CITY OF DETROIT
WATER FUND

Basic Financial Statements

June 30, 2012

(With Independent Auditors' Report Thereon)

CITY OF DETROIT
WATER FUND

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KPMG LLP
Suite 1900
150 West Jefferson
Detroit, MI 48226

Independent Auditors' Report

The Board of Water Commissioners,
The Honorable Mayor Dave Bing,
and the Honorable Members of the City Council
City of Detroit, Michigan:

We have audited the accompanying basic financial statements of the Water Fund (the Fund), an enterprise fund of the City of Detroit, Michigan (the City), as of and for the year ended June 30, 2012, as listed in the table of contents. These basic financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these basic financial statements based on our audit.

We conducted our audit 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 Fund'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 audit provides a reasonable basis for our opinion.

As discussed in note 1 to the basic financial statements, the basic financial statements referred to above present only the Fund of the City and are not intended to present fairly the financial position of the City as of June 30, 2012, the changes in its financial position, or, where applicable, its cash flows for the year then ended, in conformity with U.S. generally accepted accounting principles.

In our opinion, the basic financial statements referred to above present fairly, in all material respects, the financial position of the Water Fund as of June 30, 2012, and the changes in its financial position and its cash flows for the year then ended, in conformity with U.S. generally accepted accounting principles.

The Fund has not presented a management's discussion and analysis, schedules of employer contributions, and schedules of funding progress that U.S. generally accepted accounting principles require to supplement, although not be a part of, the basic financial statements.

KPMG LLP

Detroit, Michigan
December 28, 2012

CITY OF DETROIT
WATER FUND

Statement of Fund Net Assets

June 30, 2012

Current assets:		
Cash and cash equivalents	$	17,969,040
Accounts receivable:		
Billed accounts receivable		85,327,741
Unbilled accounts receivable		37,465,551
Other accounts receivable		4,410,841
Allowance for doubtful accounts		(28,259,741)
Total accounts receivable, net		98,944,392
Due from other funds		41,459,509
Inventories		5,660,326
Prepaid expenses		4,497,545
Restricted:		
Cash and cash equivalents		40,565,853
Investments		139,056,728
Total current assets		348,153,393
Noncurrent assets:		
Restricted:		
Cash and cash equivalents		2,179,760
Investments		195,711,983
Net pension asset		90,677,096
Deferred charges		38,321,804
Capital assets:		
Land and land rights		6,466,486
Land improvements		101,297,526
Buildings and structures		781,238,195
Mains		997,757,837
Services and meters		175,025,539
Machinery, equipment, and fixtures		1,011,433,159
Construction in progress		235,667,626
Total capital assets		3,308,886,368
Less accumulated depreciation		(1,151,082,168)
Total capital assets, net		2,157,804,200
Deferred outflows of resources		14,179,042
Total noncurrent assets and deferred outflows		2,498,873,885
Total assets and deferred outflows	$	2,847,027,278

(Continued)

CITY OF DETROIT
WATER FUND

Statement of Fund Net Assets

June 30, 2012

Current liabilities:		
Current liabilities payable from unrestricted assets:		
Accounts and contracts payable	$	28,339,950
Accrued salaries and wages		1,096,137
Due to other funds		4,331,522
Due to fiduciary funds		10,952,567
Other accrued liabilities		10,092,925
State revolving loans		393,750
Pension obligation certificates of participation		1,250,905
Accrued compensated absences		6,806,399
Accrued workers' compensation		1,489,000
Claims and judgments		68,000
Total current liabilities payable from unrestricted assets		64,821,155
Current liabilities payable from restricted assets:		
Revenue bonds and state revolving loans		32,801,250
Accrued interest		66,907,594
Accounts and contracts payable		8,396,079
Due to other funds		10,640,798
Total current liabilities payable from restricted assets		118,745,721
Total current liabilities		183,566,876
Long-term liabilities:		
Revenue bonds and state revolving loans, net		2,485,717,942
Pension obligation certificates of participation, net		78,306,872
Accrued other postemployment benefits		53,303,165
Accrued compensated absences		2,614,912
Accrued workers' compensation		8,850,000
Claims and judgments		218,500
Derivative instruments – swap liability		24,566,905
Total long-term liabilities		2,653,578,296
Total liabilities	$	2,837,145,172
Fund net assets:		
Invested in capital assets, net of related debt	$	235,302,277
Restricted for debt service		203,831,414
Unrestricted deficit		(429,251,585)
Total fund net assets	$	9,882,106

See accompanying notes to basic financial statements.

CITY OF DETROIT
WATER FUND

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

Year ended June 30, 2012

Operating revenues:		
Water sales – detroit	$	71,540,060
Water sales – suburban		258,587,439
Miscellaneous		6,002,446
Total operating revenues		336,129,945
Operating expenses:		
Source of supply		9,680,853
Low-lift pumping		8,145,801
High-lift pumping		22,998,901
Purification		19,335,784
Water quality operations		815,616
Pumping stations		24,908,886
Transmission		14,818,446
Distribution		8,685,460
Services		6,876,556
Hydrant division		417,833
Meters		4,802,039
Commercial		7,572,727
Administrative and general		36,021,547
Other items		15,124,239
Total operating expenses before depreciation		180,204,688
Depreciation		81,602,960
Total operating expenses		261,807,648
Operating income		74,322,297
Nonoperating revenues (expenses):		
Investment earnings (losses):		
Earnings on investment activity		1,706,596
Change in fair value of derivatives		(74,288,862)
Interest expense, net of capitalized interest		(108,750,464)
Amortization of bond issuance costs		(7,059,640)
Miscellaneous revenues		453,615
Total nonoperating expenses, net		(187,938,755)
Decrease in net assets before capital contributions		(113,616,458)
Capital contributions		20,500
Decrease in fund net assets		(113,595,958)
Fund net assets – beginning of year		123,478,064
Fund net assets – end of year	$	9,882,106

See accompanying notes to basic financial statements.

CITY OF DETROIT
WATER FUND

Statement of Cash Flows

Year ended June 30, 2012

Cash flows from operating activities:	
Receipts from customers	$ 318,819,510
Loans to other funds	6,769,415
Payments to suppliers	(100,852,848)
Payments to employees	(64,263,520)
Net cash provided by operating activities	160,472,557
Cash flows from noncapital financing activities:	
Interest paid on pension obligation certificates of participation	(5,318,510)
Principal paid on pension obligation certificates of participation	(913,613)
Proceeds from issuance of revenue bonds	337,586,759
Derivative termination payments	(225,620,525)
Miscellaneous nonoperating income	453,615
Net cash provided by noncapital financing activities	106,187,726
Cash flows from capital and related financing activities:	
Acquisition and construction of capital assets	(68,823,034)
Proceeds from sale of capital assets	113,436
Principal paid on capital lease	(30,534)
Principal paid on revenue bonds and state revolving loans	(141,410,000)
Interest paid on revenue bonds and state revolving loans	(110,635,586)
Proceeds from issuance of revenue bonds and state revolving loans	164,097,757
Net cash used in capital and related financing activities	(156,687,961)
Cash flows from investing activities:	
Proceeds from sales and maturities of investments	706,793,214
Purchase of investments	(815,611,808)
Derivative settlement receipts	1,706,596
Interest received on investments	37,816,078
Net cash used in investing activities	(69,295,920)
Net increase in cash and cash equivalents	40,676,402
Cash and cash equivalents at beginning of year	20,038,251
Cash and cash equivalents at end of year	$ 60,714,653
Reconciliation of operating income to net cash provided by operating activities:	
Operating income	$ 74,322,297
Adjustments to reconcile operating income to net cash provided by operating activities:	
Depreciation	81,602,960
Bad debt expense	12,764,490
Write-off of construction in progress	9,847,529
Loss on disposal of capital assets	381,963
Changes in assets and liabilities:	
Accounts receivable	(30,074,924)
Due from other funds	25,230,589
Inventories	279,659
Prepaid expenses	(2,987,544)
Net pension asset	(2,202,543)
Accounts and contracts payable	7,615,994
Accrued salaries and wages	173,613
Due to other funds	(18,461,174)
Due to fiduciary funds	2,403,512
Other accrued liabilities, compensated absences, and workers' compensation	(9,660,603)
Other postemployment benefits	12,724,239
Claims and judgments payable	(3,487,500)
Net cash provided by operating activities	$ 160,472,557
Noncash activities:	
Fair value of derivatives	$ 85,997,819
Deferred outflows of resources – hedging derivatives	(12,252,023)

See accompanying notes to basic financial statements.

(1) Summary of Significant Accounting Policies

The City of Detroit (the City) Charter established the Water Department in the year 1836 to supply water within and outside the City under the administration of the Board of Water Commissioners. The Water Fund (the Fund), an enterprise fund, separately accounts for the Water Supply System (the System), as is required by bond ordinances of the City. The following is a summary of the more significant accounting policies followed in the preparation of the Fund's basic financial statements. These policies conform to U.S. generally accepted accounting principles (GAAP).

The basic financial statements of the Fund have been included in the City's Comprehensive Annual Financial Report and reported as an enterprise fund. Copies of these reports, along with other financial information, can be obtained at the Fund's administrative office, located at 735 Randolph, Detroit, Michigan 48226.

(a) Basis of Accounting

The accounting policies of the Fund conform to GAAP as applicable to governmental entities. The accounts of the Fund, which are organized as an enterprise fund, are used to account for the Fund's activities, which are financed and operated in a manner similar to a private business enterprise. Accordingly, the Fund maintains its records on the accrual basis of accounting. Revenues from operations, investments, and other sources are recorded when earned. Expenses (including depreciation) of providing services to the public are accrued when incurred.

Nonexchange transactions, in which the Fund receives value without directly giving equal value in return, include contributions and grants. On an accrual basis, revenue from contributions and grants is recognized in the fiscal year in which all eligibility requirements have been satisfied. Eligibility requirements include timing requirements and expenditure requirements. Timing requirements specify the year when the resources are required to be used or the fiscal year when use is first permitted. Expenditure requirements specify the year in which the resources are provided to the Fund on a reimbursement basis.

In accordance with Governmental Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, the Fund applies all applicable GASB pronouncements, as well as all Financial Accounting Standards Board (FASB) Statements and Interpretations, Accounting Principles Board (APB) Opinions, and Accounting Research Bulletins (ARBs) issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements. The Fund also has the option of following FASB guidance issued after November 30, 1989, but has elected not to do so.

(b) Cash and Cash Equivalents

Cash and cash equivalents include cash on hand, demand deposits, and short-term investments with original maturities of three months or less from the date of acquisition.

(Continued)

(c) Investments

Investments are reported at fair value based on quoted market prices.

(d) Inventories

Inventories consist of operating and maintenance and repair parts for water assets and are valued at the lower of cost or market, with cost being determined on an average cost method. Inventory is recorded as expenditures when consumed rather than when purchased.

(e) Capital Assets

Capital assets are recorded at historical cost, together with interest capitalized during construction. The Fund's capitalization levels are $5,000 on tangible personal property and for improvements other than buildings, and $50,000 on infrastructure, including water mains. All acquisitions of land and land improvements are capitalized regardless of cost. Depreciation is computed using the straight-line method over the estimated useful lives of the related assets as follows:

Land improvements	67 years
Building and structures	40 years
Mains	67 years
Services and meters	20 – 67 years
Machinery, equipment, and fixtures	3 – 20 years

The Fund capitalizes qualifying net interest costs of the System on bonds issued for capital construction in accordance with FASB Statement No. 34, *Capitalization of Interest Cost*, as amended. Accordingly, capitalized interest for the year ended June 30, 2012 was $7,141,796.

(f) Taxes and City Services

The Fund pays no direct federal, state, or local taxes, except local taxes on excess property and federal Social Security taxes. The Fund reimburses the City for most of the direct services furnished by other City departments, including general staff services. Charges are billed for all water services provided to City departments.

(g) Shared Costs

Costs related to shared facilities and personnel are allocated to the Fund on a basis that relates costs incurred to the Fund benefited.

(h) Compensated Absences

The liability for compensated absences reported in the basic financial statements consists of unpaid, accumulated vacation, and sick leave balances. Unused vacation pay and banked overtime accumulate up to a maximum level until termination of employment, while there is no vesting of sick pay until an employee reaches age 60 or completes 25 years of service. The liability for compensated absences has been calculated using the vesting method, in which leave amounts for both employees who currently are eligible to receive termination payments and other employees who are expected to become eligible in the future to receive such payments upon termination are included. The liability has been calculated based on the employees' current salary level and includes salary-related costs (e.g., Social Security and Medicare tax).

(i) Bond Premiums, Discounts, Issuance Costs, and Deferred Amounts on Refunding

Bond premiums, discounts, issuance costs, and deferred amounts on refunding are deferred and amortized over the life of the bonds. Bond premiums and discounts are amortized using the effective interest method, and bond issuance costs and deferred amounts on refunding are amortized using the straight-line method. Bonds payable are reported net of the applicable bond premium, discounts, and deferred amounts on refunding. Bond issuance costs are reported as deferred charges.

(j) Net Assets

Fund net assets are categorized as follows:

Invested in Capital Assets, Net of Related Debt – This consists of capital assets, net of accumulated depreciation, and related debt.

Restricted – This consists of net assets that are legally restricted by outside parties or by law through constitutional provisions or enabling legislation. When both restricted and unrestricted resources are available for use, generally it is the Fund's policy to use restricted resources first, and then unrestricted resources when they are needed.

Unrestricted – This consists of net assets that do not meet the definition of "restricted" or "invested in capital assets".

(k) Unbilled Revenue

The Fund records unbilled revenues for services provided prior to year-end by accruing actual revenues billed in the subsequent month.

(l) Interest Expense

Interest expense in the statement of revenues, expenses, and changes in fund net assets includes amounts paid on interest rate swaps, as well as the amortization of premiums, discounts, and deferred amounts on refunding. Interest expense is reported net of capitalized interest of $7,141,796 for the year ended June 30, 2012.

(m) Classification of Revenues and Expenses

The Fund classifies its revenues and expenses as either operating or nonoperating.

Operating revenues include activities that have the characteristics of exchange transactions, such as revenue from charges for water service. Such revenue has been shown net of allowances of $12,764,490. Nonoperating revenue includes activities that have the characteristics of nonexchange transactions, such as contributions and investment income.

Operating expenses include the costs of operating the water utility, administrative expenses, and depreciation on capital assets. All expenses not meeting this definition, including interest expense, are reported as nonoperating expenses.

(n) Use of Estimates

The preparation of basic financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the basic financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(o) Upcoming Accounting Pronouncements

In November 2010, the GASB issued GASB Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*. This statement addresses financial reporting related to service concession arrangements (SCA), which are a type of public-private or public-public partnership. A SCA is an arrangement between a transferor (a government) and an operator (whether a government or nongovernmental entity) in which the transferor conveys to an operator the right and related obligation to provide services through the use of infrastructure or another public asset in exchange for significant consideration and the operator collects and is compensated by fees from third parties. The Fund is currently evaluating the impact this standard will have on the financial statements when adopted during the Fund's fiscal year ending June 30, 2013.

In November 2010, the GASB issued GASB Statement No. 61, *The Financial Reporting Entity Omnibus – An Amendment of GASB Statements No. 14 and No. 34*. This pronouncement modifies certain requirements for inclusion of component units in the financial reporting entity. This statement also amends the criteria for reporting component units as if they were part of the primary government (that is, blending) in certain circumstances. Lastly, the statement also clarifies the reporting of equity interests in legally separate organizations. The Fund is currently evaluating the impact this standard will have on the financial statements when adopted during the Fund's fiscal year ending June 30, 2013.

In December 2010, the GASB issued GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*. This statement incorporates into GASB literature certain accounting and financial reporting guidance issued on or before November 30, 1989 that is included in FASB Statements and Interpretation, APB Opinions, and Accounting Research Bulletins of the American Institute of Certified Public Accountants Committee on Accounting Procedure. The Fund is currently evaluating the impact this standard will have on the financial statements when adopted during the Fund's fiscal year ending June 30, 2013.

In June 2011, the GASB issued GASB Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*. The statement will be effective for the Fund's June 30, 2013 fiscal year. The statement incorporates deferred outflows of resources and deferred inflows of resources, as defined by GASB Concepts Statement No. 4, into the definitions of the required components of the residual measure of net position, formerly, net assets. This statement also provides a new statement of net position format to report all assets, deferred outflows of resources, liabilities, deferred inflows of resources, and net position. Once implemented, this statement will impact the format and reporting of the balance sheet at the fund level.

In March 2012, the GASB issued GASB Statement No. 65, *Items Previously Reported as Assets and Liabilities*, which is required to be implemented for financial statements for periods beginning after December 15, 2012. Statement No. 65 establishes accounting and financial reporting standards that reclassify, as deferred outflows and inflows of resources, certain items that were previously reported as assets and liabilities. This Statement also provides other financial reporting guidance related to the impact of the financial statement elements deferred outflows of resources and deferred inflows of resources. The Fund is currently evaluating the impact this standard will have on the financial statements when adopted during the Fund's fiscal year ending June 30, 2014.

In March 2012, the GASB issued GASB Statement No. 66, *Technical Corrections – an Amendment of GASB Statements No. 10 and No. 62*. This Statement amends or removes certain provisions of GASB Statements No. 10 and No. 62 related to fund-based reporting of a state and local government's risk financing activities, accounting for operating lease payments, differences between the initial investment and the principal amount of a purchased loan or group of loans, and servicing fees related to mortgage loans that are sold when the stated service fee rate differs significantly from the current (normal) servicing fee rate. The Fund is currently evaluating the impact this standard will have on the financial statements when adopted during the Fund's 2014 fiscal year.

In June 2012, the GASB issued GASB Statement No. 67, *Financial Reporting for Pension Plans*. This new standard, which replaces the requirements of GASB Statements No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and No. 50, *Pension Disclosures*, establishes standards for financial reporting that outline the basic framework for separately issued pension plan financial reports and specifies the required approach to measuring the liability of employer and certain nonemployer contributing entities, about which information is required to be disclosed. GASB Statement No. 67 is required to be adopted for years beginning after June 15, 2013. The Fund is currently evaluating the impact this standard will have on the financial statements when adopted during the Fund's fiscal year ending June 30, 2014.

In June 2012, the GASB issued GASB Statement No. 68, *Accounting and Financial Reporting for Pensions*. Statement No. 68 requires governments providing defined benefit pensions to recognize their unfunded pension benefit obligation as a liability for the first time, and to more comprehensively and comparably measure the annual costs of pension benefits. This net pension liability that will be recorded on the government-wide, proprietary, and discretely presented component unit statements will be computed differently than the current unfunded actuarial accrued liability, using specific parameters set forth by the GASB. The statement also enhances accountability and transparency through revised and new note disclosures and required supplemental information (RSI). The Fund is currently evaluating the impact this standard will have on the financial statements when adopted during the Fund's fiscal year ending June 30, 2015.

(2) Deposits and Investments

The deposits and investments of the Fund at June 30, 2012 are reported in the basic financial statements as follows:

		Cash and cash equivalents	Investments
Current unrestricted assets	$	17,969,040	—
Current restricted assets		40,565,853	139,056,728
Noncurrent restricted assets		2,179,760	195,711,983
Total cash and investments	$	60,714,653	334,768,711

State law authorizes the Fund to make deposits in the accounts of federally insured financial institutions. Cash held by fiscal agents or by trustees is secured in accordance with the requirements of the agency or trust agreement.

The Fund is authorized to invest in obligations of the U.S. government or its agencies, certificates of deposit, savings and depository accounts of insured institutions, commercial paper of certain investment quality, repurchase agreements, banker’s acceptances, mutual funds of certain investment quality, and investment pools as authorized by state law.

(a) Custodial Credit Risk of Bank Deposits

Custodial credit risk is the risk that in the event of bank failure, the Fund’s deposits may not be returned by the bank. The Fund does not have a deposit policy for custodial credit risk. All deposits held in noninterest-bearing accounts are fully insured by the Federal Depository Insurance Corporation (FDIC) by the Dodd-Frank Act through December 31, 2012. As of June 30, 2012, all Fund deposits were held in noninterest-bearing accounts and were therefore fully insured by the FDIC.

(b) Custodial Credit Risk of Investments

Custodial credit risk is the risk that in the event of failure of the counterparty, the Fund will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party. The Fund does not have a policy for custodial credit risk. As of June 30, 2012, the Fund had no investments subject to custodial credit risk.

(c) Interest Rate Risk

Interest rate risk is the risk that, over time, the value of investments will decrease as a result of an increase in interest rates. The Fund’s investment policy does not specifically restrict investment maturities other than commercial paper, which can only be purchased with a 270-day maturity. The Fund’s policy minimizes interest rate risk by requiring that the Fund attempt to match its investments with anticipated cash flow requirements. Unless related to a specific cash flow, the Fund is generally not permitted to directly invest in securities maturing more than 10 years from the original date of purchase. As of June 30, 2012, the maturities for the Fund's fixed income investments are as follows:

		Investment maturities in years		
	Fair value	**Less than one year**	**One to five years**	**Six to ten years**
Investment:				
U.S. government agency securities	$ 192,037,145	—	158,990,335	33,046,810
Commercial paper	23,450,001	23,450,001	—	—
Pooled funds	119,281,565	119,281,565	—	—
Total investments	$ 334,768,711	142,731,566	158,990,335	33,046,810

(d) ***Credit Risk***

Credit risk is the risk that the Fund will not recover its investments due to the inability of the counterparty to fulfill its obligation. The Fund limits its investments in commercial paper, mutual funds, and external investment pools that purchase commercial paper to the top two rating classifications issued by two nationally recognized statistical rating organizations (NRSROs).

As of June 30, 2012, the credit quality ratings for the Fund's fixed income investments are as follows:

		Ratings	
Investment	**Fair value**	**S&P**	**Moody's**
U.S. government agency securities	$ 177,044,695	AA+	AAA
U.S. government agency securities	14,992,450	AA+	NR
Commercial paper	23,450,001	NR	NR
Pooled funds	117,465,066	AAA	Aaa
Pooled funds	1,816,499	NR	NR
Total investments	$ 334,768,711		

(e) ***Concentration of Credit Risk***

Concentration of credit risk is the risk of loss attributed to the magnitude of the Fund's investment in a single issuer. The Fund's policy specifies a number of limitations to minimize concentration of credit risk, including prohibiting investing more than 5% of the portfolio in securities (other than U.S. government agencies, mutual funds, external investment pools, and other pooled investments) of any one issuer.

More than 5% of the Fund's investments are in Federal Home Loan Bank, Federal Home Loan Mortgage, Federal National Mortgage Association securities, and Silver Tower Commercial Paper.

(Continued)

These investments represent 5%, 18%, 32%, and 5%, respectively, of the Fund's total investments as of June 30, 2012.

(3) Restricted Assets

Restricted assets, principally cash and investments, are available for debt service on revenue bonds and to provide funds for improvements, enlargements, extensions, and construction. In certain instances, minimum levels of assets are required by bond ordinance provisions or by Board of Water Commissioners' decree. These assets are maintained as follows: (1) With respect to the Bond and Interest Redemption Fund, after provision has been made for expenses of operation and maintenance of the System, a sum proportionately sufficient to provide for payment, when due, of the current principal and interest is set aside. The Bond Reserve Account is part of the Bond and Interest Redemption Fund, and the amounts credited to this account are to be used only to pay principal and interest on the bonds when current revenues are not sufficient. (2) With respect to the Extraordinary Repair and Replacement Reserve Fund, after meeting the requirements of the foregoing funds, monthly deposits in an amount equal to one-twelfth of 3% of the budgeted operation and maintenance expense of the System for the fiscal year must be set aside until the aggregate amount funded totals at least 15% of that year's budgeted operating and maintenance costs. These deposits are to be used for major unanticipated repairs and replacement to the System with actual or anticipated cost exceeding $1 million. Once this fund is fully funded, deposits required are amounts needed to maintain fully funded status. Borrowings of up to 50% of the balance in this fund on the first day of the related fiscal year are allowed for transfer to and use from the Improvement and Extension Fund. Any such borrowings must be repaid prior to any deposits being made to the Improvement and Extension Fund. (3) After the above deposits have been made, excess amounts may be deposited in the Improvement and Extension Fund, established for the payment of improvements, enlargements, repairs, extensions, or betterment to the System. (4) With respect to the Construction Fund, the portion of the proceeds of the sale of bonds for building or improving the System is deposited in this fund. A separate depository account is required for each series of bonds. Proceeds for construction purposes received from federal and state grants and other sources that restrict the use of such proceeds are also deposited into this account.

(Continued)

(4) Capital Assets

Capital asset activity for the year ended June 30, 2012 was as follows:

	Balance, June 30, 2011	Additions	Disposals	Balance, June 30, 2012
Nondepreciated capital assets:				
Land and land rights	$ 6,062,803	403,683	—	6,466,486
Construction in progress	197,274,741	68,371,303	(29,978,418)	235,667,626
Total nondepreciable assets	203,337,544	68,774,986	(29,978,418)	242,134,112
Depreciated capital assets:				
Land improvements	100,242,927	1,061,465	(6,866)	101,297,526
Buildings and structures	779,439,395	2,409,604	(610,804)	781,238,195
Mains	984,494,019	13,420,579	(156,761)	997,757,837
Services	51,838,576	—	—	51,838,576
Meters	121,284,350	1,902,613	—	123,186,963
Machinery, equipment, and fixtures	1,002,447,145	10,005,891	(1,019,877)	1,011,433,159
Total depreciable assets	3,039,746,412	28,800,152	(1,794,308)	3,066,752,256
Less accumulated depreciation:				
Land improvements	(15,126,317)	(1,502,818)	—	(16,629,135)
Buildings and structures	(268,289,301)	(17,427,017)	1,282,662	(284,433,656)
Mains	(323,485,646)	(14,027,618)	—	(337,513,264)
Services	(26,710,849)	(135,420)	—	(26,846,269)
Meters	(39,659,419)	(5,058,659)	—	(44,718,078)
Machinery, equipment, and fixtures	(397,490,879)	(43,451,428)	541	(440,941,766)
Total accumulated depreciation	(1,070,762,411)	(81,602,960)	1,283,203	(1,151,082,168)
Net capital assets	$ 2,172,321,545	15,972,178	(30,489,523)	2,157,804,200

Certain beginning balances have been reclassified as a result of changes in asset classifications to reflect a more accurate presentation.

See note 13 for discussion of commitments related to construction activities.

(5) Long-Term Obligations

Changes in long-term obligations for the year ended June 30, 2012 were as follows:

	Balance, June 30, 2011	Increase	Decrease	Balance, June 30, 2012	Amount due within one year
Revenue bonds	$ 2,195,495,000	500,675,000	(139,775,000)	2,556,395,000	31,620,000
State revolving loans	23,579,245	1,009,516	(1,635,000)	22,953,761	1,575,000
Total revenue bonds	2,219,074,245	501,684,516	(141,410,000)	2,579,348,761	33,195,000
Add unamortized premiums	57,116,455	4,778,710	(3,351,357)	58,543,808	—
Less:					
Unamortized discounts	(3,800,596)	(204,448)	160,820	(3,844,224)	—
Deferred amounts on refunding	(112,558,442)	(79,599,228)	77,022,267	(115,135,403)	—
Total revenue bonds, net	2,159,831,662	426,659,550	(67,578,270)	2,518,912,942	33,195,000
Pension obligation certificates 2005 series	28,011,780	—	(913,613)	27,098,167	1,250,905
Pension obligation certificates 2006 series	51,506,122	—	—	51,506,122	—
Less deferred amounts on refunding	956,355	—	(2,867)	953,488	—
Total pension obligation certificates, net	80,474,257	—	(916,480)	79,557,777	1,250,905
Other long-term liabilities:					
Capital lease payable	30,534	—	(30,534)	—	—
Accrued other postemployment benefits	40,578,926	22,451,623	(9,727,384)	53,303,165	—
Accrued compensated absences	10,881,220	5,346,490	(6,806,399)	9,421,311	6,806,399
Accrued workers' compensation	10,337,000	3,332,605	(3,330,605)	10,339,000	1,489,000
Claims and judgments	3,774,000	88,610	(3,576,110)	286,500	68,000
Total other long-term liabilities	65,601,680	31,219,328	(23,471,032)	73,349,976	8,363,399
Total	$ 2,305,907,599	457,878,878	(91,965,782)	2,671,820,695	42,809,304

(6) Revenue Bonds Payable (Including State Revolving Loans)

Revenue bonds payable and state revolving loans amounted to $2,579,348,761 at June 30, 2012. Net revenues of the Fund are pledged to repayment of bonds. The following is a schedule of the revenue bonds payable at June 30, 2012:

Issue	Bond date	Amount issued	Range of interest rates	Maturity date	Outstanding balance at June 30, 2012	
Series 1993	10/15/93	$ 38,225,000	6.50%	7/01/14-15	$ 24,725,000	
Series 1995-B	10/15/95	60,485,000	5.55	7/1/2012	8,480,000	
Series 1997-A	8/01/97	186,220,000	6.00	7/01/14-15	13,430,000	
Series 2001-A	5/01/01	301,165,000	5.00	7/1/29-30	73,790,000	c
Series 2001-C	5/08/08	4,055,000	3.50 to 4.25	7/01/12-18	2,565,000	
Series 2001-C	5/08/08	186,350,000	4.50 to 5.75	7/01/19-29	186,350,000	c
Series 2003-A	1/28/03	234,805,000	4.50 to 5.00	7/01/19-34	178,785,000	c
Series 2003-B	1/28/03	41,770,000	5.00	7/01/34	41,770,000	c
Series 2003-C	1/28/03	4,335,000	Variable (*)	7/01/13-14	4,335,000	
Series 2003-C	1/28/03	25,325,000	4.25 to 5.25	7/01/15-22	25,325,000	c
Series 2003-D	8/14/06	3,180,000	4.00 to 4.20	7/01/12-16	1,625,000	
Series 2003-D	8/14/06	139,575,000	4.25 to 5.00	7/01/17-33	139,575,000	c
Series 2004-A	8/14/06	17,600,000	3.75 to 5.25	7/01/12-16	17,580,000	
Series 2004-A	8/14/06	55,165,000	4.50 to 5.25	7/01/17-25	55,165,000	c
Series 2004-B	8/14/06	52,840,000	4.00 to 5.00	7/01/12-16	35,740,000	
Series 2004-B	8/14/06	100,990,000	4.25 to 5.00	7/01/17-23	100,990,000	c
Series 2005-A	3/11/05	20,965,000	3.40 to 5.00	7/01/12-15	8,445,000	
Series 2005-A	3/11/05	84,035,000	3.90 to 5.00	7/01/16-35	84,035,000	c
Series 2005-B	5/08/08	19,070,000	4.00 to 5.50	7/01/12-18	15,465,000	
Series 2005-B	5/08/08	175,830,000	4.75 to 5.50	7/01/19-35	175,830,000	c
Series 2005-C	3/11/05	36,405,000	5.00	7/01/12-15	23,175,000	
Series 2005-C	3/11/05	90,200,000	5.00	7/01/16-22	90,200,000	c
Series 2006-A	8/14/06	42,795,000	5.00	7/01/13-16	26,900,000	
Series 2006-A	8/14/06	237,205,000	5.00	7/01/17-34	237,205,000	c
Series 2006-B	4/01/09	900,000	3.00 to 5.00	7/01/12-19	800,000	
Series 2006-B	4/01/09	119,100,000	5.50 to 7.00	7/01/20-36	119,100,000	c
Series 2006-C	8/14/06	12,585,000	4.00 to 5.00	7/01/12-16	10,650,000	
Series 2006-C	8/14/06	208,060,000	5.00	7/01/17-33	208,060,000	c
Series 2006-D	8/14/06	4,430,000	4.00 to 5.00	7/01/12-16	3,465,000	
Series 2006-D	8/14/06	142,160,000	4.25 to 5.00	7/01/17-32	142,160,000	c
Series 2011-A	12/22/11	37,880,000	3.00 to 5.00	7/01/12-21	37,880,000	
Series 2011-A	12/22/11	341,710,000	5.00 to 5.75	7/01/22-41	341,710,000	c
Series 2011-B	12/22/11	7,455,000	2.496 to 5.00	7/01/12-21	7,455,000	
Series 2011-B	12/22/11	9,740,000	6.00	7/01/22-33	9,740,000	c
Series 2011-C	12/22/11	3,925,000	3.00 to 5.00	7/01/12-21	3,925,000	
Series 2011-C	12/22/11	99,965,000	4.50 to 5.25	7/01/23-41	99,965,000	c
Total revenue bonds payable					$ 2,556,395,000	

* Interest rates are reset periodically at the stated current market interest rate.

c Indicates bonds are callable under terms specified in the indenture; all other bonds are noncallable.

The following is a schedule of the state revolving loans at June 30, 2012:

Issue	Bond date		Amount issued	Range of interest rates	Maturity date		Outstanding balance at June 30, 2012
Series 2005 SRF-1	9/22/05	$	13,805,164	2.125%	10/01/12-26	$	10,575,164
Series 2005 SRF-2	9/22/05		8,891,730	2.125	10/01/12-26		6,621,730
Series 2006 SRF-1	9/21/06		5,180,926	2.125	10/01/12-26		3,945,926
Series 2008 SRF-1	9/29/08		2,590,941	2.500	10/01/12-26		1,810,941
Total state revolving loans						$	22,953,761

The state revolving loans are issued as part of the State of Michigan's Revolving Fund Loan Program. As the System draws additional amount from time to time hereafter, the outstanding principal amounts of such bonds will correspondingly increase. All loans are callable under terms specified in the loan agreements.

As of June 30, 2012, aggregate debt service requirements of the Fund's debt (fixed-rate and variable-rate) instruments are as follows. These amounts assume that current interest rates on variable rate bonds will remain the same for their term. As these rates vary, interest payments on variable rate bonds will vary.

		Principal	Interest	Total requirements
Year(s) ending June 30:				
2013	$	33,195,000	120,246,666	153,441,666
2014		41,460,000	131,244,183	172,704,183
2015		53,425,000	129,311,454	182,736,454
2016		58,745,000	126,487,636	185,232,636
2017		61,810,000	123,379,022	185,189,022
2018 – 2022		353,345,941	568,225,969	921,571,910
2023 – 2027		447,027,820	468,716,504	915,744,324
2028 – 2032		555,235,000	344,225,567	899,460,567
2033 – 2037		656,860,000	193,562,279	850,422,279
2038 – 2042		318,245,000	51,617,389	369,862,389
	$	2,579,348,761	2,257,016,669	4,836,365,430

Bonds outstanding at June 30, 2012 include approximately $2.3 billion of bonds and loans callable at various dates after June 30, 2012. These bonds are callable at varying premiums, depending on the issue and length of time to maturity.

(a) Issuance of State Revolving Loans

The City received loans from the State of Michigan Revolving Fund Loan Program totaling $1,009,516 during the year ended June 30, 2012. The proceeds of the loans were used to pay costs of acquiring, contracting extensions, and making certain repairs and improvements to the System. At June 30, 2012, $5,368,895 in bonds was authorized and unissued.

(b) Issuance of Revenue Bonds and Advance Refunding Debt

In December 2011, the Fund issued $396,785,000 in Senior Lien Revenue Bonds. The proceeds of the bonds were used to finance capital improvements and pay swap termination fees.

The Fund also issued $103,890,000 in Senior Lien Refunding Revenue Bonds with an average interest rate of 5.11%. The proceeds of these bonds were used to advance refund $96,360,000 of bonds with an average interest rate of 5.07%. A portion of the net proceeds in the amount of $103,059,121 (after payment of $876,625 in underwriting fees, insurance, and other issuance costs, and $225,620,525 in swap termination fees) were used to purchase U.S. government securities and were deposited in an irrevocable trust with an escrow agent to provide for all future debt service payments on the original bonds. As a result, the bonds are considered to be defeased and the liability for the bonds has been removed from the Fund's long-term obligations. The advance refunding reduced total debt service payments over the next 16 years by $2,602,978, which represents an economic gain of $1,223,122.

(c) Defeased Debt

During the year, and in previous years, the Fund defeased certain revenue bonds by placing the proceeds of new revenue bonds in an irrevocable trust to provide for all future debt service payments on the old bonds. Accordingly, the trust account assets and the liability for the defeased bonds are not included in the Fund's basic financial statements. At June 30, 2012, $199,830,000 of bonds outstanding is considered defeased.

(d) Pledges of Future Revenue

The Fund has pledged substantially all revenue of the Fund, net of operating expenses, to repay the above water revenue bonds and state revolving loans. Net revenues are defined in the bond ordinance as revenues except for those transferred to the Operation and Maintenance Fund. Proceeds from the bonds provided financing for the construction of the System. The bonds are payable solely from the net revenues of the System. The remaining principal and interest to be paid on the bonds is $4,836,365,430. During the current year, net revenues of the System were $178,842,057 compared with the amount pledged for annual debt requirements of $153,441,666. In addition, the Fund has approximately $100 million in bond and interest reserves on hand at June 30, 2012.

(e) Debt Ratings

In June 2012, Moody's downgraded the ratings of the Funds Senior and Second Lien Bonds from "Baa1/Baa2" to "Baa2/Baa3".

(7) Pension Obligation Certificates (POCs)

The Detroit Retirement Systems Funding Trust issued POCs for the purpose of funding certain unfunded accrued actuarial liabilities (UAAL) of the two retirement systems of the City, which include the General Retirement System (GRS) and the Police and Fire Retirement System (PFRS). The GRS includes employees and retirees of certain governmental funds, proprietary funds (Transportation Fund, Sewage Disposal Fund, and Water Fund) and the Detroit Public Library, a discretely presented component unit of the City.

A trust was created by the General Retirement System Service Corporation (GRSSC) and the Police and Fire Retirement System Service Corporation (PFRSSC), both blended component units of the City. The City entered into service contracts with the GRSSC and PFRSSC to facilitate the transaction.

The POCs were allocated to the governmental activities and the Transportation, Sewage Disposal, and Water Funds based on those funds portion of the overall UAAL liquidated by the use of the POC's net proceeds. Since the Detroit Public Library is a discretely presented component unit of the City, its prorated portion of the POC's liability assumed was included in the balance of the POCs obligation recorded in the governmental activities.

In March 2012, Fitch's Rating Service downgraded the rating of the POCs from "BB-" to "B" and further downgraded the rating from "B" to "CC" in June 2012.

The Fund's portion of future principal and interest amounts for the POCs as of June 30, 2012 is as follows:

		Principal	Interest	Hedging derivatives, net	Total
2013	$	1,250,905	2,142,812	2,402,602	5,796,319
2014		1,604,980	2,086,484	2,402,602	6,094,066
2015		1,801,509	2,013,248	2,402,602	6,217,359
2016		2,000,473	1,930,145	2,402,602	6,333,220
2017		2,217,845	1,833,862	2,402,602	6,454,309
2018 – 2022		13,146,438	7,606,335	11,759,430	32,512,203
2023 – 2027		16,850,858	4,782,232	10,764,816	32,397,906
2028 – 2032		22,539,294	3,346,538	6,436,960	32,322,792
2033 – 2035		17,191,987	1,431,956	715,933	19,339,876
Total	$	78,604,289	27,173,612	41,690,149	147,468,050

(8) Risk Management

The Fund is exposed to various types of risk of loss including torts; theft of, damage to, or destruction of assets; errors or omissions; job-related illnesses or injuries to employees; natural disasters; and environmental occurrences. The Fund is self-insured for losses such as workers' compensation, legal, disability benefits, and vehicular liabilities. Also included is the risk of loss associated with providing health, dental, and life insurance benefits to employees and retirees.

The Fund, through the City, provides health and dental insurance benefits to employees and retirees through self-insured health plans that are administered by third-party administrators. The Fund does not purchase excess or stop-loss insurance for its self-insured health plans.

The Fund purchases public official liability insurance, property insurance for certain properties, and general liability insurance for accidents occurring at certain properties. The Fund assumes a $250,000 self-insured retention for any one loss or occurrence under its self-insured public official liability program. The Fund purchases excess liability insurance for its general liability for certain properties that provides per occurrence and aggregate protection. The Fund is fully self-insured for environmental-related liabilities and purchases no excess environmental liability insurance.

There were no significant changes in the insurance coverage from coverage provided in the prior year for any of the above-described risks.

A liability for claims is reported when it is probable that a loss has occurred and the amount of the loss can be reasonably estimated. Liabilities include an amount for claims that have been incurred but not reported. Claim liabilities are calculated considering the effects of recent claim settlement trends including frequency and amount of payouts and other economic and social factors. The claim liabilities also include estimated costs for claim administration fees and outside legal and medical assistance costs.

Changes in the balance of claim liabilities for the years ended June 30, 2012 and 2011 are as follows:

	2012	2011
Balance at beginning of year	$ 14,111,000	15,502,000
Current year claims and changes in estimates	3,421,215	9,781,680
Claims payments	(6,906,715)	(11,172,680)
Balance at end of year	$ 10,625,500	14,111,000

(9) Derivative Instruments

The table below summarizes derivative instrument activity during the reporting period and balances at the end of the period:

	Changes in fair value		Fair value at June 30, 2012		Notional
	Classification	**Amount**	**Classification**	**Amount**	**amount**
Cash flow hedges:					
Pay-fixed interest rate swaps:					
Negative fair values	Deferred outflow	$ (11,538,614)	Long-term liabilities	$ (24,566,905)	43,440,338
Positive fair values	Deferred outflow	(170,402)			
Investment derivatives:					
Pay-fixed interest rate swaps					
Negative fair values	Interest and investment earnings	(143,510,580)			
Investment derivatives:					
Pay-floating interest rate swaps					
Negative fair values	Interest and investment earnings	20,633,861			
Positive fair values	Interest and investment earnings	48,587,857			

In connection with the issuance of $396,785,000 in Senior Lien Revenue Bonds, the Fund also terminated all swap agreements, with the exception of the swaps related to the POCs, for a payment of $225,620,525 on December 22, 2011.

The fair values of the interest rate swaps were estimated using the zero-coupon method. This method calculates the future net settlement payments required by the swap, assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These payments are then discounted using the spot rates implied by the current yield curve for hypothetical zero-coupon bonds due on the date of each future net settlement on the swaps.

(a) Objectives

In order to better manage its interest rate exposure and to reduce the overall costs of its financings, the Fund has been allocated a portion of the City’s four separate pay-fixed, receive-variable interest rate swaps related to the POCs and the GRS.

(b) Terms

Certain key terms and fair values relating to the outstanding hedging derivative instruments are presented below:

Associated financing issue	Notional amount (1)	Effective date	Rate paid	Rate received	Fair value	Swap termination date	Final maturity of bonds
Pension obligation certificates:							
Taxable certificate of participation SBSFPC-0009 (2)	$ 14,792,275	6/12/2006	6.36%	3-MTH LIBOR +0.34%	$ (8,752,968)	6/15/2034	6/15/2034
Taxable certificate of participation SBSFPC-0012 (2)	6,927,894	6/12/2006	6.32	3-MTH LIBOR +0.30%	(3,529,753)	6/15/2029	6/15/2029
Taxable certificate of participation 37380341 (2)	14,792,275	6/12/2006	6.36	3-MTH LIBOR +0.34%	(8,754,283)	6/15/2034	6/15/2034
Taxable certificate of participation 37380351 (2)	6,927,894	6/12/2006	6.32	3-MTH LIBOR +0.30%	(3,529,901)	6/15/2029	6/15/2029
Total	$ 43,440,338				$ (24,566,905)		

(1) Notional amount balance as of June 30, 2012.

(2) Denotes the System's allocation of the associated notional amount.

(c) Credit Risk

Credit risk can be measured by actual market value exposure or theoretical exposure. When the fair value of any swap has a positive market value, then the Fund is exposed to the actual risk that the counterparty will not fulfill its obligations. As of June 30, 2012, the Fund had no net exposure to actual credit risk on its hedging derivatives (without regard to collateral or other security arrangements) for any of its counterparties. The table below shows the credit quality ratings of the counterparties to each swap. The Fund uses two different counterparties, as one way of diversifying its credit risk. In addition, the swap agreements contain varying collateral agreements with the counterparties. The swaps require full collateralization of the fair value of the swap should the counterparty's credit rating fall below certain rating levels by Fitch Ratings, Standard & Poor's (S&P), and/or Moody's Investors Service (Moody's). Collateral on all swaps is to be in the form of cash or U.S. government securities held by a third-party custodian. The Fund has not calculated theoretical credit exposure.

Counterparty	S&P	Moody's
SBS Financial Products Company, LLC: Credit Support provided by Merrill Lynch Capital Services, Inc. and guaranteed by Merrill Lynch & Co.	BBB	Baa2
UBS, AG	AA	A2

(d) Interest Rate Risk

All hedging derivatives are pay-fixed, receive-variable, cash flow hedges, hedging a portion of the Fund's variable rate debt. The Fund believes it has significantly reduced interest rate risk attributable to the principal amount being hedged by entering into interest rate swaps.

(e) Basis Risk

The Fund is exposed to basis risk when the variable interest received on a swap is based on a different index than the variable interest rate to be paid on the associated variable rate debt obligation. At June 30, 2012, the associated debt used the same index for the POCs (based on LIBOR) in the table above. As a result, there is no significant exposure to basis risk as of June 30, 2012.

(f) Termination Risk

The Fund or counterparty may terminate any of the swaps if the other party fails to perform under the terms of the contract. In such cases, the Fund may owe or be due a termination payment depending on the fair value of the swap at that time. The termination payment due to a counterparty may not be equal to the fair value. If any of the swaps were terminated, the associated variable rate financings would no longer carry synthetic interest rates.

On January 8, 2009, the City received formal notice from the Swap Counterparty to four of the eight Swap Agreements stating that an event had occurred, which, if not cured by the City, would constitute an Additional Termination Event. On January 14, 2009, the City also received formal notice from the Swap Counterparty to the four remaining Swap Agreements, stating that the applicable Swap Insurers had been downgraded below the thresholds set forth in the Swap Agreements. Under the Swap Agreements, such Swap Insurer downgrades, coupled with the downgrades of the POCs, if not cured by the City, constitute an Additional Termination Event. In June 2009, the City and the Counterparties agreed to an amendment to the Swap Agreements, and thereby eliminating the Additional Termination Event and the potential for an immediate demand for payment to the Swap Counterparties. As part of the amended Swap Agreements, the Counterparties waived their right to termination payments. Additionally, the City now directs its Wagering Tax revenues to a Trust as collateral for the quarterly payment to the Counterparties, increased the Swap rate by 10 basis points effective July 1, 2010, and agreed to other new termination events. The termination events under the amended Swap Agreement includes a provision granting the Counterparties the right to terminate the amended Swap Agreement if certain coverage levels of the Wagering Taxes over the required quarterly payment are not met or if POCs ratings are withdrawn, suspended, or downgraded below "Ba3" (or equivalent). In March 2012, the POCs received a credit downgrade below "Ba3. The City is currently in negotiations with the Counterparties regarding this event.

In light of recent debt rating declines of the City, a risk of a Swap Agreement Termination exists related to the Swap Agreements issued in conjunction with the issuance of the General, Police, and Fire Retirement Systems Trusts' Pension Obligation Certificates (POCs). As of June 30, 2012, the City had eight such interest rate exchange agreements (the Swap Agreements) in effect. With the

Swap Agreements, the City maintains a potential payable to the Swap Agreements' Counterparty should certain termination events occur. Potential termination events in the original Swap Agreements included cases where the POCs ratings were withdrawn, suspended, or downgraded below "Baa3" (or equivalent) or if the Swap Insurers' ratings fell below an "A3" (or equivalent) rating.

(g) Rollover Risk

The Fund is exposed to rollover risk on swaps that mature or may be terminated prior to the maturity of the associated financings. When these swaps terminate, or in the case of the termination option, if the counterparty exercises its option, the Fund will not realize the synthetic rate offered by the swaps on the underlying issues. The Fund is exposed to rollover risk on the GRS swaps should they be terminated prior to the maturity of the associated financings (POCs).

(h) Foreign Currency Risk

All derivatives are denominated in U.S. dollars, and therefore, the Fund is not exposed to foreign currency risk.

(i) Market Access Risk

The Fund is exposed to market access risk on swaps in the event it will not be able to enter credit markets or in the event the credit will become more costly.

(10) Pension Plan

Substantially all employees of the City, including employees of the Fund, are covered by a single-employer plan composed of a defined benefit with an optional employee-contributed annuity through the GRS. The GRS pays a monthly pension to qualified individuals upon retirement. The amount is based upon a combination of years of service and annual salary.

(a) Plan Description

The GRS is administered in accordance with the City of Detroit Charter and union contracts, which assign the authority to establish and amend contributions and benefit provisions to the GRS board of trustees. The GRS issues separate, stand-alone financial statements annually. A copy of these financial statements can be obtained at the Coleman A. Young Municipal Center, 2 Woodward Ave., Rm. 908, Detroit, Michigan, 48226.

(b) Funding Policy

The GRS funding policy provides for periodic employer contributions at actuarially determined rates that, expressed as percentages of annual covered payroll, are sufficient to accumulate sufficient assets to pay benefits when due. The contribution requirements are established and may be amended by the GRS board of trustees based on information provided by the GRS consulting actuary. The City's contribution is set by the City Council in conjunction with its approval of the City's annual budget based on information provided by the GRS consulting actuary.

The recommended contribution rate is determined by the GRS' consulting actuary using the entry age normal actuarial cost funding method. Significant actuarial assumptions used to compute contribution requirements are the same as those used to compute the actuarial accrued liability.

Based upon the June 30, 2010 actuarial valuation, the actuarial required contribution rate for the Fund was 21.86% of covered payroll for the year ended June 30, 2012. Contributions for the Fund were $6,590,377 for the year ended June 30, 2012.

Employees may also elect to contribute (a) 0%, (b) 3% of annual compensation up to the Social Security wage base and 5% of any excess over that, (c) 5%, or (d) 7% toward annuity savings. Contributions are voluntary for all union and nonunion employees. Contributions received from employees of the Fund were $2,567,142 during the year ended June 30, 2012.

The contribution requirements of plan members and the City are established and may be amended by the board of trustees in accordance with the City Charter, union contracts, and plan provisions. Members may retire with full benefits after attaining 30 years of service; age 55 with 30 years of service if hired after January 1, 1996; age 60 with 10 years of service; or age 65 with 8 years of service. Employees may retire after 25 years of service and collect an actuarially reduced retirement benefit. Monthly pension benefits, which are subject to certain minimum and maximum amounts, are determined according to fixed rates per year of credited service. Members of the GRS who separated prior to July 1, 1981, met the age and service requirements, and who did not withdraw their accumulated annuity contributions are generally eligible for a pension at the time they would have been eligible had they continued in City employment. Members who separate after July 1, 1981 are not required to leave their accumulated annuity contributions in the System. Pension benefits for all members of the GRS are increased annually by 2.25% of the original pension.

The annual pension cost and the change in net pension asset allocated to the Fund for the year ended June 30, 2012 are as follows:

Annual required contributions	$ 6,274,397
Interest on net pension asset	(6,989,490)
Adjustment to annual required contribution	5,102,927
Annual pension cost	4,387,834
Contributions made (employer)	6,590,377
Change in net pension asset	2,202,543
Net pension asset, beginning of year	88,474,553
Net pension asset, end of year	$ 90,677,096

The actuarial methods and significant assumptions used to determine the annual required contributions (ARCs) for the year ended June 30, 2012 were as follows:

Valuation date	June 30, 2010
Actuarial cost method	Entry age
Amortization method	Level percent
Remaining amortization period for unfunded accrued liabilities	30 years, open
Asset valuation method	7-year smoothed market
Actuarial assumptions:	
Investment rate of return	7.9%
Projected salary increases*	4.00% – 8.90%
Cost-of-living adjustments	2.25%

* Includes inflation rate of 4.00%.

(c) Three-Year Trend Information

	Fiscal year ended	APC	Percentage of APC contributed	Net pension asset
General Retirement System	June 30, 2012	$ 4,387,834	150%	$ 90,677,096
	June 30, 2011	9,082,258	132	88,474,553
	June 30, 2010	3,064,858	225	85,525,858

(d) Administrative Expenses

Actuarial investment management and bank trustee fees and expenses are included in the GRS plan's administrative expenses when incurred. In addition, the GRS plan's administrative salary, rent, accounting services, duplicating, telecommunications, and travel expenses are included in the GRS plan's administrative expenses when incurred.

(e) Funded Status and Funding Progress

As of June 30, 2011, the most recent actuarial valuation date, the GRS plan was 83% funded. The actuarial accrued liability for benefits to all employees of the City participating in GRS was $3,720,167,178 and the actuarial value of assets was $3,080,295,734, resulting in an UAAL of $639,871,444. The covered payroll (annual payroll of all employees of the City covered by the plan) was $303,379,482 and the ratio of the UAAL to covered payroll was 211%. The covered payroll for employees of the Fund was $48,601,064.

A schedule of funding progress, which presents multiyear trend information about whether the actuarial value of plan assets are increasing or decreasing over time relative to the actuarial accrued liability for benefits, is included in the City's Comprehensive Annual Financial Report.

(11) Other Postemployment Benefits

(a) Plan Description

The employees of the Fund participate in the Employee Health and Life Insurance Benefit Plan (Benefit Plan), which is a single–employer defined benefit plan administered by the City and City's Retirement Systems. The Benefit Plan provides hospitalization, dental care, vision care, and life insurance to all officers and employees of the City who were employed on the day preceding the effective date of the Benefit Plan and who continue in the employ of the City on and after the effective date of the Benefit Plan. Retirees are allowed to enroll in any of the group plans offered by the City to active employees. The City provides healthcare coverage for substantially all retirees in accordance with terms set forth in union contracts or provisions found in Section 13, Article 8 of the Code of Ordinances.

The healthcare benefit eligibility conditions for Fund employees hired before 1995 are 30 years of creditable service or age 60 and 10 years of creditable service or age 65 and 8 years of creditable service. The healthcare benefit eligibility conditions for Fund employees hired on after 1995 are age 55 and 30 years of creditable service, or age 60 and 10 years of creditable service or age 65 and 8 years of creditable service. The City provides full healthcare coverage to Fund employees who retired prior to January 1, 1984, except for the Master Medical benefit that was added on to the coverage after that date. The Fund pays up to 90% of healthcare coverage if retired after January 1, 1984; however, for Fund employees who retired between January 1, 1984 and June 30, 1994, the retiree share has been reduced by 50% by appropriations from City Council. The Fund also pays healthcare coverage for the spouse, under the same formulas noted above, as long as the spouse continues to receive a pension. The Fund does not pay health coverage for a new non-City retiree spouse. Dental and vision coverage is provided for the retiree and the spouse.

The City does provide healthcare coverage to Fund employees that opt for early retirement. For Fund employees hired before 1995, the healthcare benefit eligibility conditions are 25 years of creditable service and employees hired after 1995 is age 55 and 25 years of creditable service. The coverage begins when the retiree would have been eligible for normal retirement. The Fund pays up to 90% of healthcare coverage for the retiree and the spouse. The Fund pays up to 90% of healthcare coverage for the spouse as long as the spouse continues to receive a pension. The City does not pay for healthcare coverage for a new non-City retiree spouse. Dental and vision coverage is provided for the retiree and the spouse.

The City also provides healthcare coverage to Fund employees who meet certain healthcare benefit eligibility conditions at reduced rates for those that retire under the Deferred Retirement Benefits (Vested), the Death-in-Service Retirement Benefits Duty and Non-Duty Related, and the Disability Retirement Benefits Duty and Non-Duty Related. Complementary healthcare coverage is provided by the City for those Fund retirees that are Medicare-Eligible. Fund retirees who opt out of the retiree healthcare coverage may obtain coverage at a later date.

In addition to healthcare coverage, the City allows Fund retirees to continue life insurance coverage under the Group Insurance Protection Plan offered to active employees in accordance with Section 13, Article 9 of the Code of Ordinances. The basic life insurance coverage for Fund employees is based on the employee's basic annual earnings to the next higher thousand dollars. The life insurance benefit amounts range from $3,750 to $12,500.

The Supplemental Death Benefit Plan (Supplemental Plan) is a prefunded single-employer defined benefit plan administered by the Employee Benefits Board of Trustees. The money is held in the City of Detroit Employee Benefit Trust and the City uses the trust fund to account for the Supplemental Plan. In accordance with Section 13, Article 8 of the Code of Ordinances, effective July 1, 1999 and prior to the member's retirement from the City, a death benefit of $10,000 will be paid. After retirement of the member from the City, the amount of death benefits paid is based upon the retiree's years of City service ranging from $1,860 (for 10 or less years of service) to $3,720 (for 30 years of service). For years of service beyond 30 years, $93.00 will be added per year for each additional year of service.

There were 1,636 retirees eligible for benefits, as of June 30, 2011, the date of the most recent actuarial valuation. These plans do not issue separate financial statements.

(b) Funding Policy

Employee Health and Life Insurance Benefit Plan – The cost of benefits for the Benefit Plan, which is financed on a pay-as-you-go basis for the year ended June 30, 2012, for the Fund's retirees is as follows:

Benefits		City cost	Retiree cost	Total cost
Hospitalization	$	9,148,013	2,125,604	11,273,617
Dental		464,868	9,664	474,532
Vision		80,580	1,573	82,153
Life insurance		12,011	4,940	16,951
	$	9,705,472	2,141,781	11,847,253

Supplemental Death Benefit Plan – The cost of benefits for the Supplemental Plan, which is a prefunded plan, and the funds are held in the City of Detroit Employee Benefit Trust, for the year ended June 30, 2012 for the Fund's retirees is as follows:

Benefit		City cost	Retiree cost	Total cost
Supplemental Death Benefit Plan	$	21,913	1,436	23,349
Total	$	21,913	1,436	23,349

The City of Detroit Employee Benefit Trust paid death benefits in the amount of $121,809 for the Fund retirees for the year ended June 30, 2012.

(Continued)

(c) Annual OPEB Costs and Net OPEB Obligation

The Fund's annual other postemployment benefit (OPEB) cost (expense) is calculated based on the annual required contribution (ARC), an amount actuarially determined in accordance with the parameters of GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal costs each year and amortize any unfunded actuarial accrued liabilities (or funding excess) over a period not to exceed 30 years.

The following table shows the components of the Fund's annual OPEB cost for the year ended June 30, 2012, the amount actually contributed to the plans, and changes in the Fund's OPEB obligation for the retirees of the Fund:

	Employee health and life insurance benefit plan	Supplemental death benefit plan	Total
Annual required contribution (ARC)	$ 22,105,491	74,507	22,179,998
Interest on net OPEB obligation	1,618,759	5,497	1,624,256
Adjustment to ARC	(1,348,966)	(3,665)	(1,352,631)
Annual OPEB cost	22,375,284	76,339	22,451,623
Contributions made	(9,705,471)	(21,913)	(9,727,384)
Changes in net OPEB obligation	12,669,813	54,426	12,724,239
Net OPEB obligation, beginning of year	40,468,986	109,940	40,578,926
Net OPEB obligation, end of year	$ 53,138,799	164,366	53,303,165

The annual OPEB cost, the percentage of annual OPEB cost contributed to each plan, and the net OPEB obligation (asset) for the three most recent fiscal years ended June 30 for the retirees of the Fund were as follows:

	Year ended		Annual OPEB cost	Actual contributions	Percentage of annual OPEB cost contributed		Net OPEB obligation
Employee Health and Life Insurance Benefit Plan	June 30, 2012	$	22,375,284	9,705,471	43.4%	$	53,138,799
	June 30, 2011		21,925,262	9,368,052	42.7		40,468,986
	June 30, 2010		19,304,818	8,004,677	41.5		27,911,776
Supplemental Death Benefit Plan	June 30, 2012	$	76,339	21,913	28.7%	$	164,366
	June 30, 2011		89,444	12,164	13.6		109,940
	June 30, 2010		44,437	11,911	26.8		32,660

(d) Funded Status and Funding Progress

Employee Health and Life Insurance Benefit Plan (Benefit Plan) – As of June 30, 2011, the most recent actuarial valuation date for the Benefit Plan, the actuarial accrued liability for benefits related to all City employees was $5,718,286,228, and the actuarial value of assets was zero, resulting in an unfunded actuarial accrued liability (UAAL) of $5,718,286,228. The covered payroll (annual payroll of all active City employees covered by the plan) was $523,536,180 and the ratio of the UAAL to the covered payroll was 1,092%. The funded status related to the retirees of the Fund was not available.

Supplemental Death Benefit Plan (Supplemental Plan) – As of June 30, 2011, the most recent actuarial valuation date for the Supplemental Plan, the actuarial accrued liability for benefits related to all City employees was $34,564,960 and the actuarial value of assets was $25,681,765, resulting in an unfunded actuarial accrued liability (UAAL) of $8,883,195. The covered payroll (annual payroll of all active City employees covered by the plan) was $523,536,180 and the ratio of the UAAL to the covered payroll was 1.7%. The funded status related to the retirees of the Fund was not available.

Actuarial valuations of the ongoing plans 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 annual required contributions of the employer are subject to continual revision as actual results are compared with past expectations and new estimates are made about the future.

(e) Actuarial Methods and Assumptions

Projections of benefits for financial reporting purposes are based on the substantive plan (the plan as understood by the employer and the plan members) and include the types of benefits provided at the time of each valuation and the historical pattern of sharing of benefit costs between the employer and the plan members to that point. The actuarial methods and assumptions used include techniques that are designed to reduce the effects of short-term volatility in actuarial accrued liabilities and the actuarial value of assets, consistent with the long-term perspective of the calculations.

The actuarial methods and significant assumptions used to determine the annual required contributions for the year ended June 30, 2012 were as follows:

	Employee health and life insurance benefit plan	**Supplemental death benefit plan**
Valuation date	June 30, 2011	June 30, 2011
Actuarial cost method	Individual entry-age	Individual entry-age
Amortization method	Level percent	Level dollar
Amortization period for unfunded actuarial accrued liabilities	30 years, open	30 years, open
Asset valuation method	N/A	3 year smoothed market
Actuarial assumptions:		
Investment rate of return	4.0%	5.0%
Projected salary increases*	4.0%	N/A
Healthcare cost trend rate	9.0% for 2012, grading down to 4.5% in 2021 and 4.0% in 2022 and beyond	N/A

* Includes inflation rate of 4.0%.

In the June 30, 2011 actuarial valuation for the Employee Health and Life Insurance Benefit Plan, the mortality tables used by the City's plan to evaluate death benefits to be paid for retirees was 110% of the RP 2000 Combined Male and 110% of the RP 2000 Combined Female table setback two years. The City's plan used an annual rate of retirement of 50%, initially, reduced to an ultimate rate of 20% after age 70 for General City.

In the June 30, 2011 actuarial valuation for the Supplemental Death Benefit Plan, the mortality tables used by the City's plan to evaluate death benefits to be paid for Fund retirees was 120% of the RP 2000 Combined Male and 120% of the RP 2000 Combined Female table setback 2 years The City's plan used an annual rate of retirement of 50%, initially, reduced to an ultimate rate of 20% after age 70 for General City.

(12) Due from (to) Other Funds

During the course of operations, numerous transactions occur between individual funds and other City funds for goods provided or services rendered. Related receivables and payables are classified as "due from other funds" or "due to other funds," respectively, on the statement of fund net assets, will be settled within one year, and are summarized as follows as of June 30, 2012:

Due from other funds (unrestricted):		
General Fund	$	3,960,102
Other governmental funds		3,489,389
General Retirement System Service Corporation		31,439
Sewage Disposal Fund		33,978,579
Total due from other funds	$	41,459,509
Due to other funds (unrestricted):		
General Fund	$	3,062,431
Other governmental funds		1,249,903
Other enterprise funds		19,188
Fiduciary funds		10,952,567
Total due to other funds	$	15,284,089
Due to other funds (restricted):		
Sewage Disposal Fund	$	10,640,798

(13) Capital Improvement Program

The Fund is engaged in a variety of projects that are a part of its five-year Capital Improvement Program (the Program). The total cost of this program is anticipated to be approximately $529 million through fiscal year 2017. The Program is being primarily financed from revenues of the Fund and proceeds from the issuance of revenue bonds.

The total amount of construction contract commitments outstanding at June 30, 2012 was approximately $20.8 million.

(14) Contingencies

The City is subject to various governmental environmental laws and regulations. GASB Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*, established accounting and financial reporting standards for pollution (including contamination) remediation obligations, which are obligations to address the current or potential detrimental effects of existing pollution by participating in pollution remediation activities such as site assessments and cleanups. The standard excludes pollution prevention or control obligations with respect to current operations, and future pollution remediation activities that are required upon retirement of an asset, such as landfill closure and postclosure care. The Fund determined that there was no estimated pollution remediation obligations to be recorded at June 30, 2012.

(Continued)

The Fund is also a defendant in numerous alleged claims, lawsuits, billing disputes, and other stated and pending demands. The Fund and the City's Legal Department have estimated a reserve, which is included in the accompanying basic financial statements, for the potential outcome of such claims or the amount of potential damages in the event of an unfavorable outcome for each of the above contingencies. The Fund's management and the City's Legal Department believe that any differences in reserved amounts and final settlement, after consideration of claims covered by insurance, resulting from such litigation will not materially impact the Fund's financial position or results of operations.

The City holds various commercial insurance policies to cover other potential loss exposures.

(15) Compliance with Finance-Related Legal and Contractual Provisions

The Fund has fully implemented the necessary procedures to ensure compliance with the arbitrage rebate rules of Section 148(f) of the Internal Revenue Code of 1986 applicable to the Fund's outstanding tax-exempt obligations. The City settled selected bond issues with the Internal Revenue Service (IRS) in August 2010 and September 2011. The City paid $16,045 in August 2012 to settle the arbitrage issues concerning Water Supply System Revenue Bonds Series 1997-A and 1997-B issued August 1997.

The City is required by State of Michigan law to fund its minimally required pension contributions for the fiscal year ended June 30, 2012, prior to said date. Notwithstanding this requirement, the City failed to remit its complete contribution prior to June 30, 2012. The Fund's portion of the unremitted contributions is $8,879,035. The contributions were remitted in fiscal year 2012-13 in accordance with the payment schedule agreed to between the City and the pension board.

(16) Subsequent Events

(a) Legal Matters

On November 4, 2011, the U.S. District Court issued an order that will modify several aspects of the Fund's management processes. The order incorporated recommendations of a committee established by the Court to identify and implement strategies to ensure sustainable environmental compliance of the Fund. The principal recommendations of the Root Cause Committee report, and the provisions of the November 4, 2011 order are designed to produce more autonomous Fund operations and include:

- The Fund will continue to remain an enterprise Fund of the City, and all assets of the water and wastewater systems will remain property of the City;
- The Fund's labor relations will no longer be governed by the Collective Bargaining Agreements (CBA) that are applicable to all other City Funds. It is envisioned that separate agreements and provisions will be established that are specific to the Fund's needs. The order strikes and enjoins all other provisions that are deemed to threaten compliance;
- The Fund will be exempted from the City's procurement ordinance and will establish procurement policies that will facilitate efficiency and long-term compliance;
- The Fund will establish and distinct (from the City) resources for provision of the finance, procurement, law, human resource, and information technology services that are currently being provided by the City;

- Rates for suburban customers will no longer be subject to approval by the Detroit City Council; and
- Future Directors will continue to be appointed by the Mayor, but will be engaged with advice from a search committee that includes representation from a suburban Board member and the Detroit City Council. Removal of future Directors will require a super majority of either the Board or the City Council.

On October 5, 2012, the Court issued further clarification of its November 4, 2011 Order. Significant amongst the relief granted in the October 5, 2012 Order was an injunction against the City from "applying existing or future Charter provisions, ordinances, resolutions, executive orders, City policies, regulations, procedures or similar rules or practices that are inconsistent." with the Court's order. The Court also ordered that the City and its employees work cooperatively with the Detroit Water and Sewerage Department to implement the Court's Orders. The Court took certain other matters under advisement. A ruling on those matters is anticipated in December 2012 or January 2013.

(b) Debt Ratings

On November 28, 2012, Moody's Investors Service downgraded the ratings for the Detroit Water Revenue debt to Baa3 (Senior Lien) and Ba1 (Second Lien). The downgrades in the credit ratings to a level below investment grade status limits the Fund's access to capital, including borrowing for cash flow purposes.

(c) Other Matters

On November 14, 2012, the Detroit Water and Sewerage Department's Board of Water Commissioners approved a $2 million contract with a consultant, EMA, for job redesign and organizational optimization services with a term ending June 30, 2013. Work on this contract has begun and job redesign teams have been formed from Detroit Water and Sewerage Department volunteers.