



AUDITED FINANCIAL STATEMENTS

Puerto Rico Aqueduct and Sewer Authority
(A Component Unit of the Commonwealth of Puerto Rico)
Years Ended June 30, 2009 and 2008
With Report of Independent Auditors

Ernst & Young LLP



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

Audited Financial Statements

Years Ended June 30, 2009 and 2008

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Report of Independent Auditors

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 year ended June 30, 2009, 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 audit. The financial statements of the Authority for the year ended June 30, 2008, were audited by other auditors whose report dated October 27, 2008, expressed an unqualified opinion on those statements prior to restatement.

We conducted our audit in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Authority's internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Authority's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 2009 basic financial statements referred to above present fairly, in all material respects, the financial position of the Puerto Rico Aqueduct and Sewer Authority at June 30, 2009, 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.

We also audited the adjustments described in Note 22 that were applied to restate the 2008 financial statements. In our opinion, such adjustments are appropriate and have been properly applied.

The management's discussion and analysis and schedule of funding progress on pages 3 through 17 and page 65 are not a required part of the basic financial statements but are supplementary information required by *Governmental Accounting Standards Board*. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Ernst + Young LLP

October 15, 2009

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original of
this report.

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

Management's Discussion and Analysis

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, 2009, 2008 and 2007. Please read it in conjunction with the Authority's financial statements, which follow this section.

June 30, 2009 and 2008 Financial Highlights

- The Authority's net assets decreased by \$140.0 million to \$2,215.8 million, or 6%, primarily as the net result of a increase in water and sewer revenues of \$8.7 million, a decrease in operating expenses of \$28.7 million, a decrease of non operating revenues (expenses) of \$300.7 million and a decrease of capital contributions of \$11.9 million.
- Operating revenues increased by \$8.7 million to \$704.5 million, or 1%, due to the net effect of an increase in water and sewer revenues of \$17.5 million and an increase of the provision for bad debt of \$8.8 million.
- Operating expenses decreased by \$28.7 million to \$768.2 million, or 4%, primarily as a result of a decrease in payroll expenses of \$16.0 million, a decrease in other operating expenses of \$25.4 million, a decrease of professional and consulting services of \$2.8 million, an increase in the service contract of the Superaqueduct of \$2.5 million, an increase in electricity expense of \$3.3 million and an increase in depreciation expense of \$9.7 million.
- Capital contributions decreased by \$11.9 million to \$22.1 million, or 35%, primarily as a result of a decrease in federal grants and other contributions.
- Total assets increased by \$330.1 million to \$6,483.7million or 5%, primarily due to an increase by \$330.6 million in the Authority's capital assets. Total liabilities increased by \$470.1 million to \$4,267.9 million or 12%, primarily as a result of an increase in long term debt of \$373.4 million and an increase in other liabilities of \$96.7 million.

Puerto Rico Aqueduct and Sewer Authority
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Management's Discussion and Analysis (continued)

June 30, 2008 and 2007 Financial Highlights

- The Authority's net assets increased by \$135.1 million to \$2,355.9 million, or 6.0%, 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 \$477.1 million to \$6,153.6 million or 8.0% primarily due to an increase by \$431.6 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.

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.

Puerto Rico Aqueduct and Sewer Authority
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Management's Discussion and Analysis (continued)

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		Change
	2009	2008	
Current and other assets	\$ 490,941	\$ 491,426	\$ (485)
Capital assets, net	<u>5,992,747</u>	<u>5,662,162</u>	<u>330,585</u>
Total assets	<u>6,483,688</u>	<u>6,153,588</u>	<u>330,100</u>
Long-term debt outstanding	<u>3,594,067</u>	<u>3,220,643</u>	<u>373,424</u>
Other liabilities	<u>673,793</u>	<u>577,077</u>	<u>96,716</u>
Total liabilities	<u>4,267,860</u>	<u>3,797,720</u>	<u>470,140</u>
Net assets:			
Invested in capital assets, net of related debt	2,963,993	2,907,374	56,619
Restricted	14,481	12,024	2,457
Unrestricted deficit	<u>(762,646)</u>	<u>(563,530)</u>	<u>(199,116)</u>
Total net assets	<u>\$ 2,215,828</u>	<u>\$ 2,355,868</u>	<u>\$ (140,040)</u>

	June 30		Change
	2008	2007	
Current and other assets	\$ 491,426	\$ 445,940	\$ 45,486
Capital assets, net	<u>5,662,162</u>	<u>5,230,545</u>	<u>431,617</u>
Total assets	<u>6,153,588</u>	<u>5,676,485</u>	<u>477,103</u>
Long-term debt outstanding	<u>3,220,643</u>	<u>2,986,518</u>	<u>234,125</u>
Other liabilities	<u>577,077</u>	<u>469,206</u>	<u>107,871</u>
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	2,907,374	2,970,462	(63,088)
Restricted	12,024	19,798	(7,774)
Unrestricted	<u>(563,530)</u>	<u>(769,499)</u>	<u>205,969</u>
Total net assets	<u>\$ 2,355,868</u>	<u>\$ 2,220,761</u>	<u>\$ 135,107</u>

Puerto Rico Aqueduct and Sewer Authority
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Management's Discussion and Analysis (continued)

Net Assets

June 30, 2009 and 2008

The Authority's net assets as of June 30, 2009 were approximately \$2,215.8 million. This is a \$140.0 million increase from the net assets as of June 30, 2008 of \$2,355.8 million. Total assets increased by \$330.1 million during the fiscal year ended June 30, 2009. This is primarily a result of a net increase in capital assets of \$330.6 million due to current year net additions of \$474.3 million offset by current year depreciation and amortization of \$143.7 million.

Unrestricted and restricted cash and cash equivalents as of June 30, 2009, decreased by \$43.9 million when compared with June 30, 2008. The decrease is primarily due to the uses of funds to pay debt service. Accounts receivable, net, increased by approximately \$45.1 million primarily due the net effect of an increase of \$95.7 million in accounts receivable, mainly from water and sewer services customers and an increase in the allowance for doubtful accounts of \$50.6 million.

Total liabilities increased by \$470.1 million primarily due to an increase of \$373.4 million in long-term debt outstanding, mainly representing the net effect of an (1)increase in line of credit of \$348.9 million and an (2)increase in notes payable of \$25.4 million to finance the Authority's capital improvement program, a decrease in bonds payable of \$.9 million, and an increase of \$96.7 million in other current and noncurrent liabilities, primarily due to an increase of \$95.0 million in accounts payable, accrued liabilities and accrued interest.

June 30, 2008 and 2007

The Authority's net assets as of June 30, 2008 were approximately \$2,355.8 million. This is a \$135.1 million increase from the net assets as of June 30, 2007 of \$2,220.7 million. Total assets increased by \$330.1 million during the fiscal year ended June 30, 2008. This is primarily a result of a net increase in capital assets of \$431.6 million due to current year net additions of \$565.6 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.

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Management's Discussion and Analysis (continued)

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.

Capital Assets

Capital assets as of June 30, 2009 and 2008 were as follows (in thousands):

	June 30		Change
	2009	2008	
Capital assets being depreciated	\$ 6,831,835	\$ 6,578,154	\$ 253,681
Accumulated depreciation and amortization	(2,491,389)	(2,347,871)	(143,518)
	<u>4,340,446</u>	<u>4,230,283</u>	<u>110,163</u>
Land	60,323	58,414	1,909
Construction in progress	1,591,978	1,373,465	218,513
Capital assets, net	<u>\$ 5,992,747</u>	<u>\$ 5,662,162</u>	<u>\$ 330,585</u>

	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)
	<u>4,230,283</u>	<u>4,207,861</u>	<u>22,422</u>
Land	58,414	50,999	7,415
Construction in progress	1,373,465	971,685	401,780
Capital assets, net	<u>\$ 5,662,162</u>	<u>\$ 5,230,545</u>	<u>\$ 431,617</u>

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Management's Discussion and Analysis (continued)

June 30, 2009 and 2008

The net increase of \$330.6 million in capital assets includes an investment of \$474.3 million, reduced by \$143.7 million in depreciation and amortization. The \$466.6 million in capital investment is broken down as follows:

- \$420.1 million in the Authority's capital improvement program;
- \$51.8 million in renewal and replacement projects;
- \$2.7 million for emergency projects and consent decree projects

The Authority has approximately \$1,592.0 million in construction in progress as of June 30, 2009, and has construction commitments of approximately \$447.1 million.

June 30, 2008 and 2007

The net increase of \$431.6 million in capital assets includes an investment of \$565.6 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;
- \$59.7 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 \$1,373.6 million in construction in progress as of June 30, 2008, and has construction commitments of approximately \$393.9 million.

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Management's Discussion and Analysis (continued)

Debt Administration

Long-term debt for the years ended June 30, 2009 and 2008 was as follows (in thousands):

	June 30		Change
	2009	2008	
Bonds payable:			
2001 Series A Commonwealth Appropriation Bonds	\$ 25,875	\$ 33,825	\$ (7,950)
Act 164 PFC Commonwealth Appropriation Bonds	341,565	341,565	-
2004 Series A Commonwealth Appropriation Bonds	326,785	326,785	-
Revenue Bonds:			
2008 Series A, Serial Bonds	93,155	93,155	-
2008 Series A, Convertible Capital Appreciation	130,152	130,152	-
2008 Series A Term Bonds	1,103,218	1,095,125	8,093
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	302,742	308,030	(5,288)
Add premium on bonds refunding	38,025	39,733	(1,708)
Less :			
Bond discount	(16,683)	(17,122)	439
Deferred loss from refunding	(85,006)	(90,567)	5,561
Total bonds	<u>\$ 2,567,028</u>	<u>\$ 2,567,881</u>	<u>\$ (853)</u>

(Continued)

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Management's Discussion and Analysis (continued)

	June 30		Change
	2009	2008	
Notes payable:			
Water Pollution Control and Drinking Water Treatment Revolving Funds Loans	\$ 321,215	\$ 293,290	\$ 27,925
Notes with commercial banks	<u>247,436</u>	<u>250,000</u>	<u>(2,564)</u>
Total notes	<u>568,651</u>	<u>543,290</u>	<u>25,361</u>
Lines of credit	<u>458,387</u>	<u>109,472</u>	<u>348,915</u>
Long-term debt outstanding	<u>3,594,066</u>	<u>3,220,643</u>	<u>373,424</u>
Other long term liabilities:			
Accrued compensated absences	51,352	56,526	(5,174)
Net OPEB obligation	7,928	4,360	3,568
Early retirement obligation	3,960	7,865	(3,905)
Customer deposits	<u>77,555</u>	<u>69,895</u>	<u>7,660</u>
Total other liabilities	<u>140,795</u>	<u>138,646</u>	<u>2,149</u>
Total – long-term obligations	<u>3,734,861</u>	<u>3,359,289</u>	<u>\$ 375,572</u>
Current portion	<u>297,100</u>	<u>140,585</u>	
Long-term obligations, less current portion	<u>\$ 3,437,761</u>	<u>\$ 3,218,704</u>	

The Authority's long-term debt increased by \$373.4 million from \$3,220.6 million as of June 30, 2008 to \$3,594.1 million as of June 30, 2009.

June 30, 2009

Bonds Payable

Bonds outstanding as of June 30, 2009 decreased by \$0.8 million, mainly from the net effect of an increase in accreted value of 2008 Series A Revenue Bonds of \$8.1 million, a decrease of \$14.9 million in payments of principal and an increase for the amortization of bonds discount, bonds premium, and bonds deferred lost from bonds refunding of \$6 million.

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Management's Discussion and Analysis (continued)

Notes Payable

The Authority finances the cost of design and construction of certain capital improvements projects with notes from the Puerto Rico Water Pollution Control Revolving Fund and the Puerto Rico Safe Drinking Water Treatment Revolving Loan Fund programs that bear interest at 2%. As of June 30, 2009, the Authority's loans outstanding under these programs amounted to \$321.2 million. These loans increased approximately \$27.9 million due to the net effect of drawings of approximately \$39.6 million for payment of capital improvements and payment of principal on loans outstanding of \$11.7 million.

On September 8, 2006, the Authority entered into a term loan agreement with various commercial banks amounting to \$250 million to repay various lines of credit with Government Development Bank (GDB) and to pay the costs associated with the loan. As of June 30, 2009, the outstanding balance of the term loan was \$247.4 million.

Lines of Credit

During 2009, the Authority entered into a new \$87.6 million revolving line of credit with GDB for the purpose of financing the Authority's capital improvement program. As of June 30, 2009, approximately \$43.8 million under this line of credit was outstanding.

The existing \$190 million capital improvement program revolving line of credit with GDB was increased to \$250 million. As of June 30, 2009, \$250 million under this line of credit was outstanding.

The \$150 million revolving line of credit with GDB for the purpose of financing the operating reserve required by the Master Agreement of Trust securing its revenue bonds has an outstanding balance of \$150 million as of June 30, 2009.

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

June 30, 2008

Bonds Payable

Bonds outstanding as of June 30, 2008 increased by \$1,050.1 million, mainly from the net effect of issuance of \$1,732.8 million principal amount in new bonds, payment of principal on outstanding bonds of approximately \$24.4 million, refunding of \$262.8 million of Series 1995 Bonds with the issuance of the 2008 Revenue Refunding Bonds and the defeasance and cancellation of \$369.0 million of the Authority's share of certain Act 164 PFC Bonds.

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Management's Discussion and Analysis (continued)

The bonds issued during fiscal year 2008 for \$1,732.8 million primarily include (1) 2008 Series A and B Revenue Bonds, issued on March 18, 2008, for a principal amount of \$1,338.6 million for the purpose of refinancing certain outstanding bond anticipation notes, lines of credit, and to pay a portion of the Authority's capital improvement program, (2) 2008 Series A and B Revenue Refunding Bonds (guaranteed by the Commonwealth), issued on March 18, 2008, in the principal amount of \$284.8 million to refinance the 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 13 to the basic financial statements.

Puerto Rico Aqueduct and Sewer Authority
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Management's Discussion and Analysis (continued)

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, 2009 and 2008 (in thousands):

	Years Ended June 30		Change
	2009	2008	
Operating revenue:			
Revenues from water and sewer, net	\$ 704,457	\$ 695,735	\$ 8,722
Operating expenses:			
Payroll and payroll related expenses	279,606	295,566	(15,960)
Service contract – Superaqueduct	25,476	22,950	2,526
Professional and consulting services	28,289	31,096	(2,807)
Chemicals	27,310	27,611	(301)
Materials and replacements	15,454	15,814	(360)
Repairs and maintenance of capital assets	32,003	31,141	862
Electricity	136,497	133,180	3,317
Insurance	9,513	9,815	(302)
Other operating expenses	70,356	95,755	(25,399)
Operating expenses (excluding depreciation and amortization)	624,504	662,928	(38,424)
Depreciation and amortization	143,687	133,972	9,715
Total operating expenses	768,191	796,900	(28,709)
Operating loss	(63,734)	(101,165)	37,431
Nonoperating (expenses) income, net	(98,439)	202,249	(300,688)
(Loss) income before capital contributions	(162,173)	101,084	(263,257)
Capital contributions	22,133	34,023	(11,890)
(Decrease) increase in net assets	(140,040)	135,107	(275,147)
Net assets at beginning of year	2,355,868	2,220,761	135,107
Net assets at end of year	\$ 2,215,828	\$ 2,355,868	\$ (140,040)

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Management's Discussion and Analysis (continued)

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):

	Year 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	295,566	295,605	(39)
Service contract – Superaqueduct	22,950	20,602	2,348
Professional and consulting services	31,096	21,140	9,956
Chemicals	27,611	28,995	(1,384)
Materials and replacements	15,814	13,678	2,136
Repairs and maintenance of capital assets	31,141	29,915	1,226
Electricity	133,180	110,385	22,795
Insurance	9,815	10,278	(463)
Other operating expenses	95,755	58,421	37,334
Operating expenses (excluding depreciation and amortization)	662,928	589,019	73,909
Depreciation and amortization	133,972	135,293	(1,321)
Total operating expenses	796,900	724,312	72,588
Operating (loss) income	(101,165)	31,226	(132,391)
Nonoperating revenue (expenses), net	202,249	(85,206)	287,455
Income (loss) before capital contributions	101,084	(53,980)	155,064
Capital contributions	34,023	24,363	9,660
Increase (decrease) in net assets	135,107	(29,617)	164,724
Net assets at beginning of year	2,220,761	2,250,378	(29,617)
Net assets at end of year	\$ 2,355,868	\$ 2,220,761	\$ 135,107

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Management's Discussion and Analysis (continued)

June 30, 2009 and 2008

Net assets decreased by \$140.0 million, from \$2,355.9 million in 2008 to \$2,215.8 million in 2009, due to the results of current year operations.

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

Increase in operating revenues	\$	8,722
Decrease in operating expenses		28,709
Decrease in nonoperating revenue (expenses), net		(300,688)
Decrease in capital contributions		<u>(11,890)</u>
Net change	\$	<u>(275,147)</u>

Operating revenue increased as a result of an increase in water and sewer consumption of \$17.5 million and an increase in the provision for bad debt of \$8.8 million during the fiscal year ended June 30, 2009.

Operating expenses decreased by \$28.7 million primarily due to the net effect of the following:

- A decrease of \$15.9 million in payroll and payroll related expenses.
- A decrease of \$2.8 million in professional and consulting services expenses
- A decrease of \$25.4 million in other operating expenses.
- An increase of \$2.5 million in Service Contract – Superaqueduct expenses.
- An increase of \$3.3 million in electricity expenses.
- An increase of \$1.0 million in repair and maintenance of capital assets.
- An increase of \$9.7 million in depreciation expense.

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 decreased by \$300.7 million when compared with previous fiscal year. This is primarily due to contributions of \$369.0 million that was received from Puerto Rico Sales Tax Financing (known as COFINA for its Spanish acronym) during fiscal year ended June 30, 2008, reduced by a charge of \$75.3 million related to the termination of forward interest rate swap agreements.

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Management's Discussion and Analysis (continued)

Capital contributions decreased by \$11.9 million. This decrease is primarily the net effect of the following:

- Federal grants and other contributions decreased by approximately \$12.4 million.
- Other Commonwealth contributions increased by \$0.5 million.

June 30, 2008 and 2007

Net assets increased by \$135.1 million, from \$2,220.7 million in 2007 to \$2,355.8 million in 2008, due to the results of current year operations.

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	(72,588)
Increase in nonoperating revenue (expenses), net	287,455
Increase in capital contributions	<u>9,660</u>
Net change	<u><u>\$ 164,724</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 \$72.6 million primarily due to the net effect of the following:

- An increase of \$37.3 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 \$2.1 million.

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

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

Management's Discussion and Analysis (continued)

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.

Contacting the Authority's Financial Management

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

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

	June 30	
	2009	2008
Liabilities and net assets		
Current liabilities:		
Bonds payable	\$ 6,763	\$ 6,194
Notes payable	17,561	12,649
Lines of credit	251,192	100,724
Accounts payable	268,780	201,348
Accrued liabilities	185,311	184,840
Accrued interest	60,293	33,176
Unearned revenue	18,615	19,067
Customers' deposits	5,719	5,867
Compensated absences and postemployment benefits	15,865	15,151
Total current liabilities	830,099	579,016
Noncurrent liabilities:		
Bonds payable	2,560,265	2,561,687
Notes payable	551,090	530,641
Lines of credit	207,195	8,748
Customers' deposits	71,836	64,028
Compensated absences and postemployment benefits	47,375	53,600
Total noncurrent liabilities	3,437,761	3,218,704
Total liabilities	4,267,860	3,797,720
Net assets:		
Invested in capital assets, net of related debt	2,963,993	2,907,374
Restricted for environmental compliance, capital activity and other	14,481	12,024
Unrestricted	(762,646)	(563,530)
Total net assets	2,215,828	2,355,868
Total net assets and liabilities	\$ 6,483,688	\$ 6,153,588

See accompanying notes.

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

Statements of Revenues, Expenses, and Changes in Net Assets

(In thousands)

	Year Ended June 30	
	2009	2008
Operating revenues:		
Water	\$ 491,641	\$ 479,653
Sewer	271,280	265,749
Bad debt expense	(58,464)	(49,667)
Total net operating revenues	<u>704,457</u>	<u>695,735</u>
Operating expenses:		
Payroll and payroll related	279,606	295,566
Service contract – Superaqueduct	25,476	22,950
Professional and consulting services	28,289	31,096
Chemicals	27,310	27,611
Materials and replacements	15,454	15,814
Repairs and maintenance of capital assets	32,003	31,141
Electricity	136,497	133,180
Insurance	9,513	9,815
Other operating expenses	70,356	95,755
Operating expenses (excluding depreciation and amortization)	<u>624,504</u>	<u>662,928</u>
Depreciation and amortization	143,687	133,972
Total operating expenses	<u>768,191</u>	<u>796,900</u>
Operating loss	(63,734)	(101,165)
Nonoperating revenues (expenses):		
Interest expense, net of amortization of debt issuance cost, bond premium and discount, and deferred refunding loss	(126,978)	(152,940)
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
Commonwealth contributions for interest payments on bonds and notes	18,233	39,907
Interest income	5,202	5,714
Other income	5,104	11,181
Total nonoperating (expenses) income, net	<u>(98,439)</u>	<u>202,249</u>
(Loss) income before capital contributions	<u>(162,173)</u>	<u>101,084</u>
Capital contributions:		
Federal grants and other contributions	21,592	34,023
Other Commonwealth contributions	541	-
Total capital contributions	<u>22,133</u>	<u>34,023</u>
Change in net assets	(140,040)	135,107
Net assets at beginning of year	2,355,868	2,220,761
Net assets at end of year	<u>\$ 2,215,828</u>	<u>\$ 2,355,868</u>

See accompanying notes.

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

Statements of Cash Flows
(In thousands)

	Year Ended June 30	
	2009	2008
Cash flows from operating activities		
Cash received from customers	\$ 676,103	\$ 701,854
Cash paid to suppliers	(265,024)	(303,079)
Cash paid to employees	(282,285)	(267,695)
Net cash provided by operating activities	128,794	131,080
Cash flows from noncapital financing activities		
Proceeds from bonds	-	43,093
Proceeds from borrowings from lines of credit	150,000	50,000
Payment of lines of credit	-	(50,000)
Net cash from other income	5,104	14,412
Interest paid on notes and lines of credit	-	(25,694)
Net cash provided by noncapital financing activities	155,104	31,811
Cash flows from capital and related financing activities		
Additions to utility plant and other capital assets	(489,740)	(580,879)
Proceeds from capital contributions	12,578	45,207
Proceeds from issuance of bonds	-	291,475
Proceeds from issuance of notes payable	39,658	73,630
Proceeds from borrowings from lines of credit	198,915	192,629
Payments of bonds and notes	(27,535)	(23,246)
Payment of lines of credit	-	(96,629)
Debt issuance costs paid	-	(3,902)
Interest paid on bonds, notes and lines of credit	(66,836)	(41,930)
Net cash used in capital and related financing activities	(332,960)	(143,645)
Cash flows from investing activities		
Interest received on investments	5,202	5,714
Net cash provided by investing activities	5,202	5,714
Net (decrease) increase in cash and cash equivalents	(43,860)	24,960
Cash and cash equivalents at beginning of year	228,401	203,441
Cash and cash equivalents at end of year	\$ 184,541	\$ 228,401
For purposes of the statement of cash flows, cash and cash equivalents include:		
Unrestricted	\$ 2,183	\$ 521
Restricted	182,357	227,880
	\$ 184,540	\$ 228,401

(Continued)

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

Statements of Cash Flows (continued)

(In thousands)

	Year Ended June 30	
	2009	2008
Reconciliation of operating loss to cash provided by operating activities		
Operating loss	\$ (63,734)	\$ (101,165)
Adjustments to reconcile operating loss to net cash provided by operating activities:		
Depreciation and amortization	143,687	133,972
Provision for uncollectible accounts	58,464	49,667
Change in assets and liabilities:		
Increase in accounts receivable	(98,099)	(41,584)
Increase in accounts receivable from federal agencies	(297)	-
Increase in materials and supplies inventory	(333)	(5,186)
Decrease (increase) in prepayments and other current assets	141	(5,199)
Increase in accounts payable	82,724	47,251
Decrease in unearned revenue	(452)	(2,834)
(Decrease) increase in accrued compensated absences and early retirement obligation	(5,511)	2,200
Increase in accrued liabilities	471	53,088
Increase in customers' deposits	11,733	870
Total adjustments	192,528	232,245
Net cash provided by operating activities	\$ 128,794	\$ 131,080
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	625	554
Noncash capital and related financing activities	15,637	15,290
Net additions to utility plant and other capital assets		
Write-off of capital contributions	9,555	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	1,702	1,710
Bond premiums and discounts	1,269	1,598
Deferred refunding loss	5,561	4,486
Write-off of debt issuance costs and deferred refunding loss related to COFINA debt refunding	-	5,993
Accretion of interest on capital appreciation bonds	8,093	2,227
Principal paid by the Commonwealth	-	10,703
Interest paid by the Commonwealth	18,233	39,907
COFINA contribution for debt refunding	-	369,025

See accompanying notes.

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

Notes to Financial Statements

June 30, 2009 and 2008

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.

Summary of Significant Accounting Policies

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

Measurement Focus and Basis of Accounting

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

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

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

Notes to Financial Statements (continued)

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

Measurement Focus and Basis of Accounting (continued)

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

Cash and Cash Equivalents

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

Restricted Assets

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

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

Receivables

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

Materials and Supplies Inventory

Materials and supplies inventory is stated at average cost, not to exceed market. Inventory is presented net of reserve for obsolescence totaling approximately \$3.4 million as of June 30, 2009 and 2008.

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

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

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

Notes to Financial Statements (continued)

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

Unamortized Debt Issuance Costs, Premiums, Discounts and Deferred Refunding Losses (continued)

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.

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, 2009 and 2008 amounted to approximately \$53.8 million and \$25.8 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.

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

Notes to Financial Statements (continued)

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

Capital Assets (continued)

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.

Unearned Revenue

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

Accounting for Compensated Absences

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

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

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

Notes to Financial Statements (continued)

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

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*.

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, 2009 and 2008, the accrued liability for early retirement amounted to approximately \$4 million and \$7.9 million, respectively.

The cost of healthcare benefits paid to retired employees amounted to approximately \$2.8 million for both, 2009 and 2008.

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.

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

Notes to Financial Statements (continued)

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

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, 2009 and 2008, 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.

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.

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

Notes to Financial Statements (continued)

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

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>
51	Accounting and Financial Reporting for Intangible Assets	2010
53	Accounting and Financial Reporting for Derivative Instruments	2010

Effects of New Pronouncements

In November, 2006, GASB issued Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*. This Statement addresses 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 scope of the document 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 post closure care and nuclear power plant decommissioning. The Authority adopted the provisions of GASB Statement No. 49 during the year ended June 30, 2009. The adoption of GASB Statement No. 49 had no material impact on the Authority.

In November, 2007, GASB issued Statement No. 52, *Land and Other Real Estate Held as Investment by Endowments*. This Statement establishes consistent standards for the reporting of land and other real estate held as investments by essentially similar entities. It requires endowments to report their land and other real estate investments at fair value. Governments also are required to report the changes in fair value as investment income and to disclose the methods and significant assumptions employed to determine fair value, and other information that they currently present for other investments reported at fair value. The Authority adopted the provisions of GASB Statement No. 52 during the year ended June 30, 2009. The adoption of GASB Statement No. 52 had no material impact on the Authority.

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

Notes to Financial Statements (continued)

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

Reclassifications

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

2. Deposits

The carrying amount of deposits with financial institutions of the Authority as of June 30, 2009 and 2008 consisted of the following (in thousands):

	June 30			
	2009		2008	
	Carrying amount	Bank balance	Carrying amount	Bank balance
Unrestricted deposits in commercial banks in Puerto Rico	\$ 2,183	\$ 9,902	\$ 521	\$ 24,329
Restricted deposits in commercial banks in Puerto Rico	140,308	140,308	180,195	180,195
Restricted deposits in governmental banks:				
GDB	41,442	41,442	47,090	47,090
EDB	607	607	595	595
Total	\$ 184,540	\$ 192,259	\$ 228,401	\$ 252,209

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

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

Notes to Financial Statements (continued)

2. Deposits (continued)

Custodial Credit Risks Related to Deposits

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

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

The Authority was exposed to the following custodial credit risk arising from the balance of deposits maintained in governmental and commercial banks as of June 30, 2009 and 2008 (in thousands):

	June 30	
	2009	2008
Uninsured and uncollateralized:		
GDB	\$ 41,442	\$ 47,090
EDB	607	595
	\$ 42,049	\$ 47,685

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

Notes to Financial Statements (continued)

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	
	2009	2008
Water and sewer services:		
Residential, industrial, and commercial	\$ 414,965	\$ 349,475
Government agencies and municipalities	97,247	64,571
	512,212	414,046
Other receivables:		
Government agencies, municipalities, and private entities	22,522	25,017
Less allowance for uncollectible accounts	(319,278)	(268,724)
Total	\$ 215,456	\$ 170,339

4. Receivables from Federal Agencies

The receivables from federal agencies of approximately \$3.2 million and \$2.9 million as of June 30, 2009 and 2008, respectively, consisted primarily of amounts pending to be received from the U.S. Department of Homeland Security (USDHS) as reimbursement for expenses incurred by the Authority's disaster recovery activities.

5. Materials and Supplies Inventory

As of June 30, 2009 and 2008, 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.

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

Notes to Financial Statements (continued)

6. Capital Assets

Utility plant and other capital assets as of June 30, 2009 and 2008 and the changes therein for the years then ended are as follows (in thousands):

	June 30, 2009			Ending Balance
	Beginning Balance	Increases	Decreases	
Capital assets not being depreciated:				
Land	\$ 58,414	\$ 1,909	\$ -	\$ 60,323
Construction in progress	1,373,465	474,305	(255,792)	1,591,978
Total capital assets not being depreciated	<u>1,431,879</u>	<u>476,214</u>	<u>(255,792)</u>	<u>1,652,301</u>
Capital assets being depreciated:				
Infrastructure (water and sewer facilities)	6,004,087	232,236	(204)	6,236,119
Wells, tanks and meters	341,768	4,131	-	345,899
Buildings	66,855	790	-	67,645
Equipment, furniture, fixtures and vehicles	165,444	16,728	-	182,172
Total capital assets being depreciated	<u>6,578,154</u>	<u>253,885</u>	<u>(204)</u>	<u>6,831,835</u>
Less accumulated depreciation and amortization:				
Infrastructure (water and sewer facilities)	(2,075,401)	(123,303)	169	(2,198,535)
Wells, tanks and meters	(114,404)	(7,056)	-	(121,460)
Buildings	(24,140)	(1,971)	-	(26,111)
Equipment, furniture, fixtures and vehicles	(133,926)	(11,357)	-	(145,283)
Total accumulated depreciation	<u>(2,347,871)</u>	<u>(143,687)</u>	<u>169</u>	<u>(2,491,389)</u>
Total capital assets being depreciated, net	<u>4,230,283</u>	<u>110,198</u>	<u>(35)</u>	<u>4,340,446</u>
Total capital assets, net	<u>\$ 5,662,162</u>	<u>\$ 586,412</u>	<u>\$ (255,827)</u>	<u>\$ 5,992,747</u>

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

Notes to Financial Statements (continued)

6. Capital Assets (continued)

	June 30, 2008			Ending Balance
	Beginning Balance	Increases	Decreases	
Capital assets not being depreciated:				
Land	\$ 50,999	\$ 7,415	\$ -	\$ 58,414
Construction in progress	971,685	565,589	(163,809)	1,373,465
Total capital assets not being depreciated	<u>1,022,684</u>	<u>573,004</u>	<u>(163,809)</u>	<u>1,431,879</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>\$ 5,230,545</u>	<u>\$ 595,426</u>	<u>\$ (163,809)</u>	<u>\$ 5,662,162</u>

Puerto Rico Aqueduct and Sewer Authority
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Notes to Financial Statements (continued)

7. Restricted Assets

Restricted assets at June 20, 2009 and 2008 consisted of the following:

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

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

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

At June 30, restricted assets by category consist of:

	June 30	
	2009	2008
Construction funds	\$ 28,339	\$ 33,571
Capital activity funds	13,710	12,025
Debt service funds	140,308	182,284
	\$ 182,357	\$ 227,880

8. Accrued Liabilities

Accrued liabilities as of June 30, 2009 and 2008 consisted of the following (in thousands):

	June 30	
	2009	2008
Payroll and related accruals	\$ 56,654	\$ 55,983
Legal, labor related and environmental contingencies	76,666	82,928
Contract retentions	51,991	45,929
	\$ 185,311	\$ 184,840

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Notes to Financial Statements (continued)

9. Long-Term Liabilities

Long-term debt activity for the years ended June 30, 2009 and 2008 was as follows (in thousands):

	June 30, 2009					
	Beginning Balance	Additions/ Amortization	Reductions	Ending Balance	Due Within One Year	Due Thereafter
Bonds payable:						
2001 Series A Commonwealth Appropriation Bonds	\$ 33,825	\$ -	\$ (7,950)	\$ 25,875	\$ 8,275	\$ 17,600
Act 164 PFC Commonwealth Appropriation Bonds	341,565	-	-	341,565	-	341,565
2004 Series A Commonwealth Appropriation Bonds	326,785	-	-	326,785	-	326,785
2008 Series A Revenue Bonds	1,318,432	8,093	-	1,326,525	-	1,326,525
2008 Series B Revenue Bonds	22,445	-	-	22,445	-	22,445
2008 Series A Revenue Refunding Bonds	159,055	-	-	159,055	-	159,055
2008 Series B Revenue Refunding Bonds	125,700	-	-	125,700	-	125,700
Rural Development Serial Bonds	308,030	-	(5,288)	302,742	2,780	299,962
Add bond premium	39,733	-	(1,708)	38,025	1,708	36,317
Less bond discount	(17,122)	-	439	(16,683)	(439)	(16,244)
Less deferred loss on refunding	(90,567)	-	5,561	(85,006)	(5,561)	(79,445)
Total bonds	<u>2,567,881</u>	<u>8,093</u>	<u>(8,946)</u>	<u>2,567,028</u>	<u>6,763</u>	<u>2,560,265</u>
Notes payable:						
Water Pollution Control and Safe Drinking Water Treatment Revolving Funds Loans	293,290	39,658	(11,733)	321,215	14,813	306,402
Notes with commercial banks	250,000	-	(2,564)	247,436	2,748	244,688
Total notes	<u>543,290</u>	<u>39,658</u>	<u>(14,297)</u>	<u>568,651</u>	<u>17,561</u>	<u>551,090</u>
Lines of credit	<u>109,472</u>	<u>348,915</u>	<u>-</u>	<u>458,387</u>	<u>251,192</u>	<u>207,195</u>
Other long term liabilities:						
Accrued compensated absences	56,526	10,566	(15,740)	51,352	11,990	39,362
Net OPEB obligation	4,360	6,425	(2,857)	7,928	2,850	5,078
Early retirement obligation	7,865	-	(3,905)	3,960	1,025	2,935
Customers' deposits	69,895	12,789	(5,129)	77,555	5,719	71,836
Total other liabilities	<u>138,646</u>	<u>29,780</u>	<u>(27,631)</u>	<u>140,795</u>	<u>21,584</u>	<u>119,211</u>
Total - long-term obligations	<u>\$ 3,359,289</u>	<u>\$ 426,446</u>	<u>\$ (50,874)</u>	<u>\$ 3,734,861</u>	<u>\$ 297,100</u>	<u>\$ 3,437,761</u>

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Notes to Financial Statements (continued)

9. Long-Term Liabilities (continued)

	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
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	<u>139,524</u>	<u>242,629</u>	<u>(272,681)</u>	<u>109,472</u>	<u>100,724</u>	<u>8,748</u>
Other long term liabilities:						
Accrued compensated absences	56,876	13,286	(13,636)	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	8,050	(7,179)	69,895	5,867	64,028
Total other liabilities	<u>135,575</u>	<u>27,760</u>	<u>(24,689)</u>	<u>138,646</u>	<u>21,018</u>	<u>117,628</u>
Total – long-term obligations	<u>\$ 3,122,093</u>	<u>\$ 2,025,862</u>	<u>\$ (1,788,666)</u>	<u>\$ 3,359,289</u>	<u>\$ 140,585</u>	<u>\$ 3,218,704</u>

Puerto Rico Aqueduct and Sewer Authority
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Notes to Financial Statements (continued)

10. Bonds Payable

Bonds payable as of June 30, 2009 and 2008 consisted of the following (in thousands):

	June 30	
	<u>2009</u>	<u>2008</u>
Revenue Refunding Bonds:		
Series 2008:		
Series A and B, Term Bonds, 5.80% – 6.10% due in monthly interest payments through July 1, 2034 and annual principal payments from July 1, 2021 to 2034	\$ 284,755	\$ 284,755
Commonwealth Appropriation Bonds:		
Series 2001:		
Series A, 4.00% – 5.50% due in semiannual interest payments through 2011 and annual principal installments from August 1, 2007 through 2011	25,875	33,825
Act 164 PFC, 4.00% – 6.15% due in semiannual interest and annual principal payments from July 15, 2004 through 2030	341,565	341,565
Series 2004:		
Series A, 1.25% – 5.75% due in semiannual interest payments through August 1, 2031 and annual principal installments from July 15, 2004 to 2031	326,785	326,785
Revenue bonds:		
Series 2008:		
Series A, Serial Bonds, 5.00%, due in semiannual interest payments through July 1, 2025 and annual principal payments from July 1, 2012 to July 1, 2025	93,155	93,155
Series A, Convertible Capital Appreciation Bonds, 6.125%, due in semiannual interest payments from January 1, 2012 through July 1, 2024 and annual principal payments from July 1, 2017 to 2024	130,152	130,152
Series A, Term Bonds, 5.00% – 6.00%, due semiannual interest payments through July 1, 2047 and annual principal payments from July 1, 2026 to 2047	1,103,218	1,095,125
Series B, Serial Bonds, 6.15% due in monthly interest payments through July 1, 2038 and one principal payment on July 1, 2038	22,445	22,445
Rural development serial bonds:		
Serial bonds, 4.25% – 5.00%, due semiannually through July 1, 2045	302,742	308,030
Subtotal	<u>2,630,692</u>	<u>2,635,837</u>
Bond premium	38,025	39,733
Bond discount	(16,683)	(17,122)
Deferred amount on refundings	(85,006)	(90,567)
Total	<u>\$ 2,567,028</u>	<u>\$ 2,567,881</u>

Puerto Rico Aqueduct and Sewer Authority
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Notes to Financial Statements (continued)

10. Bonds Payable (continued)

1995 Series Refunding Bonds

On January 12, 1995, the Authority issued approximately \$400 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 it deposited the proceeds remaining (after payments of approximately \$5.2 million in the underwriters' discount, bond insurance premium, and other issuance costs) of approximately \$402.9 million of the Series 1995 Bonds, approximately \$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 approximately \$100 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 approximately \$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 approximately \$40 million. The 1995 Series Bonds were refunded during fiscal year ended June 30, 2008 with the proceeds from the 2008 Revenue Refunding Bonds.

2001 Series A and B Bonds

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

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Notes to Financial Statements (continued)

10. Bonds Payable (continued)

2001 Series A and B Bonds (continued)

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

Act 164 PFC Bonds

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

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

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

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

Puerto Rico Aqueduct and Sewer Authority
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Notes to Financial Statements (continued)

10. Bonds Payable (continued)

Act 164 PFC Bonds (continued)

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

The 2004 Series A and B Bonds are secured by promissory notes payments made by the Commonwealth to PFC pursuant to Supplemental Debt Restructuring and Assignment Agreements, between the debtors, including the Authority, and PFC. In accordance with various Appropriation Acts, principal and interest payments on such notes shall be funded by Commonwealth appropriations approved annually for the number of fiscal years specified in such Appropriation Acts. The Commonwealth is not legally bound to appropriate funds for such repayments. Until the fiscal year beginning July 1, 2005, the Authority's promissory note payments were made by Commonwealth appropriations authorized by J.R. 523 and Act 164. 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 2008A and B proceeds were deposited in escrow with The Bank of New York/Mellon as master escrow agent. As a result, approximately \$180.2 million of the Authority's share of the Act 164 PFC Bonds were considered legally defeased. The proceeds of the Series 2007C Bonds were used, in part, to purchase and cancel approximately \$61.4 million of the Authority's share of the Act 164 PFC Bonds. The proceeds of the Series 2008A Bonds were used to purchase and cancel approximately \$127.4 million of the Authority's share of the Act 164 PFC Bonds.

Puerto Rico Aqueduct and Sewer Authority
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Notes to Financial Statements (continued)

10. Bonds Payable (continued)

Act 164 PFC Bonds (continued)

As of June 30, 2007, the Authority's share of the Act 164 PFC Bonds was approximately \$721.3 million. After the COFINA debt refunding, the balance was reduced to approximately \$341.6 million at June 30, 2008.

2004 Series A Refunding Bonds

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

2008 Revenue Bonds Series A and B

On March 18, 2008, the Authority issued approximately \$1,338.6 million of Revenue Bonds, Series A and B (the 2008 Revenue Bonds). The 2008 Revenue Bonds Series A consist of (1) \$93.2 million of serial bonds bearing interest at 5% per annum with maturity dates ranging from July 1, 2012 to July 1, 2025, (2) \$127.9 million of capital appreciation term bonds bearing interest at 6 1/8% per annum and with maturity dates ranging from July 1, 2017 to July 1, 2024, and (3) \$1,095.1 million of term bonds bearing interest at rates ranging from 5% to 6% per annum with maturity dates ranging from July 1, 2026 to July 1, 2047. As of June 30, 2009, the outstanding balance for the 2008 Revenue Bonds Series A was approximately \$1,326.5 million, which included approximately \$10.3 million of accreted value. The 2008 Revenue Bonds Series B consist of an approximately \$22.4 million term bond bearing interest at 6.15% per annum and maturing on July 1, 2038. The 2008 Revenue Bonds were issued, to raise funds to be used by the Authority to repay certain outstanding bond anticipation notes and lines of credit and to pay a portion of the cost of the Authority's capital improvement program. The 2008 Revenue Bonds are considered senior debt.

2008 Revenue Refunding Bonds Series A and B

On March 18, 2008, the Authority issued approximately \$284.8 million of Revenue Refunding Bonds, Series A and B (guaranteed by the Commonwealth) (the 2009 Revenue Refunding Bonds), to refund the Authority's outstanding Revenue Refunding Bonds, Series 1995 (guaranteed by the Commonwealth) in the amount of approximately \$262.8 million. The 2008 Revenue Refunding Bonds bear interest at rates ranging from 5.80% to 6.10% per annum with maturity dates ranging from July 1, 2021 to July 1, 2034. The Revenue Refunding Bonds,

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Notes to Financial Statements (continued)

10. Bonds Payable (continued)

2008 Revenue Refunding Bonds Series A and B (continued)

Series A and B net proceeds of approximately \$279.5 million (after payment of approximately \$5.3 million in underwriters' discount, insurance, and other issuance costs) and other funds made available from sinking funds and investment accounts from the refunded bonds, were deposited in an irrevocable trust with an escrow agent to pay all future principal and interest payments of the Series 1995 Bonds to their respective dates of redemption or maturity. As a result, the 1995 Series Bonds are considered to be legally defeased and the liability for those bonds has been removed from the Authority's balance sheets.

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

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

Rural Development Serial Bonds

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, 2009 and 2008 was approximately \$302.7 million and \$308 million, respectively.

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Notes to Financial Statements (continued)

10. Bonds Payable (continued)

Rural Development Serial Bonds (continued)

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.

Debt Service Payments

Future principal and interest payments on all bonds payable outstanding at June 30, 2009 are as follows (in thousands):

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
Fiscal year:			
2010	\$ 11,055	\$ 129,876	\$ 140,931
2011	14,328	135,970	150,298
2012	14,938	140,926	155,864
2013	18,458	135,586	154,044
2014	33,164	134,951	168,115
2015 – 2019	201,873	647,296	849,169
2020 – 2024	256,782	584,087	840,869
2025 – 2029	486,088	489,938	976,026
2030 – 2034	585,836	342,851	928,687
2035 – 2039	312,909	234,264	547,173
2040 – 2044	353,107	143,345	496,452
2045 – 2049	342,154	36,148	378,302
Total	2,630,692	\$ 3,155,238	\$ 5,785,930
Plus unamortized premium	38,025		
Less:			
Unamortized discount	(16,683)		
Deferred loss on debt refunding	(85,006)		
Bonds payable, net	\$ 2,567,028		

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Notes to Financial Statements (continued)

11. Notes Payable

As of June 30, 2009 and 2008, notes payable consisted of the following (in thousands):

	June 30	
	2009	2008
Puerto Rico Water Pollution Control Revolving Fund	\$ 207,016	\$ 198,242
Puerto Rico Safe Drinking Water Treatment Revolving Loan Fund	114,199	95,048
Notes with commercial banks	247,436	250,000
	\$ 568,651	\$ 543,290

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, 2009 and 2008, the Authority had outstanding approximately \$321.2 million and \$293.3 million, respectively, under these loan agreements.

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

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Notes to Financial Statements (continued)

11. Notes Payable (continued)

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% (3.25% and 3.96% as of June 30, 2009 and 2008, respectively). The loan is payable in quarterly installments commencing on September 1, 2008 and due on September 1, 2011. The outstanding balance as of June 30, 2009 was approximately \$247.4 million. 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, 2009 is as follows (in thousands):

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
Year ending June 30:			
2010	\$ 17,561	\$ 12,685	\$ 30,246
2011	18,019	12,423	30,442
2012	256,545	6,089	262,634
2013	14,515	3,787	18,302
2014	14,806	3,495	18,301
2015 – 2019	69,180	13,092	82,272
2020 – 2024	54,337	6,929	61,266
2025 – 2029	40,101	1,883	41,984
	<u>485,064</u>	<u>\$ 60,383</u>	<u>\$ 545,447</u>
Interim construction loans:			
Puerto Rico Water Pollution Control Revolving Fund	60,953		
Puerto Rico Safe Drinking Water Treatment Revolving Loan Fund	22,634		
Total	<u>\$ 568,651</u>		

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

Notes to Financial Statements (continued)

12. Lines of Credit

On October 19, 2000, the Authority entered into a line of credit agreement with GDB. This agreement provides the Authority with an available maximum amount of approximately \$103.9 million. On October 29, 2004, the maximum available amount was increased to approximately \$276 million to assist the Authority in financing the construction of aqueduct and sewer facilities in rural areas. As of June 30, 2009 and 2008, the Authority had an outstanding balance of approximately \$14.6 million and \$8.7 million, respectively, under this line of credit agreement.

On November 13, 2006, the Authority entered into a line of credit agreement with GDB. This agreement provides the Authority with an available maximum amount of \$190 million to be used to provide funding for the capital improvement program of the Authority. On February, 2009, an increase of approximately \$60 million for a maximum amount of approximately \$250 million was approved. As of June 30, 2009 and 2008, the Authority had an outstanding balance of approximately \$250 million and \$100.7 million, respectively, under this line of credit agreement. Principal and interest on this line of credit are due on June 30, 2010.

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 approximately \$150 million to be used to satisfy the Operating Reserve Requirement pursuant to the Master Agreement of Trust dated as of March 1, 2008 between the Authority and the bond trustee related to the 2009 Revenue Bonds. Principal and interest on this line of credit are due on June 30, 2013. As of June 30, 2009, the Authority had an outstanding balance of approximately \$150 million.

On May 2009, the Authority entered into a revolving line-of-credit agreement with GDB. This agreement provides the Authority with an available maximum amount of approximately \$87.6 million to be used to provide funding for the capital improvement program of the Authority. As of June 30, 2009, the Authority had an outstanding balance of approximately \$43.8 million.

Puerto Rico Aqueduct and Sewer Authority
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Notes to Financial Statements (continued)

12. Lines of Credit (continued)

Future amounts required to pay principal balances at June 30, 2009 are as follows (in thousands):

Fiscal year:	
2010	\$ 251,192
Line of credit without fixed repayment terms	<u>207,195</u>
	<u>\$ 458,387</u>

13. Financial Covenants

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

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

As of June 30, 2009 and 2008, the Authority was in compliance with the senior indebtedness and the senior and senior subordinated indebtedness annual debt service coverage requirements.

However, failure by the Authority to pay principal of or interest on Commonwealth Guaranteed Indebtedness or Commonwealth Supported Obligations does not constitute an event of default under the MAT.

Puerto Rico Aqueduct and Sewer Authority
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Notes to Financial Statements (continued)

13. Financial Covenants (continued)

During fiscal year 2009, the Authority was unable to make the deposits required under the MAT for the Commonwealth Supported Obligations debt, and the payment as its due date was made by the Commonwealth. This constitutes an event of non compliance of the rate covenant, however, failure by the Authority to pay principal of or interest on Commonwealth Guaranteed Indebtedness or Commonwealth Supported Obligations does not constitute an event of default under the MAT. The Authority is taking the steps to comply with the rate covenant requirements.

The Term Loan Agreement requires the Authority to maintain, for each fiscal year, a senior and senior Subordinated debt service coverage ratio equal to at least 1.20. As of June 30, 2009 and 2008, the Authority was in compliance with the senior and senior subordinated debt service coverage ratio under the Term Loan Agreement.

14. Capital Contributions

Capital contributions for the fiscal years ended June 30, 2009 and 2008 were as follows (in thousands):

	June 30	
	2009	2008
Appropriations from Commonwealth	\$ 541	\$ -
Other contributions from Commonwealth	1,725	-
Federal grants:		
USDA Rural Development Program	11,250	26,900
Federal Emergency Management Agency	1,279	144
Developer contributions	5,609	5,253
Other contributions	1,729	1,726
	\$ 22,133	\$ 34,023

Puerto Rico Aqueduct and Sewer Authority
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Notes to Financial Statements (continued)

15. Related-Party Transactions

Operating revenues for services provided to the Commonwealth and its component units amounted to approximately \$78.6 million and \$73.9 million during the years ended June 30, 2009 and 2008, respectively. Further, operating, administrative, and general expenses during the fiscal years ended June 30, 2009 and 2008 included approximately \$136.5 million and \$133.2 million, respectively, of charges from Puerto Rico Electric Power Authority (PREPA), a component unit of the Commonwealth.

As of June 30, 2009 and 2008, the Authority had approximately \$71.4 million and \$46.2 million, respectively, of receivables from the Commonwealth and its component units, which were reported in accounts receivable in the accompanying basic financial statements.

The Authority had approximately \$1.6 million and \$3.6 million of excess of collections over billings from the Commonwealth, recorded as unearned revenue in the basic financial statements as of June 30, 2009 and 2008, respectively.

Over the years, GDB, as fiscal agent and bank of the Commonwealth, had extended lines of credit to the Authority in order to finance capital improvement projects and operational deficits. As of June 30, 2009 and 2008, the Authority had an outstanding balance of approximately \$458.4 million and \$109.5 million, respectively, under these lines of credit.

16. Pension Plan

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

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

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

Puerto Rico Aqueduct and Sewer Authority
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Notes to Financial Statements (continued)

16. Pension Plan (continued)

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

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

Total employer contributions during years ended June 30, 2009, 2008, and 2007 amounted to approximately \$10.7 million, \$10.9 million, and \$11.2 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.

Puerto Rico Aqueduct and Sewer Authority
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Notes to Financial Statements (continued)

16. Pension Plan (continued)

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, 2009, 2008, and 2007, amounted to approximately \$4 million, \$3.4 million, and \$2.9 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, 2009 and 2008, a copy of which can be obtained from the Administrator of the Retirement System: P.O. Box 42003, San Juan, Puerto Rico 00940.

17. Other Postemployment Benefits

Plan Description

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

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

Puerto Rico Aqueduct and Sewer Authority
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Notes to Financial Statements (continued)

17. Other Postemployment Benefits (continued)

Plan Description (continued)

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

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

Funding Policy

The contribution requirements of the Authority are established and may be amended, by each collective bargain agreement. The benefits are paid directly by the Authority to the retirees at a rate of a maximum of \$125 per month per retiree. The Plan is financed on a pay-as-you-go basis and the amount contributed during the year ended June 30, 2009 and 2008 was approximately \$2.9 million and \$2.0 million, respectively, which is in accordance with the funding policy. There is no contribution requirement for plan members.

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, 2009 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.

The annual required contribution estimated for the year ended June 30, 2009 amounted to (in thousands):

ARC, July 1, 2008 – June 30, 2009:	
Normal costs, end of year	\$ 1,395
Amortization of UAAL, end of year:	
Initial UAAL	5,029
	<hr/>
GASB Statement No. 45 ARC, July 1, 2008 – June 30, 2009	<u>\$ 6,424</u>

Puerto Rico Aqueduct and Sewer Authority
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Notes to Financial Statements (continued)

17. Other Postemployment Benefits (continued)

Annual OPEB costs and Net OPEB obligation (continued)

OPEB costs components are as follows (in thousands):

Annual OPEB costs, July 1, 2008 – June 30, 2009:	
ARC	\$ 6,424
Total annual OPEB costs, July 1, 2008 – June 30, 2009	<u>\$ 6,424</u>

The net OPEB obligation change is as follows:

Change in net OPEB obligation:	
Net OPEB obligation, June 30, 2008	\$ 4,360
Total annual OPEB costs, July 1, 2008 – June 30, 2009	6,424
Actual benefit payments, July 1, 2008 – June 30, 2009	<u>2,856</u>
Net OPEB obligation, June 30, 2009	<u>\$ 7,928</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, 2009 and 2008.

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>\$ 45,629</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.

Puerto Rico Aqueduct and Sewer Authority
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Notes to Financial Statements (continued)

17. Other Postemployment Benefits (continued)

Annual OPEB costs and Net OPEB obligation (continued)

Actuarial Assumptions

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

Economic Assumptions

Discount Rate

The discount rate considered 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.

Puerto Rico Aqueduct and Sewer Authority
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Notes to Financial Statements (continued)

17. Other Postemployment Benefits (continued)

Disability Table

The Hunter disability table was used for the valuation.

Actuarial Cost Method

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

Amortization of Initial UAAL

Period

The initial UAAL will be amortized in a 12-year period based on the average future years of service of the active population, starting on fiscal year ended June 30, 2009. 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.

18. Labor Union Contracts

The collective bargaining agreement with the HIEPAAA union, which covers approximately some 200 professional employees, was signed effective June 1, 2005 until May 31, 2009. On August 22, 2009, the agreement was extended up to May 31, 2010.

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, 2009, the contract was in process of being formalized and signed by the parties.

Puerto Rico Aqueduct and Sewer Authority
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Notes to Financial Statements (continued)

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

During fiscal year 2001, Thames-Dick Superaqueduct Partners and the Authority signed a contract for the operation and maintenance of the water intakes and the interconnections tanks with the Authority distribution system, along the PR North Coast route, from Arecibo to Bayamon (Superaqueduct). The contract also includes the operation of a filter plant. Thames-Dick is responsible for the operation, maintenance, security, and for the environmental and regulatory compliance (water quality) for all the operations under the contract. All costs associated with the contract (\$25.5 million and \$23 million for the years ended June 30, 2009 and 2008, respectively) are reported under the caption of *Service contract – Superaqueduct* in the accompanying statements of revenues, expenses, and changes in net assets.

20. Commitments and Contingencies

Environmental Matters

Facilities and operations of the Authority's water and sewer system are subject to 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 million which was paid during fiscal year 2008. In accordance with the consent decree, the Authority had to deposit in an escrow account with GDB, approximately \$3 million payable in four payments over two years starting on December 1, 2006. As of June 30, 2009, the Authority has deposited the total required amount of \$3 million 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.

Puerto Rico Aqueduct and Sewer Authority
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Notes to Financial Statements (continued)

20. Commitments and Contingencies (continued)

Environmental Matters (continued)

On May 25, 2006, the Authority entered into a plea agreement with the U. S. Department of Justice related to violations of the Clean Water Act, Title 33, USC, Sections 11311(a) and 1319(c)(2)(A). As part of the agreement, the Authority agreed to pay a \$9 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 million as a result of this plea agreement. As of June 30, 2008, the outstanding balance of the accrued liability was \$5.4 million. 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 León Avenue area of San Juan for a cost of not less than \$10 million to prevent direct discharges to the Martin Peña Channel, (ii) upgrade nine waste water treatment plants for a cost not less than \$109 million, and (iii) comply with 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 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 approximately \$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 approximately \$2.7 million for penalties for noncompliance as stipulated by the final agreement, which were paid during fiscal year 2009. also, as part of the penalties for noncompliance with the remedial measures of the agreement with the Department of Health during fiscal year 2009, a \$1.3 million has to be deposited in an escrow account in three installments. The first payment of \$.5 million was made on August 21, 2009 and the remaining two payments of \$.4 million each, has to be deposited on September, 2009 and October, 2009, respectively. The amount of \$1.3 million was accrued as of June 30, 2009.

Puerto Rico Aqueduct and Sewer Authority
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Notes to Financial Statements (continued)

20. Commitments and Contingencies (continued)

Environmental Matters (continued)

On November 2007, the Authority entered into negotiation of a consent decree with EPA that requires the Authority to implement system wide remedial measures at all of the sludge treatment systems at the water treatment plants owned and operated by the Authority. The consent decree will establish deadlines for the compliance with the conditions set forth in the proposed agreement and stipulates penalties for violation of any of those deadlines. The Authority will be assessed a penalty of \$3.2 million which will be paid during fiscal year 2009-2010. In accordance with this consent decree, the Authority will have to pay a civil penalty of approximately \$1 million to the Treasurer of the United States of America and will have to deposit in an escrow account with GDB, \$2.2 million. The Authority has accrued this liability as of June 30, 2009. These funds will be used for the implementation of a Supplemental Environmental Project. One of the projects that are being discussed is to restructure (provide aeration) Lake Cidra and Lake Toa Vaca.

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, 2009.

Puerto Rico Aqueduct and Sewer Authority
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Notes to Financial Statements (continued)

20. Commitments and Contingencies (continued)

Risk Management

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

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

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

Puerto Rico Aqueduct and Sewer Authority
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Notes to Financial Statements (continued)

20. Commitments and Contingencies (continued)

Construction Projects

The Authority enters in construction projects for the replacements or expansion of its facilities. As of June 30, 2009, there were outstanding commitments for projects in process for approximately \$447.1 million.

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 approximately \$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.

Operating Leases

Certain commercial offices and warehouse facilities of the Authority are leased under operating lease agreements. During the years ended June 30, 2009 and 2008, the Authority incurred approximately \$4.9 million and \$4.8 million, respectively, in rent expense.

Puerto Rico Aqueduct and Sewer Authority
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Notes to Financial Statements (continued)

20. Commitments and Contingencies (continued)

Operating Leases (continued)

Future minimum noncancelable lease payments on existing operating leases at June 30, 2009, which have an initial term of one year or more, are as follows (in thousands):

2010	\$ 1,877
2011	1,220
2012	823
2013	705
2014	237
2015 – 2019	719
2020 – 2024	256
	<hr/> <u>\$ 5,837</u>

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 approximately \$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.

21. Subsequent Events

On September 24, 2009, the Authority issued \$15 million of Series GG of USDA Rural Development Program Bonds, at 4.25% of interest payable semiannually and maturing in semiannual installments through July 1, 2049. The funds raised by this issuance were used to partially repay the outstanding balance of USD Rural Development Program lines of credit for construction projects from GDB. The payment of principal and interest on these bonds is guaranteed by the Commonwealth.

Puerto Rico Aqueduct and Sewer Authority
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Notes to Financial Statements (continued)

22. Restatement of 2008 Financial Statements

During the year ended June 30, 2009, management of the Authority determined that its June 30, 2008 construction in progress, operating expenses and net assets at beginning of year were overstated by \$15,005, \$2,218 and \$17,223, respectively.

In addition, management of the Authority also determined that the components of net assets in the 2008 balance sheet were not properly classified.

The effect of the restatement on balances as of and for the year ended June 30, 2008 is as follows:

	Balance Before Restatement	Construction in Progress Restatement	Restated Balance
Construction in progress	\$1,388,470	\$15,005	\$1,373,465
Net assets at beginning of year	2,237,984	17,223	2,220,761
Payroll and payroll related	295,692	126	295,566
Professional and consulting services	31,108	12	31,096
Materials and replacements	16,399	585	15,814
Repairs and maintenance of capital assets	32,190	1,049	31,141
Other operating expenses	96,201	446	95,755

Puerto Rico Aqueduct and Sewer Authority
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Notes to Financial Statements (continued)

22. Restatement of 2008 Financial Statements (continued)

The net assets balances by category were reclassified for the year ended June 30, 2008 as follow:

	Balance Before Restatement	Reclassification Restatement	Construction in Progress Restatement	Restated Balance
Net assets:				
Invested in capital assets, net of related debt	\$2,955,388	\$ 33,009	\$15,005	\$2,907,374
Restricted for environmental compliance, capital activity and other	12,024	-	-	12,024
Unrestricted	(596,539)	(33,009)	-	(563,530)
Total net assets	<u>\$2,370,873</u>	<u>\$ -</u>	<u>\$15,005</u>	<u>\$2,355,868</u>

Required Supplementary Information

Schedule

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

Required Supplementary Information
Schedule of Funding Progress for Postemployment Healthcare Benefits

(In thousands)

<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, 2008	\$ —	\$ 45,629	\$ 45,629	—%	\$ 167,959	27%

See accompanying independent auditors' report.