capital improvements and operational expenses. Lines of credit with GDB during fiscal year 2007 decreased by \$585.6 million due the net effect of drawings from those lines of approximately \$237.8 million and repayments of \$823.4 million.

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June 30, 2008 and 2007

*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, 2008 and 2007 (in thousands):

	Years ended June 30		Change
	2008	2007	
Operating revenue:			
Revenues from water and sewer, net	\$ 695,735	755,538	(59,803)
Operating expenses:			
Payroll and payroll related expenses	295,692	295,605	87
Service contract – Superaqueduct	22,950	20,602	2,348
Professional and consulting services	31,108	21,140	9,968
Chemicals	27,611	28,995	(1,384)
Materials and replacements	16,399	13,678	2,721
Repairs and maintenance of capital assets	32,190	29,915	2,275
Electricity	133,180	110,385	22,795
Insurance	9,815	10,278	(463)
Other operating expenses	96,201	58,421	37,780
Operating expenses (excluding depreciation and amortization)	665,146	589,019	76,127
Depreciation and amortization	133,972	135,293	(1,321)
Total operating expenses	799,118	724,312	74,806
Operating (loss) income	(103,383)	31,226	(134,609)
Nonoperating revenue (expenses), net	202,249	(85,206)	287,455
Net income (loss) before capital contributions	98,866	(53,980)	152,846
Capital contributions	34,023	24,363	9,660
Increase (decrease) in net assets	132,889	(29,617)	162,506
Net assets, beginning of year	2,237,984	2,267,601	(29,617)
Net assets, end of year	\$ 2,370,873	2,237,984	132,889

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The following table provides a summary of the Authority's changes in net assets for the years ended June 30, 2007 and 2006 (in thousands):

	Years ended 30		Change
	2007	2006	
Operating revenue:			
Revenues from water and sewer, net	\$ 755,538	503,203	252,335
Operating expenses:			
Payroll and payroll related expenses	295,605	278,596	17,009
Service contract – Superaqueduct	20,602	22,401	(1,799)
Professional and consulting services	21,140	35,847	(14,707)
Chemicals	28,995	25,020	3,975
Materials and replacements	13,678	8,560	5,118
Repairs and maintenance of capital assets	29,915	19,908	10,007
Electricity	110,385	113,907	(3,522)
Insurance	10,278	9,368	910
Other operating expenses	58,421	56,279	2,142
Operating expenses (excluding depreciation and amortization)	589,019	569,886	19,133
Depreciation and amortization	135,293	153,764	(18,471)
Total operating expenses	724,312	723,650	662
Operating income (loss)	31,226	(220,447)	251,673
Nonoperating expenses, net	(85,206)	(82,564)	(2,642)
Net loss before capital contributions	(53,980)	(303,011)	249,031
Capital contributions	24,363	77,946	(53,583)
Decrease in net assets	(29,617)	(225,065)	195,448
Net assets, beginning of year	2,267,601	2,492,666	(225,065)
Net assets, end of year	\$ 2,237,984	2,267,601	(29,617)

*June 30, 2008 and 2007*

Net assets increased by \$132.9 million, from \$2,238.0 million in 2007 to \$2,370.9 million in 2008, due to the results of current year operations.

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

Decrease in operating revenues	\$	(59,803)
Increase in operating expenses		(74,806)
Increase in nonoperating revenue (expenses), net		287,455
Increase in capital contributions		<u>9,660</u>
Net change	\$	<u><u>162,506</u></u>

Operating revenue decreased as a result of a decrease in water and sewer consumption and an increase in the provision for bad debt during the fiscal year ended June 30, 2008.

Operating expenses increased by \$74.8 million primarily due to the net effect of the following:

- An increase of \$37.8 million in other operating expenses.
- An increase of \$22.8 million in electricity expense.
- An increase in professional and consulting services expense of \$10.0 million.
- An increase in materials and replacements of \$2.7 million.

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

Nonoperating revenue increased by \$287.5 million when compared with previous fiscal year. This is primarily due to contributions received from COFINA for \$369.0 million to purchase and cancel or legally defease a portion of the Authority's share of certain series of the Act 164 PFC Bonds, offset by a charge of \$75.3 million related to the termination of forward interest rate swap agreements in 2008 by the Authority, in consultation with GDB, its fiscal agent. The mentioned charge was the result of a decrease in long-term market interest rates.

Capital contributions increased by \$9.7 million. This increase is primarily the net effect of the following:

- Federal grants and other contributions increased by approximately \$10.9 million.
- Contributions from the Commonwealth and PRIFA for capital projects decreased by \$501,000.
- Other Commonwealth contributions decreased by \$700,000.

*June 30, 2007 and 2006*

Net assets decreased by \$29.6 million, from \$2,267.6 million in 2006 to \$2,238.0 million in 2007, due to the results of current year operations.



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

Increase in operating revenues	\$ 252,335
Increase in operating expenses	(662)
Increase in nonoperating expenses, net	(2,642)
Decrease in capital contributions	<u>(53,583)</u>
Net change	<u>\$ 195,448</u>

Operating revenues increased as a result of an increase in water and sewer rates that took place during the fiscal year ended June 30, 2007.

Operating expenses increased by \$662,000 primarily due to the net effect of the following:

- An increase in payroll and related expenses of \$17.0 million.
- An increase of \$10.0 million in repairs and maintenance of capital assets.
- An increase in materials and replacements of \$5.1 million.
- A decrease of \$18.5 million in depreciation and amortization due to certain equipment and other capital assets that were fully depreciated as of June 30, 2006.
- A decrease in professional and consulting services expense of \$14.7 million.

Nonoperating expenses, decreased by \$2.6 million when compared with previous fiscal year. This is primarily due to the following:

- An increase in interest expense of \$34.1 million.
- An increase of \$27.9 million in contributions provided by the Commonwealth for the payment of interest on bonds.
- An increase in interest income of \$4.5 million.

Capital contributions decreased by \$53.6 million. This decrease is primarily the net effect of the following:

- Contributions from the Commonwealth and PRIFA for capital projects decreased by \$40.9 million.
- Capital assets donated by PRIFA decreased by \$15.4 million.
- Federal grants and other contributions increased by \$2.0 million.

#### **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**  
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Balance Sheets

June 30, 2008 and 2007

(In thousands)

Assets	<u>2008</u>	<u>2007</u>
<b>Current assets:</b>		
Cash and cash equivalents	\$ 521	45,420
Accounts receivable, net	170,339	189,605
Receivables from federal agencies	2,873	6,104
Materials and supplies inventory	22,098	16,912
Prepayments and other current assets	5,941	742
Total current assets	<u>201,772</u>	<u>258,783</u>
<b>Noncurrent assets:</b>		
<b>Restricted assets:</b>		
Cash and cash equivalents	227,880	158,021
Total restricted assets	<u>227,880</u>	<u>158,021</u>
<b>Capital assets:</b>		
Capital assets being depreciated	6,578,154	6,421,760
Accumulated depreciation and amortization	<u>(2,347,871)</u>	<u>(2,213,899)</u>
	4,230,283	4,207,861
Land	58,414	50,999
Construction in progress	1,388,470	988,908
Total capital assets, net	<u>5,677,167</u>	<u>5,247,768</u>
<b>Other assets:</b>		
Deferred debt issuance cost, net of accumulated amortization of \$4,654 and \$6,258 for 2008 and 2007, respectively	<u>61,774</u>	<u>29,136</u>
Total assets	<u>\$ 6,168,593</u>	<u>5,693,708</u>

**PUERTO RICO AQUEDUCT AND SEWER AUTHORITY**  
(A Component Unit of the Commonwealth of Puerto Rico)

Balance Sheets

June 30, 2008 and 2007

(In thousands)

<b>Liabilities and Net Assets</b>	<u>2008</u>	<u>2007</u>
<b>Current liabilities:</b>		
Bonds payable	\$ 6,194	35,911
Notes payable	12,649	9,027
Lines of credit	100,724	76,054
Accounts payable	201,348	169,387
Accrued liabilities	184,840	131,752
Accrued interest	33,176	10,591
Unearned revenue	19,067	21,901
Customers' deposits	5,867	5,429
Compensated absences and postemployment benefits	15,151	12,386
Total current liabilities	<u>579,016</u>	<u>472,438</u>
<b>Noncurrent liabilities:</b>		
Bonds payable	2,561,687	1,481,910
Bond anticipation notes	—	850,000
Notes payable	530,641	470,146
Lines of credit	8,748	63,470
Customers' deposits	64,028	63,595
Compensated absences and postemployment benefits	53,600	54,165
Total noncurrent liabilities	<u>3,218,704</u>	<u>2,983,286</u>
Total liabilities	<u>3,797,720</u>	<u>3,455,724</u>
<b>Net assets:</b>		
Invested in capital assets, net of related debt	2,955,388	2,987,685
Restricted for environmental compliance, capital activity and other	12,024	19,798
Unrestricted	(596,539)	(769,499)
Total net assets	<u>2,370,873</u>	<u>2,237,984</u>
Total net assets and liabilities	<u>\$ 6,168,593</u>	<u>5,693,708</u>

See accompanying notes to basic financial statements.

**PUERTO RICO AQUEDUCT AND SEWER AUTHORITY**  
(A Component Unit of the Commonwealth of Puerto Rico)

Statements of Revenues, Expenses, and Changes in Net Assets

Years ended June 30, 2008 and 2007

(In thousands)

	2008	2007
Operating revenue:		
Water	\$ 447,692	492,342
Sewer	248,043	263,196
Total net operating revenue	695,735	755,538
Operating expenses:		
Payroll and payroll related	295,692	295,605
Service contract – Superaqueduct	22,950	20,602
Professional and consulting services	31,108	21,140
Chemicals	27,611	28,995
Materials and replacements	16,399	13,678
Repairs and maintenance of capital assets	32,190	29,915
Electricity	133,180	110,385
Insurance	9,815	10,278
Other operating expenses	96,201	58,421
Operating expenses (excluding depreciation and amortization)	665,146	589,019
Depreciation and amortization	133,972	135,293
Total operating expenses	799,118	724,312
Operating (loss) income	(103,383)	31,226
Nonoperating revenue (expenses):		
Interest expense, net of amortization of debt issuance cost, bond premium and discount, and deferred refunding loss	(152,940)	(141,215)
Termination of forward interest rate swap agreements	(75,348)	—
Write off for debt issuance cost and deferred refunding loss on COFINA debt refunding	(5,993)	—
COFINA contributions for debt refunding	369,025	—
Commonwealth contributions for principal payments on bonds and notes	10,703	2,733
Commonwealth contributions for interest payments on bonds and notes	39,907	40,414
Interest income	5,714	7,650
Other income	11,181	5,212
Total nonoperating income (expenses), net	202,249	(85,206)
Income (loss) before capital contributions	98,866	(53,980)
Capital contributions:		
PRIFA contributions for capital projects	—	501
Federal grants and other contributions	34,023	23,162
Other Commonwealth contributions	—	700
Total capital contributions	34,023	24,363
Change in net assets	132,889	(29,617)
Net assets at beginning of year	2,237,984	2,267,601
Net assets at end of year	\$ 2,370,873	2,237,984

See accompanying notes to basic financial statements.

**PUERTO RICO AQUEDUCT AND SEWER AUTHORITY**  
(A Component Unit of the Commonwealth of Puerto Rico)

Statements of Cash Flows

Years ended June 30, 2008 and 2007

(In thousands)

	2008	2007
Cash flows from operating activities:		
Cash received from customers	\$ 701,854	687,323
Cash paid to suppliers	(320,587)	(298,598)
Cash paid to employees	(267,695)	(289,158)
Net cash provided by operating activities	113,572	99,567
Cash flows from noncapital financing activities:		
Proceeds from bonds	43,093	—
Proceeds from bond anticipation notes	—	684,492
Proceeds from notes payable	—	250,000
Proceeds from borrowings from lines of credit	50,000	35,221
Payment of bond anticipation notes	—	(342,246)
Payment of lines of credit	(50,000)	(530,123)
Net cash from other income	14,412	9,769
Interest paid on notes and lines of credit	(25,694)	(42,647)
Net cash provided by noncapital financing activities	31,811	64,466
Cash flows from capital and related financing activities:		
Additions to utility plant and other capital assets	(563,371)	(453,248)
Proceeds from capital contributions	45,207	24,363
Proceeds from bonds	291,475	—
Proceeds from bond anticipation notes	—	835,428
Proceeds from issuance of notes payable	73,630	49,179
Proceeds from borrowings from lines of credit	192,629	202,529
Payments of bonds and notes	(23,246)	(34,308)
Payment of bond anticipation notes	—	(327,674)
Payment of lines of credit	(96,629)	(293,255)
Debt issuance costs paid	(3,902)	(2,088)
Interest paid on bonds, notes and lines of credit	(41,930)	(74,533)
Net cash used in capital and related financing activities	(126,137)	(73,607)
Cash flows from investing activities:		
Interest received on investments	5,714	7,650
Net cash provided by investing activities	5,714	7,650
Net increase in cash and cash equivalents	24,960	98,076
Cash and cash equivalents at beginning of year	203,441	105,365
Cash and cash equivalents at end of year	\$ 228,401	203,441
For purposes of the statement of cash flows, cash and cash equivalents include:		
Unrestricted	\$ 521	45,420
Restricted	227,880	158,021
	\$ 228,401	203,441

**PUERTO RICO AQUEDUCT AND SEWER AUTHORITY**  
(A Component Unit of the Commonwealth of Puerto Rico)

Statements of Cash Flows

Years ended June 30, 2008 and 2007

(In thousands)

	2008	2007
Reconciliation of operating (loss) income to cash provided by operating activities:		
Operating (loss) income	\$ (103,383)	31,226
Adjustments to reconcile operating (loss) income to net cash provided by operating activities:		
Depreciation and amortization	133,972	135,293
Revenue reduced for uncollectible accounts	49,666	40,966
Change in assets and liabilities:		
Increase in accounts receivable	(41,584)	(108,327)
Increase in materials and supplies inventory	(5,186)	(3,167)
(Increase) decrease in prepayments and other current assets	(5,199)	1,163
Increase (decrease) in accounts payable	31,961	(14,768)
(Decrease) increase in unearned revenue	(2,834)	825
Increase in accrued compensated absences and early retirement obligation	2,200	4,572
Increase in accrued liabilities	53,088	13,463
Increase (decrease) in customers' deposits	871	(1,679)
Total adjustments	216,955	68,341
Net cash provided by operating activities	\$ 113,572	99,567
Noncash noncapital financing activities:		
Bond proceeds deposited with escrow agent for:		
Payment of principal on lines of credit	\$ 19,121	—
Payment of interest on lines of credit	1,338	—
Termination of interest rate swap agreements	23,972	—
Payment of principal on bond anticipation notes	319,091	—
Payment of interest on bond anticipation notes	2,929	—
Costs related to debt issuance deducted from bond proceeds	13,125	—
Amortization of debt issuance cost	554	—
Noncash capital and related financing activities:		
Capital contributions reduced for uncollectible accounts	11,184	—
Bond proceeds deposited with escrow agent for:		
Payment of principal on lines of credit	106,931	—
Payment of interest on lines of credit	3,346	—
Termination of interest rate swap agreements	51,376	—
Payment of principal on bond anticipation notes	530,909	—
Payment of interest on bond anticipation notes	4,874	—
Defeasance of debt	279,522	—
Costs related to debt issuance deducted from bond proceeds	24,423	—
Net increase in refunding loss from bond transactions	16,267	—
Amortization of:		
Debt issuance cost	1,710	1,690
Bond premiums and discounts	1,598	1,708
Deferred refunding loss	4,486	4,194
Write-off of debt issuance costs and deferred refunding loss related to COFINA debt refunding	5,993	—
Accretion of interest on capital appreciation bonds	2,227	—
Principal paid by the Commonwealth	10,703	2,733
Interest paid by the Commonwealth	39,907	40,414
COFINA contribution for debt refunding	369,025	—

See accompanying notes to basic financial statements.

**PUERTO RICO AQUEDUCT AND SEWER AUTHORITY**  
(A Component Unit of the Commonwealth of Puerto Rico)

Notes to Basic Financial Statements

June 30, 2008 and 2007

**(1) Reporting Entity and Summary of Significant Accounting Policies**

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.

**(a) 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.

**(b) 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. The Authority recognizes revenue on unbilled utility services based on estimated consumption.

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.

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

**PUERTO RICO AQUEDUCT AND SEWER AUTHORITY**  
(A Component Unit of the Commonwealth of Puerto Rico)

Notes to Basic Financial Statements

June 30, 2008 and 2007

**(c) 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.

**(d) 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.

**(e) 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.

**(f) Materials and Supplies Inventory**

Materials and supplies inventory is stated at average cost, not to exceed market.

**(g) 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 interest rate 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 life of the original debt, or the life 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.

**(h) Capital Assets**

The Authority defines capital assets as tangible assets used in the Authority's operations; with a useful life longer than a year, not for sale and with individual cost of over \$100 for technology hardware and software and over \$500 for other capital assets.

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, 2008 and 2007 amounted to \$25.8 million and \$5.4 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.



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Notes to Basic Financial Statements

June 30, 2008 and 2007

Depreciation is calculated using the straight-line method over an estimated useful life of the assets as follows:

Description	Useful life
Wells, tanks and meters	Forty-eight (48) years
Equipment and vehicles	Five (5) years
Furniture and fixtures	Ten (10) years
Water and sewer plants, tanks and pump stations	Forty-eight (48) years
Buried infrastructure	Forty-eight (48) years
Dams	Range from fifty (50) to one hundred (100) years
Buildings	Range from twenty (20) to fifty (50) years

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

**(i) 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.

**(j) 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.

**(k) 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. Beginning on July 1, 2007, the contribution for postretirement healthcare benefits is accrued as incurred in accordance with GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions*. Prior to July 1, 2007, the contribution for postretirement healthcare benefits was expensed when paid.

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Notes to Basic Financial Statements

June 30, 2008 and 2007

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, 2008 and 2007, the accrued liability for early retirement amounted to \$7.9 and \$9.7 million, respectively.

The cost of healthcare benefits paid to retired employees amounted to approximately \$2.8 million and \$2.5 million during 2008 and 2007, respectively.

**(l) 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.

**(m) 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, 2008 and 2007, 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.

**(n) 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.

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Notes to Basic Financial Statements

June 30, 2008 and 2007

(o) *Future Adoption of Accounting Standards*

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

<u>GASB Statement No.</u>		<u>Adoption required in fiscal year</u>
49	Accounting and Financial Reporting for Pollution Remediation Obligations	2009
51	Accounting and Financial Reporting for Intangible Assets	2010
52	Land and other Real Estate held as investments by endowments	2009
53	Accounting and Financial Reporting for Derivative Instruments	2012

The impact of these standards has not yet been determined.

(p) *Effects of New Pronouncements*

In June 2004, the GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, which requires employers that participate in single-employer or agent multiple-employer defined benefit (OPEB) plans (sole and agent employers) to measure and disclose an amount for annual OPEB cost on the accrual basis of accounting. Annual OPEB cost is equal to the employer's annual required contribution to the plan (ARC), with certain adjustments if the employer has a net OPEB obligation for past under- or over-contributions. The ARC is defined as the employer's required contributions for the year, calculated in accordance with certain parameters, and includes (a) the normal cost for the year and (b) a component for amortization of the total unfunded actuarial accrued liabilities (UAAL) or funding excess of the plan, over a period not to exceed 30 years. The parameters include requirements for the frequency and timing of actuarial valuations as well as for the actuarial methods and assumptions that are acceptable for financial reporting. If the methods and assumptions used in determining a plan's funding requirements meet the parameters, the same methods and assumptions are required for financial reporting by both a plan and its participating employer(s). However, if a plan's method of financing does not meet the parameters (for example, the plan is financed on a pay-as-you-go basis), the parameters nevertheless apply for financial reporting purposes. The Authority adopted the provisions of GASB Statement No. 45 during the year ended June 30, 2008. As a result of adopting this statement, the Authority accrued \$4.4 million of unfunded OPEB cost as of June 30, 2008 and modified its disclosures related to the OPEB plan to conform to the requirements of GASB Statement No. 45 (see note 18).

In June 2005, the GASB issued Statement No. 47, *Accounting for Termination Benefits*, which establishes accounting standards for termination benefits. In addition, this statement requires employers to disclose a description of termination benefit arrangements, the cost of the termination benefits (required in the period in which the employer becomes obligated if that information is not otherwise identifiable from information displayed on the face of the financial statements), and

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Notes to Basic Financial Statements

June 30, 2008 and 2007

significant methods and assumptions used to determine termination benefit liabilities. The Authority adopted the provisions of GASB Statement No. 47 during the year ended June 30, 2007. The adoption of GASB Statement No. 47 had no material impact on the Authority.

In September 2006, GASB issued Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*, which establishes criteria that governments will use to ascertain whether the proceeds received should be reported as revenue or as a liability. The criteria is used to determine the extent to which a transferor government either retains or relinquishes control over the receivables or future revenues through its continuing involvement with those receivables or future revenues. This statement establishes that a transaction will be reported as a collateralized borrowing unless the criteria indicating that a sale has taken place are met. If it is determined that a transaction involving receivables should be reported as a sale, the difference between the carrying value of the receivables and the proceeds should be recognized in the period of the sale in the change statements. If it is determined that a transaction involving future revenues should be reported as a sale, the revenue should be deferred and amortized, except when specific criteria are met. This statement also provides additional guidance for sales of receivables and future revenues within the same financial reporting entity. The Authority adopted the provisions of GASB Statement No. 48 during the year ended June 30, 2008. The adoption of GASB Statement No. 48 had no material impact on the Authority.

In May 2007, GASB issued Statement No. 50, *Pension Disclosures an Amendment of GASB Statements No. 25 and No. 27*. This statement more closely aligns the financial reporting requirements for pensions with those for other postemployment benefits (OPEB) and, in doing so, enhances information disclosed in notes to financial statements or presented as required supplementary information (RSI) by pension plans and by employers that provide pension benefits. The reporting changes required by this statement amend applicable note disclosure and RSI requirements of Statements No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and No. 27, *Accounting for Pensions by State and Local Governmental Employers*, to conform with requirements of Statements No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, and No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. The Authority adopted the provisions of GASB Statement No. 50 during the year ended June 30, 2008. The adoption of GASB Statement No. 50 had no material impact on the Authority.

**(q) Reclassifications**

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

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Notes to Basic Financial Statements

June 30, 2008 and 2007

**(2) Deposits**

The carrying amount of deposits with financial institutions of the Authority as of June 30, 2008 and 2007 consisted of the following (in thousands):

	June 30			
	2008		2007	
	Carrying amount	Bank balance	Carrying amount	Bank balance
Unrestricted deposits in commercial banks in Puerto Rico	\$ 521	24,329	45,420	65,702
Restricted deposits in commercial banks in:				
Puerto Rico	180,195	180,195	115,593	115,592
United States	—	—	8,748	8,603
Restricted deposits in governmental banks:				
GDB	47,090	47,090	33,410	32,912
EDB	595	595	270	270
Total	\$ 228,401	252,209	203,441	223,079

Cash and cash equivalents consist of demand deposits, interest-bearing accounts, and certificates of deposit.

***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.

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Notes to Basic Financial Statements

June 30, 2008 and 2007

The Authority was exposed to the following custodial credit risk arising from the balance of deposits maintained in governmental and commercial banks as of June 30, 2008 and 2007 (in thousands):

	June 30	
	2008	2007
Uninsured and uncollateralized:		
GDB	\$ 47,090	32,912
EDB	595	270
Commercial banks	—	8,603
	\$ 47,685	41,785

**(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 at June 30 (in thousands):

	June 30	
	2008	2007
Water and sewer services:		
Residential, industrial, and commercial	\$ 349,475	324,681
Government agencies and municipalities	64,571	54,984
	414,046	379,665
Other receivables:		
Government agencies, municipalities, and private entities	25,017	19,059
Less allowance for uncollectible accounts	(268,724)	(209,119)
Total	\$ 170,339	189,605

**(4) Receivables from Federal Agencies**

The receivables from federal agencies of \$2.9 and \$6.1 million as of June 30, 2008 and 2007, 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 recovery activities in the aftermath of Tropical Storm Jeanne.

**(5) Materials and Supplies Inventory**

As of June 30, 2008 and 2007, 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.

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Notes to Basic Financial Statements

June 30, 2008 and 2007

**(6) Capital Assets**

Utility plant and other capital assets as of June 30, 2008 and 2007 and the changes therein for the years then ended are as follows (in thousands):

	June 30, 2008			Ending balance
	Beginning balance	Increases	Decreases	
Capital assets not being depreciated:				
Land	\$ 50,999	7,415	—	58,414
Construction in progress	988,908	563,371	(163,809)	1,388,470
Total capital assets not being depreciated	<u>1,039,907</u>	<u>570,786</u>	<u>(163,809)</u>	<u>1,446,884</u>
Capital assets being depreciated:				
Infrastructure (water and sewer facilities)	5,875,230	128,857	—	6,004,087
Wells, tanks and meters	319,096	22,672	—	341,768
Buildings	64,431	2,424	—	66,855
Equipment, furniture, fixtures and vehicles	163,003	2,441	—	165,444
Total capital assets being depreciated	<u>6,421,760</u>	<u>156,394</u>	<u>—</u>	<u>6,578,154</u>
Less accumulated depreciation and amortization:				
Infrastructure (water and sewer facilities)	(1,958,520)	(116,881)	—	(2,075,401)
Wells, tanks and meters	(107,611)	(6,793)	—	(114,404)
Buildings	(22,258)	(1,882)	—	(24,140)
Equipment, furniture, fixtures and vehicles	(125,510)	(8,416)	—	(133,926)
Total accumulated depreciation	<u>(2,213,899)</u>	<u>(133,972)</u>	<u>—</u>	<u>(2,347,871)</u>
Total capital assets being depreciated, net	<u>4,207,861</u>	<u>22,422</u>	<u>—</u>	<u>4,230,283</u>
Total capital assets, net	<u>\$ 5,247,768</u>	<u>593,208</u>	<u>(163,809)</u>	<u>5,677,167</u>

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	June 30, 2007			
	Beginning balance	Increases	Decreases	Ending balance
Capital assets not being depreciated:				
Land	\$ 43,131	7,868	—	50,999
Construction in progress	615,786	457,613	(84,491)	988,908
Total capital assets not being depreciated	658,917	465,481	(84,491)	1,039,907
Capital assets being depreciated:				
Infrastructure (water and sewer facilities)	5,822,595	52,635	—	5,875,230
Wells, tanks and meters	316,994	2,102	—	319,096
Buildings	57,216	7,215	—	64,431
Equipment, furniture, fixtures and vehicles	152,697	10,306	—	163,003
Total capital assets being depreciated	6,349,502	72,258	—	6,421,760
Less accumulated depreciation and amortization:				
Infrastructure (water and sewer facilities)	(1,841,968)	(116,552)	—	(1,958,520)
Wells, tanks and meters	(101,011)	(6,600)	—	(107,611)
Buildings	(21,047)	(1,211)	—	(22,258)
Equipment, furniture, fixtures and vehicles	(114,580)	(10,930)	—	(125,510)
Total accumulated depreciation	(2,078,606)	(135,293)	—	(2,213,899)
Total capital assets being depreciated, net	4,270,896	(63,035)	—	4,207,861
Total capital assets, net	\$ 4,929,813	402,446	(84,491)	5,247,768

**(7) Restricted Assets**

As of June 30, 2008 and 2007, restricted assets with a book balance of \$227.9 million and \$158.0 million, respectively, consisted of cash and cash equivalents, including nonnegotiable certificates of deposit with maturities of one month or less.



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**(8) Accrued Liabilities**

Accrued liabilities as of June 30, 2008 and 2007 consisted of the following (in thousands):

	June 30	
	2008	2007
Payroll and related accruals	\$ 55,983	40,631
Legal, labor related and environmental contingencies	82,928	60,130
Contract retentions	45,929	30,991
	\$ 184,840	131,752

**(9) Long-Term Liabilities**

Long-term debt activity for the years ended June 30, 2008 and 2007 was as follows (in thousands):

	June 30, 2008					
	Beginning balance	Additions/ amortization	Reductions	Ending balance	Due within one year	Due thereafter
Bonds payable:						
1995 Serial Bonds	\$ 73,725	—	(73,725)	—	—	—
1995 Term Bonds	152,900	—	(152,900)	—	—	—
1995 Periodic Auction Reset Bonds	18,100	—	(18,100)	—	—	—
1995 Inverse Floating Rate Bonds	18,100	—	(18,100)	—	—	—
2001 Series A Commonwealth Appropriation Bonds	35,280	—	(1,455)	33,825	7,950	25,875
2001 Series B Commonwealth Appropriation Bonds	6,250	—	(6,250)	—	—	—
Act 164 PFC Commonwealth Appropriation Bonds	721,293	—	(379,728)	341,565	—	341,565
2004 Series A Commonwealth Appropriation Bonds	326,785	—	—	326,785	—	326,785
2008 Series A Revenue Bonds	—	1,318,432	—	1,318,432	—	1,318,432
2008 Series B Revenue Bonds	—	22,445	—	22,445	—	22,445

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	June 30, 2008					
	Beginning balance	Additions/ amortization	Reductions	Ending balance	Due within one year	Due thereafter
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	204,706	109,352	(6,028)	308,030	2,621	305,409
Add bond premium	41,441	—	(1,708)	39,733	1,708	38,025
Less bond discount	—	(17,232)	110	(17,122)	(439)	(16,683)
Less deferred loss on refunding	(80,759)	(35,909)	26,101	(90,567)	(5,646)	(84,921)
Total bonds	<u>1,517,821</u>	<u>1,681,843</u>	<u>(631,783)</u>	<u>2,567,881</u>	<u>6,194</u>	<u>2,561,687</u>
Bond anticipation notes:						
Series 2007 B	850,000	—	(850,000)	—	—	—
Notes payable:						
Water Pollution Control and Safe Drinking Water Treatment Revolving Funds Loans	229,173	73,630	(9,513)	293,290	10,085	283,205
Notes with commercial banks	250,000	—	—	250,000	2,564	247,436
Total notes	<u>479,173</u>	<u>73,630</u>	<u>(9,513)</u>	<u>543,290</u>	<u>12,649</u>	<u>530,641</u>
Lines of credit	139,524	242,629	(272,681)	109,472	100,724	8,748
Other long term liabilities:						
Accrued compensated absences	56,876	24,858	(25,208)	56,526	11,348	45,178
Net OPEB obligation	—	6,424	(2,064)	4,360	1,995	2,365
Early retirement obligation	9,675	—	(1,810)	7,865	1,808	6,057
Customers' deposits	69,024	18,059	(17,188)	69,895	5,867	64,028
Total other liabilities	<u>135,575</u>	<u>49,341</u>	<u>(46,270)</u>	<u>138,646</u>	<u>21,018</u>	<u>117,628</u>
Total – long-term obligations	<u>\$ 3,122,093</u>	<u>2,047,443</u>	<u>(1,810,247)</u>	<u>3,359,289</u>	<u>140,585</u>	<u>3,218,704</u>

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	June 30, 2007					
	Beginning balance	Additions/ amortization	Reductions	Ending balance	Due within one year	Due thereafter
<b>Bonds payable:</b>						
1995 Serial Bonds	\$ 88,735	—	(15,010)	73,725	15,915	57,810
1995 Term Bonds	152,900	—	—	152,900	—	152,900
1995 Periodic Auction Reset Bonds	18,100	—	—	18,100	—	18,100
1995 Inverse Floating Rate Bonds	18,100	—	—	18,100	—	18,100
2001 Series A Commonwealth Appropriation Bonds	35,280	—	—	35,280	1,455	33,825
2001 Series B Commonwealth Appropriation Bonds	13,570	—	(7,320)	6,250	6,250	—
Act 164 PFC Commonwealth Appropriation Bonds	724,026	—	(2,733)	721,293	10,704	710,589
2004 Series A Commonwealth Appropriation Bonds	326,785	—	—	326,785	—	326,785
Rural Development Serial Bonds	208,623	—	(3,917)	204,706	4,074	200,632
Add bond premium	43,149	—	(1,708)	41,441	3,184	38,257
Less deferred loss on refunding	(84,953)	—	4,194	(80,759)	(5,671)	(75,088)
<b>Total bonds</b>	<b>1,544,315</b>	<b>—</b>	<b>(26,494)</b>	<b>1,517,821</b>	<b>35,911</b>	<b>1,481,910</b>
<b>Bond anticipation notes:</b>						
Series 2006 A	—	619,920	(619,920)	—	—	—
Series 2007 A	—	50,000	(50,000)	—	—	—
Series 2007 B	—	850,000	—	850,000	—	850,000
<b>Total bond anticipation notes</b>	<b>—</b>	<b>1,519,920</b>	<b>(669,920)</b>	<b>850,000</b>	<b>—</b>	<b>850,000</b>
<b>Notes payable:</b>						
Water Pollution Control and Safe Drinking Water Treatment Revolving Funds notes	188,055	49,179	(8,061)	229,173	9,027	220,146
Notes with commercial banks	—	250,000	—	250,000	—	250,000
<b>Total notes</b>	<b>188,055</b>	<b>299,179</b>	<b>(8,061)</b>	<b>479,173</b>	<b>9,027</b>	<b>470,146</b>
<b>Lines of credit</b>	<b>725,152</b>	<b>237,749</b>	<b>(823,377)</b>	<b>139,524</b>	<b>76,054</b>	<b>63,470</b>
<b>Other long-term liabilities:</b>						
Accrued compensated absences	52,304	22,559	(17,987)	56,876	10,578	46,298
Early retirement obligation	9,675	2,552	(2,552)	9,675	1,808	7,867
Customers' deposits	70,703	7,903	(9,582)	69,024	5,429	63,595
<b>Total other liabilities</b>	<b>132,682</b>	<b>33,014</b>	<b>(30,121)</b>	<b>135,575</b>	<b>17,815</b>	<b>117,760</b>
<b>Total – long-term obligations</b>	<b>\$ 2,590,204</b>	<b>2,089,862</b>	<b>(1,557,973)</b>	<b>3,122,093</b>	<b>138,807</b>	<b>2,983,286</b>

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**(10) Bonds Payable**

Bonds payable as of June 30, 2008 and 2007 consisted of the following (in thousands):

	June 30	
	2008	2007
<b>Revenue Refunding Bonds:</b>		
Series 1995:		
Serial Bonds, 4.40% – 6.25%, due annually through July 1, 2013	\$ —	73,725
Term Bonds, 5.00%, \$46,085 due July 1, 2015 and \$106,815 on July 1, 2019	—	152,900
Periodic Auction Reset Bonds, 3.50%, \$8,800 due July 1, 2010, \$9,300 due July 1, 2011	—	18,100
Inverse Floating Rate Securities, 8.22%, \$8,800 due July 1, 2010, \$9,300 due July 1, 2011	—	18,100
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	—
<b>Commonwealth Appropriation Bonds:</b>		
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	33,825	35,280
Series B, 4.85% – 5.50%, due in semiannual interest and annual principal payments from July 15, 2004 through 2007	—	6,250
Act 164 PFC, 4.00% – 6.15% due in semiannual interest and annual principal payments from July 15, 2004 through 2030	341,565	721,293
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
<b>Revenue bonds:</b>		
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	—
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	130,152	—

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	June 30	
	2008	2007
Series A, Term Bonds, 5.00% – 6.00%, due in semiannual interest payments through July 1, 2047 and annual principal payments from July 1, 2026 to 2047	\$ 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	—
Rural development serial bonds:		
Serial bonds, 4.25% – 5.00%, due semiannually through July 1, 2045	308,030	204,706
Subtotal	2,635,837	1,557,139
Bond premium	39,733	41,441
Bond discount	(17,122)	—
Deferred amount on refundings	(90,567)	(80,759)
Total	\$ 2,567,881	1,517,821

**(a) 1995 Series Refunding Bonds**

On January 12, 1995, the Authority issued \$400.0 million of refunding bonds, Series 1995, guaranteed by the Commonwealth, to refund the Authority's outstanding Revenue Bonds, Series 1988A and 1988AA. The net proceeds of the Series 1995 Bonds, and other funds made available from sinking funds and investment accounts from prior bonds, were deposited in escrow accounts to provide funds sufficient to pay the principal and interest of the refunded bonds to their date of redemption.

The Authority entered into two separate escrow agreements to defease prior bonds under which agreements it deposited the proceeds remaining (after payments of \$5.2 million in the underwriters' discount, bond insurance premium, and other issuance costs) of \$402.9 million of the Series 1995 Bonds, \$37.3 million of the old bond's sinking funds, and other moneys made available from the defeasance. The defeasance of the prior bonds reduced the Authority's total debt service payments over the next 24 years by almost \$100.0 million, which resulted in an economic gain (net present value of the difference between the debt service payments on the old and new debt) of \$46.2 million. The advance refunding resulted in a deferred accounting loss between reacquisition price and the net carrying amount of the old bonds of \$40.0 million. As of June 30, 2007, the outstanding balance of 1995 Series Bonds was \$262.8 million. The 1995 Series Bonds were refunded during fiscal year ended June 30, 2008 with the proceeds from the 2008 Revenue Refunding Bonds.

**(b) 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 \$390 million. The funds from the line of credit were used to finance the construction of the

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north coast supraqueduct 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 \$356.7 million of Series A Bonds at a premium of \$2.3 million and \$33.3 million of Series B Bonds. The net proceeds of the 2001 Series A and B Bonds of \$381.1 million, after payment of the cost of issuance of \$9.6 million and \$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 \$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.

On June 28, 2004, \$321.4 million of the Authority's share of the 2001 Series A and B Bonds was advance refunded upon the issuance by PFC of its 2004 Series A and B Refunding Bonds (discussed below). As of June 30, 2008 and 2007, the outstanding unrefunded balance of the 2001 Series A Bonds was \$33.8 million and \$35.3 million, respectively, and the outstanding balance of the 2001 Series B Bonds was \$6.3 million as of June 30, 2007. The 2001 Series B Bonds were fully paid during fiscal year ended June 30, 2008.

*(c) 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 \$771.3 million of Series C Bonds, \$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 \$609.2 million was restructured with proceeds of \$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.

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 \$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.

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On June 28, 2004, PFC issued \$1,206.1 million of Series A Refunding Bonds at a premium of \$89.4 million, and \$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 \$1,395.0 million, after payment of the cost of issuance and bond premium of \$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 \$734.0 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 \$11.7 million, a net premium of \$44.4 million, and deferred refunding loss of \$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. After July 1, 2005, the Authority began paying the debt service payments on the portion of the 2004 Series A bonds related to Superaqueduct. Payments of principal and interest on bonds are due on or before July 15 of each fiscal year.

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 2008A, 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 2007A and B proceeds were deposited in escrow with The Bank of New York/Mellon as master escrow agent. As a result, \$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 \$61.4 million of the Authority's share of the Act 164 PFC Bonds. The proceeds of the Series 2008A Bonds were used to purchase and cancel \$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 \$721.3 million. After the COFINA debt refunding, the balance was reduced to \$341.6 million at June 30, 2008.

**(d) 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 \$326.8 million as of the refunding date, with maturity dates ranging from August 1, 2013 to August 1, 2031.

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*(e) 2008 Revenue Bonds Series A and B*

On March 18, 2008, the Authority issued \$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. As of June 30, 2008, the outstanding balance for the 2008 Revenue Bonds Series A was \$1,318.4 million, which included \$2.2 million of accreted value. The 2008 Revenue Bonds Series B consist of a \$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.

*(f) 2008 Revenue Refunding Bonds Series A and B*

On March 18, 2008, the Authority issued \$284.8 million of Revenue Refunding Bonds, Series A and B (guaranteed by the Commonwealth) (the 2008 Revenue Refunding Bonds), to refund the Authority's outstanding Revenue Refunding Bonds, Series 1995 (guaranteed by the Commonwealth) in the amount of \$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 \$279.5 million (after payment of \$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 \$292.8 million and resulted in an economic loss (difference between the present values of the old and new debt service payments) of \$12.7 million. The advance refunding resulted in a difference between the reacquisition price and the net carrying amount of the old debt of \$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 interest method.

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.



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**(g) Rural Development Serial Bonds**

U.S. 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, 2008, the USDA Rural Development Program Serial Bonds consisted of twenty-three (23) separate series, issued from 1983 through 2008, bearing interest from 4.25% to 5% due in semiannual installments through 2048. The outstanding balance of the USDA Rural Development Program Serial Bonds as of June 30, 2008 and 2007 was \$308.0 million and \$204.7 million, respectively.

The USDA Rural Development Program Serial Bonds are guaranteed by the Commonwealth, pursuant to Law No. 140 of 2000, 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 debt.

**(h) Debt Service Payments**

Future principal and interest payments on all bonds payable outstanding at June 30, 2008 are as follows (in thousands):

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
Fiscal year:			
2009	\$ 10,571	115,988	126,559
2010	13,733	136,720	150,453
2011	14,328	136,122	150,450
2012	14,938	141,077	156,015
2013	18,458	135,736	154,194
2014 – 2018	187,085	658,238	845,323
2019 – 2023	236,928	598,816	835,744
2024 – 2028	400,356	512,750	913,106
2029 – 2033	653,706	374,044	1,027,750
2034 – 2038	328,174	253,112	581,286
2039 – 2043	338,366	163,193	501,559
2044 – 2048	419,194	56,505	475,699
Total	<u>2,635,837</u>	<u>3,282,301</u>	<u>5,918,138</u>
Plus unamortized premium	39,733		
Less:			
Unamortized discount	(17,122)		
Deferred loss on debt refunding	<u>(90,567)</u>		
Bonds payable, net	<u>\$ 2,567,881</u>		

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**(11) Bond Anticipation Notes**

On December 27, 2006 and January 22, 2007 the Authority issued \$619.9 million and \$50 million of Series 2006A and Series 2007A Bond Anticipation Notes, respectively. The proceeds were used to repay various lines of credit with GDB and fees associated with the bond anticipation notes and to finance capital improvement projects.

On May 24, 2007 the Authority issued \$850 million of Series 2007B Bond Anticipation Notes. The proceeds were used for the purpose of refunding the Series 2006A and 2007A Bond Anticipation Notes and paying the costs of various capital improvements of the Authority. The Bond Anticipation Notes bear interest at the Securities Industry and Financial Markets Association (SIFMA) municipal swap index plus 80 basis points (4.53% as of June 30, 2007) payable monthly commencing in July 2007. The bond anticipation notes were retired on March 18, 2008 with proceeds from the 2008 Revenue Bonds.

**(12) Notes Payable**

As of June 30, 2008 and 2007, notes payable consisted of the following (in thousands):

	June 30	
	2008	2007
Puerto Rico Water Pollution Control Revolving Fund	\$ 198,242	155,925
Puerto Rico Safe Drinking Water Treatment Revolving Loan Fund	95,048	73,248
Notes with commercial banks	250,000	250,000
	\$ 543,290	479,173

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, 2008 and 2007, the Authority had outstanding \$293.3 million and \$229.2 million, respectively, under these loan agreements.

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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.

On September 8, 2006, the Authority entered into a \$250 million term loan agreement with various banks. The proceeds were used to repay various lines of credit with GDB and pay costs and fees associated with the term loan. The loan bears interest at LIBOR plus 1.15% (3.96% and 6.51% as of June 30, 2008 and 2007, respectively). The loan is payable in quarterly installments commencing on September 1, 2008 and due on September 1, 2011. The installment due on September 1, 2008 has been paid. 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 under these revolving funds payable as of June 30, 2008 is as follows (in thousands):

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
Year ending June 30:			
2009	\$ 12,649	15,430	28,079
2010	13,035	15,484	28,519
2011	13,438	15,277	28,715
2012	251,871	7,663	259,534
2013	9,747	4,997	14,744
2014 – 2018	46,778	22,054	68,832
2019 – 2023	28,006	18,217	46,223
2024 – 2028	15,621	15,896	31,517
	<u>391,145</u>	<u>115,018</u>	<u>506,163</u>
Interim construction loans:			
Puerto Rico Water Pollution Control Revolving Fund	90,744		
Puerto Rico Safe Drinking Water Treatment Revolving Loan Fund	<u>61,401</u>		
Total	<u>\$ 543,290</u>		

**(13) 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 \$103.9 million. On October 29, 2004, the maximum available amount was increased to \$276 million to assist the Authority in financing the construction of aqueduct and sewer facilities in rural areas. As of June 30, 2008 and 2007, the Authority

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had an outstanding balance of \$8.7 million and \$63.5 million, respectively, under this line of credit agreement.

On May 21, 2004, the Authority entered into a line of credit agreement with GDB. This agreement provides the Authority with an available maximum amount of \$100 million to finance certain legal claims and accrued vacations. This line of credit was repaid and canceled during fiscal year 2007 with the proceeds of the term loan dated September 8, 2006.

On October 21, 2004, the Authority entered into a line of credit agreement with GDB. This agreement provides the Authority with an available maximum amount of \$325 million to be used to provide funding for the operational deficit of the Authority and urgent projects identified, and for the purchase of power generators and/or alternative projects to address the occurrence of power failures in the filtration and pump plants. This line of credit was repaid and canceled during fiscal year 2007 with the proceeds of the term loan dated September 8, 2006, and the 2006A Bond Anticipation Note issued on December 27, 2006.

On January 21, 2005, the Authority entered into a 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 improvements program of the Authority. This line of credit was repaid and canceled during fiscal year 2007 with the proceeds of the 2006A Bond Anticipation Note issued on December 27, 2006.

On October 27, 2005, the Authority entered into a line of credit agreement with GDB. This agreement provides the Authority with an available maximum amount of \$100 million to be used to provide funding for the operational deficit of the Authority due to the discontinuance of various government subsidies. On February 14, 2006, the line of credit was increased by \$28 million to provide for the payment of principal and interest of the Act 164 PFC Bonds, 2001 Series C and E, and 2004 Series A and B Commonwealth Appropriation Bonds. On June 12, 2006, the line of credit was increased by \$125 million to fund the Authority's operational deficit for that fiscal year. As of June 30, 2007, the Authority had an outstanding balance of \$19.1 million under this line-of-credit agreement. This line of credit was paid in full during the year ended June 30, 2008 with the proceeds of the 2008 Revenue Bonds, Series B.

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. As of June 30, 2008 and 2007, the Authority had an outstanding balance of \$100.7 million and \$56.9 million, respectively, under this line of credit agreement. Principal and interest on this line of credit are due on June 30, 2009.

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 2008 Revenue Bonds. Principal and interest on this line of credit are due on June 30, 2013. As of June 30, 2008, the Authority had no balance outstanding under this line of credit agreement.

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Future amounts required to pay principal balances at June 30, 2008 are as follows (in thousands):

Fiscal year:		
2009	\$	100,724
Line of credit without fixed repayment terms		8,748
	\$	109,472

**(14) Financial Covenant**

The Term Loan Agreement governing the notes with commercial banks and the Master Agreement of Trust governing the 2008 Revenue Bonds, contain a financial covenant requiring the maintenance of a senior and senior subordinated minimum debt service coverage ratio of 1.20 to 1.00. As of June 30, 2008 and 2007, the Authority was in compliance with the senior and senior subordinated minimum debt service coverage ratio covenant contained in the Term Loan Agreement and the Master Agreement of Trust.

**(15) Capital Contributions**

Capital contributions for the fiscal years ended June 30, 2008 and 2007 were as follows (in thousands):

	June 30	
	2008	2007
Appropriations from Commonwealth	\$ —	700
Contributions from PRIFA for capital projects	—	501
Federal grants:		
USDA Rural Development Program	26,900	2,160
U.S. Department of Homeland Security	—	4,485
Federal Emergency Management Agency	144	508
Developer contributions	11,034	15,091
Other contributions	4,889	918
	\$ 42,967	24,363

**(16) Related-Party Transactions**

Operating revenues for services provided to the Commonwealth and its component units amounted to approximately \$73.9 million and \$82.3 million during the years ended June 30, 2008 and 2007, respectively. Further, operating, administrative, and general expenses during the fiscal years ended June 30, 2008 and 2007 included approximately \$133.2 million and \$110.4 million, respectively, of charges from Puerto Rico Electric Power Authority (PREPA), a component unit of the Commonwealth.

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As of June 30, 2008 and 2007, the Authority had approximately \$46.2 million and \$30.7 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 \$3.6 million and \$7.8 million of excess of collections over billings from the Commonwealth, recorded as unearned revenue in the basic financial statements for the years ended June 30, 2008 and 2007, respectively.

PRIFA was created to provide financial and other assistance to certain public corporations of the Commonwealth, including the Authority. The Authority and PRIFA have entered into an Agreement, as amended, under which PRIFA may exercise certain oversight powers to assist the Authority. The Agreement provides a contractual framework for construction of water and sewer facilities, to assist the Authority in implementing the capital improvement program and to improve the operations of the water and sewer system. Donated capital assets were recorded at their estimated fair value at the date of donation. For the year ended June 30, 2007, the Authority received contributions from PRIFA for capital projects and the "Agua para Todos" program in the amount of \$0.5 million, which are reported in PRIFA contributions for capital projects line item in the accompanying basic financial statements. No contributions were received from PRIFA for capital projects or the "Agua para Todos" program during the year ended June 30, 2008.

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, 2008 and 2007, the Authority had an outstanding balance of \$109.5 million and \$139.5 million, respectively, under these lines of credit.

**(17) 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.

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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, 2008, 2007, and 2006 amounted to approximately \$14.7 million, \$11.2 million, and \$10.9 million, respectively, which represented 100% of required contributions.

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, 2008, 2007, and 2006, amounted to approximately \$3.4 million, \$2.9 million, and \$2.4 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, 2008 and 2007, a copy of which can be obtained from the Administrator of the Retirement System: P.O. Box 42003, San Juan, Puerto Rico 00940.

**(18) Other Postemployment Benefits**

**(a) 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

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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.

**(b) 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, 2008 was \$2.0 million, which is in accordance with the funding policy. There is no contribution requirement for plan members.

**(c) 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, 2008 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 liabilities over a period of 12 years.



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The annual required contribution for the year ended June 30, 2008 amounted to (in thousands):

ARC, July 1, 2007 – June 30, 2008:	
Normal costs, end of year	\$ 1,395
Amortization of UAAL, end of year:	
Initial UAAL	5,029
	6,424
GASB Statement No. 45 ARC, July 1, 2007 – June 30, 2008	\$ <u><u>6,424</u></u>

OPEB costs components are as follows (in thousands):

Annual OPEB costs, July 1, 2007 – June 30, 2008:	
ARC	\$ <u>6,424</u>
Total annual OPEB costs, July 1, 2007 – June 30, 2008	\$ <u><u>6,424</u></u>

The net OPEB obligation change is as follows (in thousands):

Change in net OPEB obligation:	
Net OPEB obligation, June 30, 2007	\$ —
Total annual OPEB costs, July 1, 2007 – June 30, 2008	6,424
Actual benefit payments, July 1, 2007 – June 30, 2008	<u>2,064</u>
Net OPEB obligation, June 30, 2008	\$ <u><u>4,360</u></u>

The net OPEB obligation is recorded as a component of compensated absences and postemployment benefits in the accompanying balance sheet as of June 30, 2008.

**(d) Funded Status**

Funded status of the plan as of July 1, 2007, the most recent actuarial valuation date, is as follows (in thousands):

UAAL, July 1, 2007:	
Active employees	\$ 20,639
Retirees	<u>24,990</u>
Actuarial accrued liability	45,629
Actuarial value of assets	<u>—</u>
UAAL, July 1, 2007	\$ <u><u>45,629</u></u>

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.

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(e) ***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 is 4.59% representing the bank interest rate for 10 year term investments. This rate 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 is zero. 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**

The turnover table used for the valuation is 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. This mortality table reflects expected mortality improvements beyond the valuation year to the year 2009.

**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).

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**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 was 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.

**(19) Labor Union Contracts**

The collective bargaining agreement with the HIEPAAA union, which covers approximately some 200 professional employees, was signed effective June 1, 2005.

The collective bargaining agreement with the UIA union, which covers approximately 4,500 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, 2008, the contract was in process of being formalized and signed by the parties.

**(20) Agreement for Operation, and Management, of the Water and Sewer System**

From July 1, 2002 to January 15, 2004, the Authority was managed and operated by Ondeo de Puerto Rico (the Operator). The agreement for management and operation was for a period of 10 years. Under this agreement, the Authority remained as owner of the property, with control of the rates, the revenues, and the planning of capital improvements and its respective financing.

The Authority and the Operator entered into a Resolution Agreement on January 13, 2004, and amended it on June 14, 2005, pursuant to which the parties agreed to terminate the agreement for the management of the Authority's water and wastewater systems, settle outstanding and potential claims in connection with that agreement, and mutually terminate and release each other in respect of certain of their rights and obligations thereunder.

On February 9, 2007, the Authority and the Operator entered into a Final Settlement Agreement in which the Authority and the Operator agreed that the Authority will assume the outstanding claims that have not been resolved as of that date, which included unpaid invoices and legal, environmental, and labor claims that arose during the Service Agreement and Transition Service Agreement periods. Pursuant to the agreement, the Operator agreed to pay the Authority \$3.8 million in consideration of being released from any further claims and their mutual letters of credit were canceled.

During fiscal year 2001, Thames-Dick 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

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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 (\$23.0 million and \$20.6 million as of June 30, 2008 and 2007, respectively) are reported under the caption of *Service contract – Superaqueduct* in the accompanying statements of revenues, expenses, and changes in net assets.

**(21) Commitments and Contingencies**

**(a) Environmental Matters**

Facilities and operations of the Authority's water and sewer system are subject to regulation 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 April 28, 2006, the Authority entered into a consent decree with EPA that requires the Authority to implement system-wide remedial measures at all of the waste water 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 penalty of \$1.0 million which was paid during fiscal year 2007. In accordance with the consent decree, the Authority has to deposit in an escrow account with GDB, \$3 million payable in four payments over two years starting on December 1, 2006. As of June 30, 2008 and 2007, the Authority has deposited the total required amount of \$3 million and \$1.5 million, respectively, in this account. These funds will be used for providing sewer service to a community that has not been connected to the Authority's sewer system.

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, Title 33, USC, Sections 11311(a) and 1319(c)(2)(A). As part of the agreement, the Authority agreed to pay a \$9.0 million fine in equal installments without interest during a five-year term period. Until this fine is satisfied in full, all of the Authority's real property will be subject to a statutory lien held by the federal government entitling it to foreclose on such property in order to satisfy this mandatory obligation. During fiscal year 2006, the Authority accrued a liability of \$9.0 million as a result of this plea agreement. As of June 30, 2008 and 2007, the outstanding balance of the accrued liability was \$5.4 million and \$7.2 million, respectively. On August 13, 2008 the Authority paid the total outstanding amount of \$5.4 million that was holding the statutory lien on the Authority's real property. 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 Leon 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 a consent decree signed by the Authority with the U.S. government on April 26, 2006. The plea agreement also established stipulated penalties for violation of any of the deadlines or performance standards set forth in the agreement.

On December 15, 2006, an agreement was signed between the Authority and the Department of Health of the Commonwealth relating to violations of the Safe Drinking Water Act. The agreement

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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 preventive and mitigation measures, and execute a preventive maintenance program for the purpose of meeting the requirements of the Safe Drinking Water Act. As part of the agreement, but prior to the amendment and final approval on June 20, 2008, the Authority paid a penalty of \$1 million during fiscal year ended June 30, 2007 to the Puerto Rico Secretary of the Treasury. During fiscal year ended June 30, 2008 and based on the amendment and final approval of the agreement, the Authority accrued \$2.7 million for penalties for noncompliance as stipulated by the final agreement.

The Authority is a defendant in other environmental 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, 2008.

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**(b) 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:

<u>Coverage</u>	<u>Deductible</u>	<u>Policy limit</u>
Real and personal property:		
Windstorm	\$10 million plus a 2% additional deductible up to a maximum of \$7.5 million per location	\$300 million <sup>1</sup>
Flood	\$10 million plus a 2% additional deductible up to a maximum of \$3 million per location	\$300 million <sup>1</sup>
Earthquake	\$10 million plus a 5% additional deductible up to a maximum of \$7.5 million per location	\$300 million <sup>1</sup>
All other	\$10 million plus \$150 thousand per occurrence	\$300 million <sup>1</sup>
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	—	\$2 million

<sup>1</sup> The policies limit was increased from \$150 million that were in place as of June 30, 2007.

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

**(c) Other Employee Benefits**

The State Insurance Fund Corporation (SIF), a component unit of the Commonwealth, provides workers' compensation insurance to the Authority. The Authority is self-insured to pay the difference between SIFs payment and 100% of management and professional employees' salaries for 52 weeks and 100% of the salaries of the maintenance and clerical employees for 115 weeks.

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**(d) Construction Projects**

The Authority enters in construction projects for the replacements or expansion of its facilities. As of June 30, 2008, there were outstanding commitments for projects in process for approximately \$393.9 million.

**(e) Interest Rate Swap**

On June 29, 2007, the Authority entered into two forward interest rate swap agreements for the purpose of reducing the risks that an increase in long-term interest rates would have on the amount of money the Authority could borrow to implement its capital improvements program, at the time it was ready to issue its senior lien revenue bonds. The intention of the swaps was to effectively change the Authority's variable interest rate on the bonds to be issued on a future date to a synthetic fixed rate. The floating rate of these agreements was based upon the SIFMA municipal swap index. The aggregate notional amount under such agreements was \$930 million on the basis of the Authority's estimate regarding the total principal amount of senior lien, net revenue bonds expected to be issued by the Authority. The agreements evidencing these swaps permitted the Authority to terminate them on or prior to the effective date of March 12, 2008 at the agreements' fair market value. The structure of the agreements was such that should long-term market interest rates increase from their date of execution to March 12, 2008, the Authority would receive a termination payment approximating the present value increase in borrowing costs on the Authority's senior net revenue bonds, and should long-term market interest rates instead decrease, the Authority would be obligated to make a termination payment that approximates the decrease in such borrowing costs (similarly computed).

On February 14, 2008, the Authority terminated the two forward interest rate swap agreements, and was obligated to make a termination payment of approximately \$75 million to the holders of the agreements. The Authority funded the termination payment from the proceeds of the 2008 Revenue Bonds, Series A issued during the fiscal year ended June 30, 2008. The Authority reported an expense of approximately \$75 million during the year ended June 30, 2008 related to this termination payment.

**(f) Operating Leases**

Certain commercial offices and warehouse facilities of the Authority are leased under operating lease agreements. During the years ended June 30, 2008 and 2007, the Authority incurred approximately \$4.8 million and \$3.9 million, respectively, in rent expense.

**PUERTO RICO AQUEDUCT AND SEWER AUTHORITY**  
(A Component Unit of the Commonwealth of Puerto Rico)

Notes to Basic Financial Statements

June 30, 2008 and 2007

Future minimum noncancelable lease payments on existing operating leases at June 30, 2008, which have an initial term of one year or more, are as follows (in thousands):

2009	\$	2,415
2010		1,449
2011		901
2012		334
2013		134
2014 – 2018		640
2019 – 2023		395
	\$	<u>6,268</u>

**(g) Litigation**

The Authority is defendant various lawsuits presented by customers alleging that the Authority has over billed them due to the methodology used to estimate consumption. The plaintiffs requested a certification of the suit as a class action and seek recovery of damages in the amount of \$750 million and an injunction enjoining the Authority from continuing to bill using the current methodology. The Authority's potential exposure from these lawsuits cannot be presently determined and, as such, no liability is being reported on the accompanying basic financing 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.



## REQUIRED SUPPLEMENTARY INFORMATION

**PUERTO RICO AQUEDUCT AND SEWER AUTHORITY**  
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Required Supplementary Information – Schedule of Funding Progress for  
 Postemployment Healthcare Benefits

(in thousands)

<u>Valuation date</u>	<u>Actuarial value of assets</u>	<u>Actuarial accrued liability</u>	<u>Unfunded actuarial liability</u>	<u>Funded ratio</u>	<u>Annual covered payroll</u>	<u>UAAL as a percentage of covered payroll</u>
July 1, 2007	\$ —	45,629	45,629	—%	\$ 178,573	26%

See accompanying independent auditors' report.

