

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

Audited Financial Statements

Years Ended June 30, 2012 and 2011

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Report of Independent Auditors

The Board of Directors
Puerto Rico Aqueduct and Sewer Authority

We have audited the accompanying balance sheets of the Puerto Rico Aqueduct and Sewer Authority, a component unit of the Commonwealth of Puerto Rico (the Authority), as of June 30, 2012 and 2011, and the related statements of revenues, expenses and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the Authority's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Puerto Rico Aqueduct and Sewer Authority at June 30, 2012 and 2011, and the changes in its financial position and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated February 1, 2013, on our consideration of the Puerto Rico Aqueduct and Sewer Authority's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Accounting principles generally accepted in the United States require that the management's discussion and analysis on pages 3 through 21 and the schedule of funding progress on page 78 be presented to supplement the financial statements. Such information, although not a part of the financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the financial statements in an appropriate operational, economic or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the financial statements, and other knowledge we obtained during our audit of the financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Ernst & Young LLP

February 1, 2013

Stamp No. 2659368
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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

Year Ended June 30, 2012

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, 2012, 2011 and 2010. Please read it in conjunction with the Authority's financial statements, which follow this section.

June 30, 2012 and 2011 Financial Highlights

- The Authority's net assets increased by \$64.5 million to \$2,998.9 million, or 2.2%, which represents an increase of \$176.7 million when compared to the 2010 decrease in net assets of \$112.7 million. The increase was primarily as the net result of an increase in operating revenues of \$4 million, an increase of total operating expenses, including depreciation and amortization, of \$101.2 million, a decrease in nonoperating expenses of \$256.1 million, and an increase in capital contributions of \$17.8 million.
- Operating revenues increased by \$4 million to \$813.2 million, or 1.0%, due to an increase in water and sewer revenues of \$23.8 million, an increase in the provision for bad debts of \$5.0 million and a decrease of \$14.7 million from appropriations received from the Central Government.
- Operating expenses, including depreciation and amortization, increased by \$101.2 million to \$949.9 million, or 11.9%, primarily as a result of an increase in payroll and related expenses of \$24.6 million, an increase in repairs and maintenance expenses of \$3.3 million, an increase in electricity expenses of \$43.6 million, an increase of other operating expenses of \$41.9 million, an increase in chemical expenses of \$6.1 million, an increase in depreciation and amortization expense of \$10.1 million, a decrease of the service contract of the Superaqueduct of \$22.7 million as a result of the Authority reassuming control of its operations, a decrease of professional and consulting services of \$2.4 million, and a decrease in materials and replacements of \$3.7 million.
- Non operating revenues and (expenses) increased by \$256.1 million to \$149.2 million, primarily as a result of an increase of \$319.6 million for a contribution from 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 Commonwealth Appropriations Bonds, a loss of \$15.6 million on COFINA debt redemption, a decrease of \$38.5 million of Commonwealth contributions for interest payments of bonds and notes, and an increase of \$13.1 million in interest expense, net of amortization of debt issuance cost, bond premium and discount, and deferred refunding losses.

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

June 30, 2012 and 2011 Financial Highlights (continued)

- Capital contributions increased by \$17.8 million to \$52.1 million, primarily as a result of an increase of \$20.1 million in federal grants received from Rural Development.
- Total assets increased by \$856.6 million to \$8,597.6 million or 11.1%, primarily due to an increase in current assets of \$54.7 million, increase in non current assets of \$645.8 million as a result of the proceeds of 2012 Series A and B Revenue Bonds, other assets for the amount of \$9.2 million and an increase of \$146.8 million in the Authority's capital assets. Total liabilities increased by \$792.1 million to \$5,598.7 or 16.5%, primarily as a result of an increase in long term debt of \$790.1 million.

June 30, 2011 and 2010 Financial Highlights

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

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

Overview of the Financial Statements

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

Financial Analysis of the Authority

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

Analysis of Financial Results

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

	June 30		Change
	2012	2011	
Current and other assets	\$ 1,238,818	\$ 529,006	\$ 709,812
Capital assets, net	<u>7,358,802</u>	<u>7,212,020</u>	146,782
Total assets	<u>8,597,620</u>	<u>7,741,026</u>	856,594
Long-term debt outstanding	5,055,030	4,264,882	790,148
Other liabilities	<u>543,675</u>	<u>541,732</u>	1,943
Total liabilities	<u>5,598,705</u>	<u>4,806,614</u>	792,091
Net assets:			
Invested in capital assets, net of related debt	3,205,651	3,374,252	(168,601)
Restricted	26,186	24,482	1,704
Unrestricted deficit	<u>(232,922)</u>	<u>(464,322)</u>	231,400
Total net assets	<u>\$ 2,998,915</u>	<u>\$ 2,934,412</u>	\$ 64,503

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

Analysis of Financial Results (continued)

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

Net Assets

June 30, 2012 and 2011

The Authority's net assets as of June 30, 2012 were approximately \$2,998.9 million. This is an increase of \$64.5 million from the net assets as of June 30, 2011 of \$2,934.4 million.

Total assets increased by \$856.6 million during the fiscal year ended June 30, 2012.

Restricted cash and unrestricted cash and cash equivalents as of June 30, 2012, increased by \$645.3 million when compared with June 30, 2011. The increase is primarily due to deposits made to restricted accounts of the net proceeds from the issuance of 2012 Series A and B Revenue Bonds and Series HH Rural Development Bonds.

Accounts receivable, net, increased by \$9.9 million primarily due the net effect of a an increase of \$38.5 million in accounts receivable from water and sewer services customers, an increase of \$2.4 million in other receivables, reduced for an increase in the allowance for doubtful accounts of \$30.9 million.

Receivable from Commonwealth for the amount of \$51.8 million as of June 30, 2012, represents proceeds from PFC 2011 Series A, 2011 Series B and 2012 Series A Refunding Bonds that will be used by the Commonwealth to pay interest on bonds.

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

Net Assets (continued)

June 30, 2012 and 2011 (continued)

Capital Assets increased by \$146.8 million due to net current year additions and retirements of \$340.4 million offset by current year depreciation and amortization including retirements of \$193.5 million

Total liabilities increased by \$792.1 million. This is primarily due to a net increase of \$790.1 million in long-term debt outstanding. Bonds payable increased by \$1,915.4 million. This represents the net effect of (1) issuance of bonds, (2) payment of principal, (3) amortization of premium, discount and deferred refunding losses, and (4) defeasance of PFC Bonds by the issuance of COFINA Series C Refunding Bonds. Notes payable decreased for the amount of \$205.1 million and lines of credit decreased for the amount of \$920.1 million. Decrease in notes payable and lines of credits is mainly due to the payment of commercial loan and certain lines of credit with the proceeds of 2012 Series A and B Revenue Bonds.

An increase of \$1.9 million in other current and noncurrent liabilities is primarily due to a net effect of a decrease of \$17.8 million in accounts payable, a decrease in accrued liabilities of \$11.4 million, an increase in accrued interest of \$26.7 million, and an increase of \$4.4 million in unearned revenues, accrued compensated absences and customer deposits.

June 30, 2011 and 2010

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

Unrestricted and restricted cash and cash equivalents as of June 30, 2011, increased by \$74.3 million when compared with June 30, 2010. The increase is primarily due to deposits made to restricted accounts to pay debt service and reimbursement of funds requested for payment of capital projects. Accounts receivable, net, decreased by \$29.1 million primarily due the net effect of a decrease of \$1.7 million in accounts receivable from water and sewer services customers and an increase in the allowance for doubtful accounts of \$27.4 million.

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

Net Assets (continued)

June 30, 2011 and 2010 (continued)

Total liabilities increased by \$286.7 million. This is primarily due to an increase of \$312.1 million in long-term debt outstanding, mainly representing the net effect of an (1) increase in lines of credit of \$278.7 million, (2) an increase in notes payable of \$34.7 million (3) a decrease in bonds payable of \$1.2 million.

A decrease of \$25.4 million in other current and noncurrent liabilities is primarily due to an increase of \$16 million in accounts payable, a decrease in accrued liabilities of \$22.1 million, a decrease in accrued interest of \$20.3 million, and an increase of \$1 million in unearned revenues, accrued compensated absences and customer deposits.

Capital Assets

Capital assets as of June 30, 2012 and 2011 were as follows (in thousands):

	June 30		Change
	2012	2011	
Capital assets being depreciated	\$ 8,677,917	\$ 8,276,363	\$ 401,554
Accumulated depreciation and amortization	(3,036,651)	(2,843,090)	(193,561)
	<u>5,641,266</u>	<u>5,433,273</u>	<u>207,993</u>
Land and other nondepreciable assets	69,931	66,851	3,080
Construction in progress	1,647,605	1,711,896	(64,291)
Capital assets, net	<u>\$ 7,358,802</u>	<u>\$ 7,212,020</u>	<u>\$ 146,782</u>

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

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

Capital Assets (continued)

June 30, 2012 and 2011

The net increase of \$146.8 million in capital assets includes additions of \$390.5 million, reduced by \$210.6 million in depreciation and amortization and \$33.1 million in net retirements. The \$390.5 million in capital investment is broken down as follows:

- \$358.4 million in the Authority's capital improvement program;
- \$ 32.1 million in renewal and replacement projects;

The Authority has approximately \$1,647.6 million in construction in progress as of June 30, 2012, and has construction commitments of approximately \$191.3 million.

June 30, 2011 and 2010

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

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

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

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

Debt Administration

Long-term debt for the years ended June 30, 2012 and 2011 was as follows (in thousands):

	June 30		Change
	2012	2011	
Bonds payable:			
2001 Series A PFC Commonwealth Appropriation Bonds	\$ -	\$ 8,985	\$ (8,985)
Act 164 PFC Commonwealth Appropriation Bonds	-	341,565	(341,565)
2004 Series A PFC Commonwealth Appropriation Bonds	-	326,785	(326,785)
2011 Series A PFC Commonwealth Appropriation Bonds	90,099	-	90,099
2011 Series B PFC Commonwealth Appropriation Bonds	102,183	-	102,183
2011 Series B PFC Commonwealth Appropriation Bonds (SA)	162,700	-	162,700
2012 Series A PFC Commonwealth Appropriation Bonds	56,247	-	56,247
Revenue Bonds:			
2008 Series A Serial Bonds	93,155	93,155	-
2008 Series A Convertible Capital Appreciation Bonds	155,975	155,975	-
2008 Series A Term Bonds	1,095,125	1,095,125	-
2008 Series B Serial Bonds	22,445	22,445	-
2008 Series A and B Revenue Refunding Term Bonds	284,755	284,755	-
2012 Series A Serial Bonds	418,455	-	418,455
2012 Series A Term Bonds	1,381,995	-	1,381,995
2012 Series B Serial Bonds	188,130	-	188,130
2012 Series B Term Bonds	107,115	-	107,115
Rural Development Serial Bonds	368,511	306,030	62,481
Add premium on bonds refunding	27,762	34,609	(6,847)
Less :			
Bond discount	(16,547)	(15,805)	(742)
Deferred loss from refunding	(42,907)	(73,884)	30,977
Total bonds	<u>\$ 4,495,198</u>	<u>\$ 2,579,740</u>	<u>\$ 1,915,458</u>

(Continued)

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

Debt Administration (continued)

	June 30		Change
	2012	2011	
Bonds payable	\$ 4,495,198	\$ 2,579,740	\$ 1,915,458
Notes payable:			
Water Pollution Control and Drinking Water Treatment Revolving Funds Loans	450,044	413,449	36,595
Notes with commercial banks	-	241,744	(241,744)
Total notes	<u>450,044</u>	<u>655,193</u>	<u>(205,149)</u>
Lines of credit	<u>109,788</u>	<u>1,029,949</u>	<u>(920,161)</u>
Long-term debt outstanding	<u>5,055,030</u>	<u>4,264,882</u>	<u>790,148</u>
Other long term liabilities:			
Accrued compensated absences	45,271	46,442	(1,171)
Net OPEB obligation	22,652	17,148	5,504
Early retirement obligation	886	2,308	(1,422)
Customer deposits	<u>80,976</u>	<u>80,098</u>	<u>878</u>
Total other liabilities	<u>149,785</u>	<u>145,996</u>	<u>3,789</u>
Total – long-term obligations	<u>5,204,815</u>	<u>4,410,878</u>	<u>793,937</u>
Current portion	<u>60,102</u>	<u>322,942</u>	<u>(262,840)</u>
Long-term obligations, less current portion	<u>\$ 5,144,713</u>	<u>\$ 4,087,936</u>	<u>\$ 1,056,777</u>

The Authority's long-term debt increased by \$790.1 million from \$4,264.8 million as of June 30, 2011, to \$5,055 million as of June 30, 2012.

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

Debt Administration (continued)

June 30, 2012

Bonds Payable

Bonds outstanding as of June 30, 2012 increased by \$1,915.4 million, mainly from the net effect of issuance of \$2,577.1 principal amounts of new bonds, payment of principal on outstanding bonds of approximately \$685.1 million, a decrease of \$6.8 million in bonds premiums, and a decrease of \$30.2 million in bonds discounts and deferred refunding losses, net of amortization.

The bonds issued during fiscal year 2012 for \$2,557.1 million primarily include (1) 2012 Series A and B Revenue Bonds issued on February 29, 2012 for the par amount of \$2,095.7 million for the purpose of pay off certain lines of credit and commercial loans, establish reserves for debt service and operating costs, and establish a construction fund for the capital improvement program, (2) Series HH of the Rural Development Serial Bonds for the amount of \$70.2 million for the purpose to pay interim lines of credit with GDB and establish a construction fund to complete the capital projects under construction, and (3) 2011 Series A, 2011 Series B, and 2012 Series A Series PFC Refunding Bonds for the amount of \$411.2 million to refinance 2001 Series C, 2003 Series A, 2004 Series A and B PFC Bonds.

On December 13, 2011, COFINA issued 2011 Series C Sales Tax Revenue Bonds to refinance certain series of Act 164 and others PFC Bonds outstanding and retired various notes issued to PFC by certain agencies and component units of the Commonwealth (including the Authority). Proceeds were used to purchase, cancel or deposit in an escrow to advance refund the Authority's share of the Act 164 and other PFC Bonds. This transaction had a net effect of \$304.0 million and was presented as a contribution from COFINA in the Statement of Revenues and Expenses for the period ended June 30, 2012. The liability was considered defeased or cancelled and was removed from the Authority's balance sheet as of June 30, 2012.

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, 2012, the Authority's loans outstanding under these programs amounted to approximately \$450.0 million. These loans increased approximately \$36.6 million due to the net effect of drawings of approximately \$54.9 million for payment of capital improvements and payment of principal on loans outstanding of approximately \$18.3 million.

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

Debt Administration (continued)

June 30, 2012 (continued)

Notes Payable

On September 8, 2006, the Authority entered into a term loan agreement with various commercial banks amounting to \$250 million to repay various lines of credit with Government Development Bank (GDB) and to pay the costs associated with the loan. The outstanding balance of the loan was paid on January 17, 2012 with the issuance of 2012 Series A Bond Anticipation Notes (BAN) from Bank of America and Merrill Lynch for the amount of \$241.0 million.

The proceeds of 2012 Series A and B Revenue Bonds were used in part to repay the 2012 Series A Bond Anticipation Notes.

Lines of Credit

On August 16, 2011, the Authority entered into an Asset Purchase Agreement with the Puerto Rico Industrial, Tourism, Educational, Medical and Environmental Facilities Financing Authority (AFICA), a public corporation of the Commonwealth of Puerto Rico to purchase certain assets that were being used to develop the Southern Gas Pipeline Project for the total purchase price of approximately \$23.5 million and assumed the rights and obligations of PREPA (Puerto Rico Electric Power Authority) under a Subordinated Loan Agreement between AFICA and PREPA and a Subordinated Note and Loan Agreement of approximately \$31.0 million. On February 29, 2012 this line of credit was paid in full with the proceeds of 2012 Series A and B Revenue Bonds.

On February 29, 2012, the Authority entered into non revolving line of credit with GDB for the purpose of assisting with the Authority's cash flow needs during the transition period after amending and restating the Trust Agreement after the issuance of 2012 Series A and B Revenue Bonds. As of June 30, 2012, approximately \$72.3 million under this line of credit was outstanding.

The existing \$70.0 million line of credit with GDB used to provide funding for the capital improvement program of the Authority had an outstanding balance as of June 30, 2012 of approximately \$37.4 million.

The outstanding balance as of December 31, 2011 of \$269.0 million, \$87.6 million, \$125.0 million, \$150.0 million, \$200.0 million, and \$250.0 million lines of credit were paid in full with the proceeds of 2012 Series A and B Revenue Bonds on February 29, 2012.

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

Debt Administration (continued)

June 30, 2012 (continued)

Notes Payable

The \$125.0 million revolving line of credit with GDB for the purpose of financing the operating reserve, required by the Master Agreement of Trust securing its revenue bonds, had no outstanding balance as of June 30, 2012.

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

June 30, 2011

Bonds Payable

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

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

Notes Payable

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

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

Debt Administration (continued)

June 30, 2011 (continued)

Notes Payable (continued)

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

Lines of Credit

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

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

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

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

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

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

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, 2012 and 2011 (in thousands):

	Years Ended June 30		Change
	2012	2011	
Operating revenue:			
Revenues from water and sewer, net	\$ 742,891	\$ 724,108	\$ 18,783
Central Government appropriations	70,264	85,000	(14,736)
Total operating revenues	<u>813,155</u>	<u>809,108</u>	4,047
Operating expenses:			
Payroll and payroll related expenses	275,613	250,968	24,645
Service contract – Superaqueduct	5,813	28,473	(22,660)
Professional and consulting services	31,707	34,138	(2,431)
Chemicals	35,577	29,453	6,124
Materials and replacements	12,387	16,110	(3,723)
Repairs and maintenance of capital assets	48,668	45,405	3,263
Electricity	200,195	156,583	43,612
Insurance	9,687	9,276	411
Other operating expenses	<u>119,147</u>	<u>77,248</u>	41,899
Operating expenses (excluding depreciation and amortization)	738,794	647,654	91,140
Depreciation and amortization	<u>211,127</u>	<u>201,037</u>	10,090
Total operating expenses	<u>949,921</u>	<u>848,691</u>	101,230
Operating loss	(136,766)	(39,583)	(97,183)
Nonoperating revenues (expenses), net	<u>149,173</u>	<u>(106,910)</u>	256,083
Income (loss) before capital contributions	12,407	(146,493)	158,900
Capital contributions	<u>52,096</u>	<u>34,275</u>	17,821
Increase (decrease) in net assets	64,503	(112,218)	176,721
Net assets at beginning of year	<u>2,934,412</u>	<u>3,046,630</u>	(112,218)
Net assets at end of year	<u>\$ 2,998,915</u>	<u>\$ 2,934,412</u>	\$ 64,503

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

Management's Discussion and Analysis (continued)

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

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

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

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

Management's Discussion and Analysis (continued)

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

June 30, 2012 and 2011

Net assets increased by \$64.5 million, from \$2,934.4 million in 2011 to \$2,998.9 million in 2012, due to the results of current year operations.

Major fluctuations that resulted in an increase in net assets of \$176.7 million when compared to 2011 operational results are broken down as follows (in thousands):

Increase in operating revenues	\$ 4,047
Increase in operating expenses	(101,230)
Increase in nonoperating revenues (expenses), net	256,083
Increase in capital contributions	<u>17,821</u>
Net change	<u>\$ 176,721</u>

Operating revenues increased by \$4.0 million for fiscal year ended June 30, 2012 when compared fiscal year ended June 30, 2011. The increase is a net effect of an increase in water and sewer billed of \$23.8 million, a decrease in the provision for bad debt of \$14.7 million and a decrease of \$5.0 million from appropriations received from the Commonwealth during the fiscal year ended June 30, 2012.

Operating expenses increased by \$101.2 million primarily due to the net effect of the following:

- An increase of \$43.6 million in electricity expenses.
- An increase of \$41.9 million in other operating expenses.
- An increase of \$24.6 million in payroll and payroll related expenses.
- An increase of \$10.1 million in depreciation and amortization expense.
- An increase of \$6.1 million in chemical expenses.
- An decrease of \$3.7 million in material and replacements expenses
- A decrease of \$22.6 million in Service Contract – Superaqueduct expenses.

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)

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

June 30, 2012 and 2011 (continued)

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

Actually, the Authority has an agreement with Caribbean Water Specialist Corp. and pays a management fee for the operation of the North Coast Aqueduct. This amount is reported under the caption of *Service Contract - Superaqueduct*. All other operational cost considered as pass-through cost under the Thames-Dick Agreement (electricity, chemicals, etc.) associated with the operation of the system were captioned in their respective expense category.

Nonoperating revenues (expenses) increased by \$256.1 million when compared with previous fiscal year. This is primarily the net effect of contributions received from COFINA for \$319.6 million to purchase and cancel or legally defease a portion of the Authority's share of certain series of the Act 164 and 2004 Series A PFC Bonds, a loss of \$15.6 million of PFC bonds redemption, an increase of \$13.1 million in interest expense on bonds, notes and lines of credits, a decrease in Commonwealth contributions of \$38.5 million for the payment of principal and interest on outstanding debt, and an increase other income of \$3.6 million.

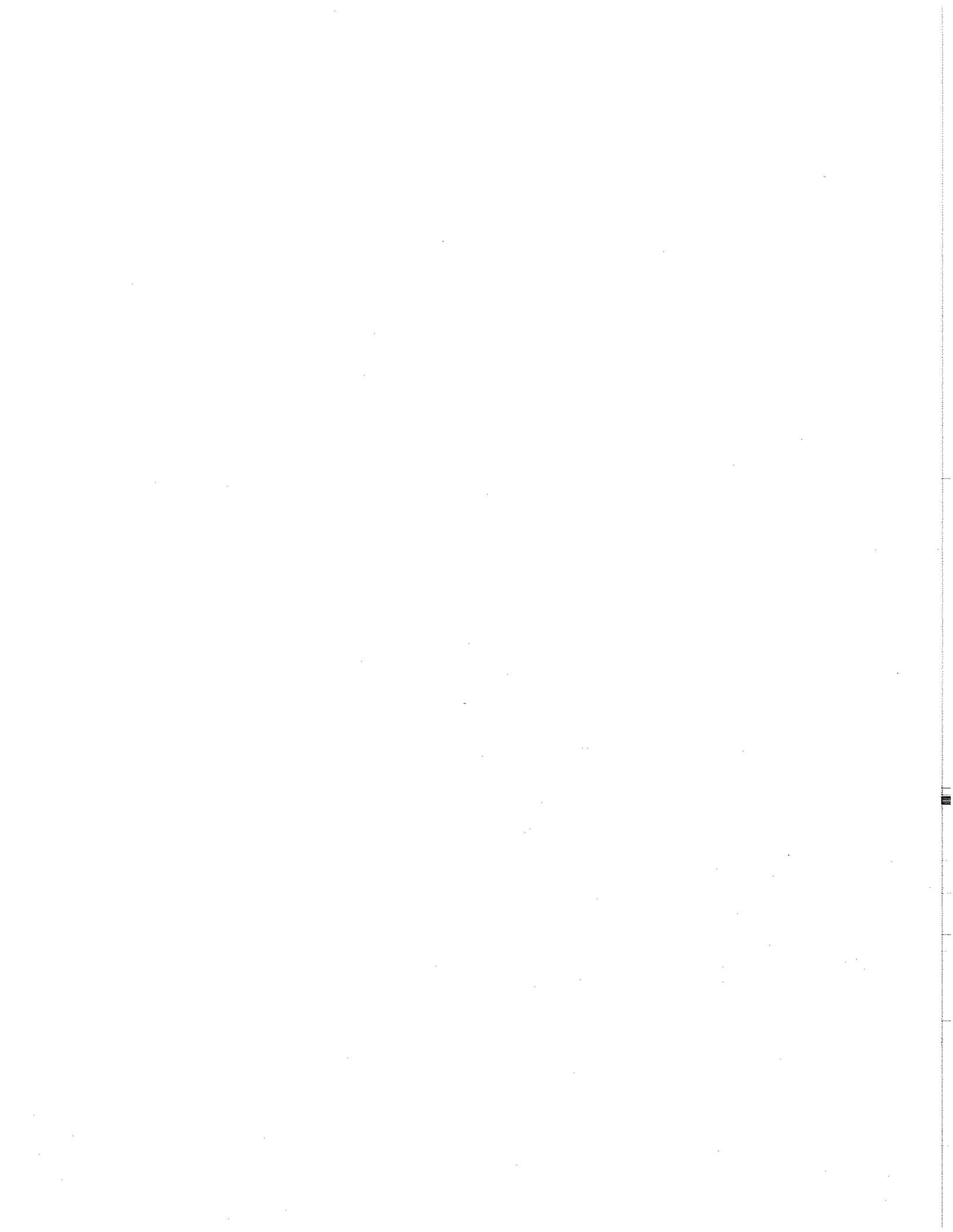
Capital contributions increased by \$17.8 million. This is primarily due to an increase in Rural Development contributions of \$20.1 million and a decrease in other contributions of \$2.3 million.

June 30, 2011 and 2010

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

Major fluctuations that resulted in a decrease in net assets of \$943.0 million when compared to 2010 operational results are broken down as follows (in thousands):

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



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

Management's Discussion and Analysis (continued)

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

June 30, 2011 and 2010 (continued)

Operating revenues increased by \$96.3 million as a result of a decrease in water and sewer billed of \$19.8 million, a decrease in the provision for bad debt of \$31.2 million and an increase of \$85.0 million from appropriations received from the Commonwealth during the fiscal year ended June 30, 2011.

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

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

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

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

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

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

Balance Sheets
(In thousands)

	June 30	
	2012	2011
Assets		
Current assets:		
Cash and cash equivalents	\$ 62,060	\$ 62,630
Accounts receivable, net	173,584	163,589
Receivables from federal agencies	2,883	3,344
Receivables from Commonwealth	51,816	-
Materials and supplies inventory, net	21,357	28,572
Prepayments and other current assets	7,289	6,130
Total current assets	318,989	264,265
Noncurrent assets:		
Restricted cash and cash equivalents	855,702	209,852
Capital assets:		
Capital assets being depreciated	8,677,917	8,276,363
Accumulated depreciation and amortization	(3,036,651)	(2,843,090)
	5,641,266	5,433,273
Land and other nondepreciable assets	69,931	66,851
Construction in progress	1,647,605	1,711,896
Total capital assets, net	7,358,802	7,212,020
Other assets:		
Deferred debt issuance cost, net of accumulated amortization of \$1,913 and \$12,224 for 2012 and 2011, respectively	64,127	54,889
Total assets	\$ 8,597,620	\$ 7,741,026

(Continued)

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

Balance Sheets (continued)

(In thousands)

	June 30	
	2012	2011
Liabilities and net assets		
Current liabilities:		
Bonds payable	\$ 12,658	\$ 7,815
Notes payable	19,658	260,041
Lines of credit	-	27,770
Accounts payable	145,020	162,858
Accrued liabilities	140,334	151,747
Accrued interest	88,606	61,862
Unearned revenue	19,930	19,269
Customers' deposits	6,408	6,146
Compensated absences and postemployment benefits	21,378	21,170
Total current liabilities	453,992	718,678
Noncurrent liabilities:		
Bonds payable	4,482,540	2,571,925
Notes payable	430,386	395,152
Lines of credit	109,788	1,002,179
Customers' deposits	74,568	73,952
Compensated absences and postemployment benefits	47,431	44,728
Total noncurrent liabilities	5,144,713	4,087,936
Total liabilities	5,598,705	4,806,614
Net assets:		
Invested in capital assets, net of related debt	3,205,651	3,374,252
Restricted for environmental compliance, capital activity and other	26,186	24,482
Unrestricted (deficit)	(232,922)	(464,322)
Total net assets	2,998,915	2,934,412
Total net assets and liabilities	\$ 8,597,620	\$ 7,741,026

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	
	2012	2011
Operating revenues:		
Water	\$ 502,600	\$ 492,847
Sewer	267,726	253,657
Central Government appropriations	70,264	85,000
Bad debt expense	(27,435)	(22,396)
Total net operating revenues	813,155	809,108
Operating expenses:		
Payroll and payroll related	275,613	250,968
Service contract – Superaqueduct	5,813	28,473
Professional and consulting services	31,707	34,138
Chemicals	35,577	29,453
Materials and replacements	12,387	16,110
Repairs and maintenance of capital assets	48,668	45,405
Electricity	200,195	156,583
Insurance	9,687	9,276
Other operating expenses	119,147	77,248
Operating expenses (excluding depreciation and amortization)	738,794	647,654
Depreciation and amortization	211,127	201,037
Total operating expenses	949,921	848,691
Operating loss	(136,766)	(39,583)
Nonoperating revenues (expenses):		
Interest expense, net of amortization of debt issuance cost, bond premium and discount, and deferred refunding loss	(166,134)	(153,068)
Loss on COFINA debt redemption	(15,644)	
COFINA contributions for debt refunding	319,617	-
Commonwealth contributions for principal payments on bonds and notes	-	819
Commonwealth contributions for interest payments on bonds and notes	-	37,749
Interest income	4,670	4,578
Other income	6,664	3,012
Total nonoperating revenues (expenses), net	149,173	(106,910)
Income (loss) before capital contributions	12,407	(146,493)
Capital contributions:		
Federal grants and other contributions	48,327	31,798
Other Commonwealth contributions	3,769	2,477
Total capital contributions	52,096	34,275
Change in net assets	64,503	(112,218)
Net assets at beginning of year	2,934,412	3,046,630
Net assets at end of year	\$ 2,998,915	\$ 2,934,412

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	
	2012	2011
Cash flows from operating activities		
Cash received from customers	\$ 731,126	\$ 748,865
Cash received from Commonwealth	70,264	85,000
Cash paid to suppliers	(489,346)	(380,937)
Cash paid to employees	(276,146)	(254,239)
Net cash provided by operating activities	35,898	198,689
Cash flows from noncapital financing activities		
Proceeds from issuance of bonds	535,245	—
Proceeds from bond anticipation notes	241,000	—
Payments of bond anticipation notes	(241,000)	—
Payments of notes	(241,744)	(2,944)
Debt issuance cost paid	(3,853)	—
Net cash from other income	6,664	3,012
Interest paid on notes and lines of credit	(4,915)	(8,026)
Net cash provided by (used in) noncapital financing activities	291,397	(7,958)
Cash flows from capital and related financing activities		
Additions to utility plant and other capital assets	(321,020)	(350,819)
Proceeds from capital contributions	55,406	39,196
Proceeds from issuance of bonds	1,630,661	—
Proceeds from issuance of notes payable	54,892	74,663
Proceeds from borrowings from lines of credit	266,307	297,069
Proceeds from premium on bonds issuance	22,014	—
Payments of bonds and notes	(35,012)	(31,328)
Payment of lines of credit	(1,216,483)	(37,926)
Debt issuance cost paid	(16,489)	—
Interest paid on bonds, notes and lines of credit	(126,729)	(111,820)
Net cash provided by (used in) capital and related financing activities	313,547	(120,965)
Cash flows from investing activities		
Interest received on investments	4,438	4,578
Net cash provided by investing activities	4,438	4,578
Net increase in cash and cash equivalents	645,280	74,344
Cash and cash equivalents at beginning of year	272,482	198,138
Cash and cash equivalents at end of year	\$ 917,762	\$ 272,482
For purposes of the statement of cash flows, cash and cash equivalents include:		
Unrestricted	\$ 62,060	\$ 62,630
Restricted	855,702	209,852
	\$ 917,762	\$ 272,482

(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	
	2012	2011
Reconciliation of operating loss to net cash provided by operating activities		
Operating loss	\$ (136,766)	\$ (39,583)
Adjustments to reconcile operating loss to net cash provided by operating activities:		
Depreciation and amortization	211,127	201,037
Provision for uncollectible accounts	27,435	22,396
Change in assets and liabilities:		
(Increase) decrease in accounts receivable	(40,739)	1,796
Decrease in accounts receivable from federal agencies	461	73
Decrease (increase) in materials and supplies inventory	7,215	(4,409)
(Increase) in prepayments and other current assets	(1,159)	(260)
(Decrease) increase in accounts payable	(24,713)	38,752
Increase in unearned revenue	661	307
Increase in accrued compensated absences and early retirement obligation	2,911	468
Decrease in accrued liabilities	(11,413)	(22,146)
Increase in customers' deposits	878	258
Total adjustments	<u>172,664</u>	<u>238,272</u>
Net cash provided by operating activities	<u>\$ 35,898</u>	<u>\$ 198,689</u>
Noncash noncapital financing activities		
Amortization of debt issuance cost	\$ 83	\$ 332
Noncash capital and related financing activities		
Net additions to utility plant and other capital assets	36,890	22,757
Write-off of capital contributions	3,310	4,922
Refunding of PFC bonds by Commonwealth	411,229	-
Issuance cost related to debt issuance	4,232	-
Premium cost related to debt issuance	6,127	-
Defeasance of debt related to PFC refunding bonds	668,350	-
Net increase in refunding loss from PFC bonds transactions	19,556	-
Cancellation of principal on lines of credit by Commonwealth	30,014	-
Capitalized interest on PFC refunding bonds held by the Commonwealth	50,732	-
Amortization of:		
Debt issuance cost	(1,031)	1,996
Bond premiums and discounts	1,907	1,269
Deferred refunding loss	3,229	5,561
Write-off of debt issuance cost, and deferred refunding loss related to COFINA debt refunding.	63,589	-
Write-off of premium related to COFINA debt refunding	33,824	-
COFINA contribution for debt refunding	319,617	-
Loss on COFINA debt redemption	15,644	-
Accretion of interest on capital appreciation bonds	-	9,132
Principal paid by the Commonwealth	-	819
Interest paid by the Commonwealth	11,111	37,749

See accompanying notes.

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

Notes to Financial Statements

June 30, 2012

1. Reporting Entity and Summary of Significant Accounting Policies

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

Summary of Significant Accounting Policies

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

Measurement Focus and Basis of Accounting

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

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

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.

The Authority maintains some construction fund accounts related to past bond issuances invested in mutual funds. As of June 30, 2012 and 2011, the account balances amounted to approximately \$33.8 million and \$17.9 million, respectively. The accounts are held under the Puerto Rico Government Investment Trust Fund (the Trust Fund), a collective investment trust created by the Secretary of the Treasury of Puerto Rico as settler and the Government Development Bank of Puerto Rico as trustee. The Trust Fund seeks to maintain a constant net asset value per unit of \$1 through investment in high-grade short term money market instruments with a dollar-weighted average portfolio maturity of less than 60 days, including, but not limited to, obligations of the U.S. Government, the Puerto Rico Government, their respective agencies and instrumentalities, repurchase agreements with respect to obligations of the U.S. Government, certificates of deposit, time deposits, bank notes and banker's acceptances issued by the U.S. or Puerto Rico regulated banks, commercial paper and corporate obligations. The Authority can invest, reinvest or redeem units acquired at any time without charge or penalty.

The Trust Fund values its investments on the basis of amortized cost. Although the Trust Fund's policies are designed to help maintain a stable net asset value per unit of \$1, all money market instruments can change in value when interest rates or issuers' creditworthiness change, or if an issuer or guarantor of a security fails to pay interest or principal when due. As of June 30, 2012 and 2011 the net asset value per unit of the Trust Fund was \$1.

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)

Restricted Assets

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

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

Receivables

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

Materials and Supplies Inventory

Materials and supplies inventory is stated at average cost, not to exceed market. Inventory is presented net of a reserve for obsolescence totaling approximately \$3.9 million and \$3.8 million as of June 30, 2012 and 2011 respectively.

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

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

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

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

Capital Assets

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

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)

Utility plant and other capital assets are carried at historical cost or estimated historical 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, 2012 and 2011 amounted to approximately \$70.0 million and \$67.2 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.

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

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

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

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

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)

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

Unearned Revenue

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

Accounting for Compensated Absences

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

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

Postemployment Health Benefits

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

The Authority has the obligation to contribute a maximum of \$125 monthly per retired employee for coverage under the medical plan. The Authority accounts for its postretirement healthcare benefits in accordance with GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions*, as detailed in Note 17.

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

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

Postemployment Health Benefits (continued)

The Authority maintains an Early Retirement Program established during fiscal year 2002, which provides for a monthly payment to certain retired employees to cover healthcare premiums for a maximum of \$280 per month, up to the age of seventy (70) years or for a maximum of ten (10) years, whichever occurs first. The present value of future healthcare benefit contributions for these early retired employees is accrued and reported as a liability in the accompanying balance sheets. As of June 30, 2012 and 2011, the accrued liability for early retirement amounted to approximately \$0.9 million and \$2.3 million, respectively.

The total cost of healthcare benefits paid to retired employees amounted to approximately \$3.8 million and \$3.6 million for 2012 and 2011 respectively.

Pension Benefits

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

Net Assets

Net assets are reported in three categories:

- ▶ ***Invested in Capital Assets, Net of Related Debt*** – These consists of capital assets, net of accumulated depreciation and amortization and reduced by outstanding balances for bonds, notes, and other debt that are attributed to the acquisition, construction, or improvement of those assets. Debt pertaining to significant unspent debt proceeds is not included in the calculation of invested in capital assets, net of related debt.
- ▶ ***Restricted Net Assets*** – These result when constraints, on the use of net assets are either externally imposed by creditors, grantors, contributors, and the like, or imposed by law through constitutional provisions or enabling legislation. At June 30, 2012 and 2011, 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 that can be removed or modified.

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

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

Use of Estimates

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

Future Adoption of Accounting Standards

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

<u>GASB Statement</u>	<u>Adoption required in fiscal year</u>
60	Accounting and Financial Reporting for Service Concession Arrangements 2013
61	Accounting and Financial Reporting Entity: Omnibus, an amendment of GASB Statements No. 14 and No. 34 2013
62	Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements 2013
63	Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources and Net Position 2013
65	Items Previously Reported as Assets and Liabilities 2014
66	Technical Corrections-2012, an amendment of GASB Statements No. 10 and No. 62 2014
67	Financial Reporting of Pension Plans - an amendment of GASB Statement No. 77 2014
68	Accounting and Financial Reporting for Pensions - an amendment of GASB Statement No. 27 2015

The impact of these standards has not yet been determined.

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

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

Effects of New Pronouncements

In December 2009, GASB issued Statement No. 57, *OPEB Measurements by Agent Employers and Agent Multiple Employers Plan*. The objective of this Statement is to address issues related to the use of the alternative measurement method and the frequency and timing of measurements by employers that participate in agent multiple-employer other postemployment benefit (OPEB) plans (that is, agent employers). The Authority adopted the provisions of GASB Statement No. 57 during the year ended June 30, 2012. The adoption of GASB Statement No. 57 had no impact on the Authority.

Commonwealth Appropriations

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

2. Deposits

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

	June 30			
	2012		2011	
	Carrying amount	Bank balance	Carrying amount	Bank balance
Unrestricted deposits in commercial banks in Puerto Rico	\$ 62,060	\$ 104,721	\$ 62,630	\$ 69,047
Restricted deposits in commercial banks in Puerto Rico	695,070	695,070	166,930	166,930
Restricted deposits in governmental banks:				
GDB	58,036	58,036	41,208	41,208
EDB	102,596	102,596	1,714	1,714
Total	<u>\$ 917,762</u>	<u>\$ 960,423</u>	<u>\$ 272,482</u>	<u>\$ 278,899</u>

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

2. Deposits (continued)

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

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 banks as follows (in thousands):

	June 30	
	2012	2011
Uninsured and uncollateralized:		
GDB	\$ 58,036	\$ 41,208
EDB	102,596	1,714
	\$ 160,632	\$ 42,922

Puerto Rico Aqueduct and Sewer Authority
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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 (in thousands):

	June 30	
	2012	2011
Water and sewer services:		
Residential, industrial, and commercial	\$ 501,224	\$ 468,443
Government agencies and municipalities	76,227	70,537
	577,451	538,980
Other receivables:		
Government agencies and municipalities	3,374	3,401
Private entities	28,658	26,195
	32,032	29,596
	609,483	568,576
Less allowance for uncollectible accounts	(435,899)	(404,987)
Total	\$ 173,584	\$ 163,589

4. Receivables from Federal Agencies

The receivables from federal agencies of approximately \$2.9 million and \$3.3 million as of June 30, 2012 and 2011, 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, 2012 and 2011, 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, 2012 and 2011 and the changes therein for the years then ended are as follows (in thousands):

	June 30, 2012			Ending Balance
	Beginning Balance	Increases	Decreases	
Capital assets not being depreciated:				
Land	\$ 58,394	\$ 2,610	\$ -	\$ 61,004
Easement	8,457	470	-	8,927
Construction in progress	1,711,896	381,392	(445,683)	1,647,605
Total capital assets not being depreciated	<u>1,778,747</u>	<u>384,472</u>	<u>(445,683)</u>	<u>1,717,536</u>
Capital assets being depreciated:				
Infrastructure (water and sewer facilities)	7,580,214	261,042	(46,761)	7,794,495
Wells, tanks and meters	414,524	170,954	(3,329)	582,149
Buildings and improvements	70,517	6,120	-	76,637
Equipment, furniture, fixtures and vehicles	211,108	13,528	-	224,636
Total capital assets being depreciated	<u>8,276,363</u>	<u>451,644</u>	<u>(50,090)</u>	<u>8,677,917</u>
Less accumulated depreciation and amortization:				
Infrastructure (water and sewer facilities)	(2,502,281)	(176,604)	15,501	(2,663,384)
Wells, tanks and meters	(141,438)	(19,642)	1,487	(159,593)
Buildings and improvements	(29,914)	(1,687)	-	(31,601)
Equipment, furniture, fixtures and vehicles	(169,457)	(12,616)	-	(182,073)
Total accumulated depreciation and amortization	<u>(2,843,090)</u>	<u>(210,549)</u>	<u>16,988</u>	<u>(3,036,651)</u>
Total capital assets being depreciated, net	<u>5,433,273</u>	<u>241,095</u>	<u>(33,102)</u>	<u>5,641,266</u>
Total capital assets, net	<u>\$ 7,212,020</u>	<u>\$ 625,567</u>	<u>\$ (478,785)</u>	<u>\$ 7,358,802</u>

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

6. Capital Assets (continued)

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

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

7. Restricted Assets

Restricted assets at June 30, 2012 and 2011 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 and in Banco Popular de Puerto Rico (Trustee Agent).

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, fines and penalties assessed by EPA that will be used for construction of infrastructure projects to provide water services and to comply with environmental regulations.

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

Restricted assets by category consist of:

	June 30	
	2012	2011
Construction funds	\$ 287,806	\$ 21,455
Capital activity funds	123,425	13,494
Debt service funds	444,471	174,903
	\$ 855,702	\$ 209,852

8. Accrued Liabilities

Accrued liabilities consisted of the following (in thousands):

	June 30	
	2012	2011
Payroll and related accruals	\$ 38,393	\$ 43,511
Legal, labor related and environmental contingencies	63,263	68,554
Contract retentions	38,678	39,682
	\$ 140,334	\$ 151,747

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

9. Long-Term Liabilities

Long-term debt activity for the years ended June 30, 2012 and 2011 was as follows (in thousands):

	June 30, 2012					
	Beginning Balance	Additions/ Amortization	Reductions	Ending Balance	Due Within One Year	Due Thereafter
Bonds payable:						
2001 Series A PFC Commonwealth Appropriation Bonds	\$ 8,985	\$ -	\$ (8,985)	\$ -	\$ -	\$ -
Act 164 PFC Commonwealth Appropriation Bonds	341,565	-	(341,565)	-	-	-
2004 Series A PFC Commonwealth Appropriation Bonds	326,785	-	(326,785)	-	-	-
2011 Series A PFC Commonwealth Appropriation Bonds	-	90,099	-	90,099	-	90,099
2011 Series B PFC Commonwealth Appropriation Bonds	-	102,183	-	102,183	-	102,183
2011 Series B PFC Commonwealth Appropriation Bonds (Superaqueduct)	-	162,700	-	162,700	-	162,700
2012 Series A PFC Commonwealth Appropriation Bonds	-	56,247	-	56,247	-	56,247
2008 Series A Revenue Bonds	1,344,255	-	-	1,344,255	12,290	1,331,965
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
2012 Series A Revenue Bonds	-	1,800,450	-	1,800,450	-	1,800,450
2012 Series B Revenue Bonds	-	295,245	-	295,245	-	295,245
Rural Development Serial Bonds	306,030	70,211	(7,730)	368,511	3,633	364,878
Add bond premium	34,609	28,141	(34,988)	27,762	459	27,303
Less bond discount	(15,805)	-	(742)	(16,547)	(161)	(16,386)
Less deferred loss on refunding	(73,884)	(19,556)	50,533	(42,907)	(3,563)	(39,344)
Total bonds	<u>2,579,740</u>	<u>2,585,720</u>	<u>(670,262)</u>	<u>4,495,198</u>	<u>12,658</u>	<u>4,482,540</u>

(Continued)

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

9. Long-Term Liabilities (continued)

	June 30, 2012					
	Beginning Balance	Additions/ Amortization	Reductions	Ending Balance	Due Within One Year	Due Thereafter
<i>Balance brought forward</i>	2,579,740	2,585,720	(670,262)	4,495,198	12,658	4,482,540
Notes payable:						
Water Pollution Control and Safe Drinking Water Treatment Revolving Funds Loans	413,449	54,892	(18,297)	450,044	19,658	430,386
Bond Anticipation Notes 2012A		241,000	(241,000)	-	-	-
Notes with commercial banks	241,744	-	(241,744)	-	-	-
Total notes	655,193	295,892	(501,041)	450,044	19,658	430,386
Lines of credit	1,029,949	297,295	(1,217,456)	109,788	-	109,788
Other long-term liabilities:						
Accrued compensated absences	46,442	11,301	(12,472)	45,271	12,704	32,567
Net OPEB obligation	17,148	7,881	(2,377)	22,652	7,881	14,771
Early retirement obligation	2,308	-	(1,422)	886	793	93
Customers' deposits	80,098	9,123	(8,245)	80,976	6,408	74,568
Total other liabilities	145,996	28,305	(24,516)	149,785	27,786	121,999
Total - long-term obligations	<u>\$ 4,410,878</u>	<u>\$ 3,207,212</u>	<u>\$ (2,413,275)</u>	<u>\$ 5,204,815</u>	<u>\$ 60,102</u>	<u>\$ 5,144,713</u>

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

9. Long-Term Liabilities (continued)

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

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

10. Bonds Payable

Bonds payable consisted of the following (in thousands):

	June 30	
	2012	2011
PFC Commonwealth Appropriation Bonds:		
Series 2001:		
Series A, 4.00% – 5.50% due in semiannual interest payments through 2011 and annual principal installments from August 1, 2007 through 2011	\$ –	\$ 8,985
Act 164 PFC, 4.00% – 6.15% due in semiannual interest and annual principal payments from July 15, 2004 through 2030	–	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
Series 2011:		
Series A, 6.50% due in semiannual interest payments through August 1, 2028 and annual principal installments from August 1, 2027 to 2028	90,099	–
Series B, 5.50% – 6.00% due in semiannual interest payments through August 1, 2031 and annual principal installments from August 1, 2024 to 2031	102,183	–
Series B - Superaqueduct, 5.50% – 6.00% due in semiannual interest payments through August 1, 2031 and annual principal installments from August 1, 2024 to 2031	162,700	–
Series 2012:		
Series A, 3.10% – 5.35% due in monthly interest payments through August 1, 2031 and annual principal installments from August 1, 2015 to 2031	56,247	–
Revenue Refunding Bonds:		
Series 2008:		
Series A and B, Term Bonds, 5.80% – 6.10% due in monthly interest payments through July 1, 2034 and annual principal payments from July 1, 2021 to 2034	284,755	284,755
Revenue bonds:		
Series 2008:		
Series A, Serial Bonds, 5.00%, due in semiannual interest payments through July 1, 2025 and annual principal payments from July 1, 2012 to July 1, 2025	93,155	93,155
Series A, Convertible Capital Appreciation Bonds, 6.125%, due in semiannual interest payments from January 1, 2012 through July 1, 2024 and annual principal payments from July 1, 2017 to 2024	155,975	155,975

(Continued)

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

10. Bonds Payable (continued)

	June 30	
	2012	2011
Series A, Term Bonds, 5.00% – 6.00%, due in semiannual interest payments through July 1, 2047 and annual principal payments from July 1, 2026 to 2047	1,095,125	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
Series 2012:		
Series A, Serial Bonds, 4.00% – 5.25%, due in semiannual payments through July 1, 2030 and annual principal payments from July 1, 2015 to July 1, 2030	418,455	–
Series A, Term Bonds, 5.00% – 6.00%, due in semiannual interest payments through July 1, 2047 and annual principal payments from July 1, 2033 to 2047	1,381,995	–
Series B, Serial Bonds, 3.35% – 5.00%, due in semiannual payments through July 1, 2023 and annual principal payments from July 1, 2014 to July 1, 2023	188,130	–
Series B, Term Bonds, 5.35%, due in semiannual interest payments through July 1, 2027 and one principal payment on July 1, 2027	107,115	–
Rural development serial bonds:		
Serial bonds, 4.25% – 5.00%, due semiannually through July 1, 2050	368,511	306,030
Subtotal	4,526,890	2,634,820
Bond premium	27,762	34,609
Bond discount	(16,547)	(15,805)
Deferred loss on refundings	(42,907)	(73,884)
Total	\$ 4,495,198	\$ 2,579,740

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

10. Bonds Payable (continued)

2001 Series A and B PFC 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 subsidiary corporation of GDB, on August 1, 2001, of approximately \$356.7 million of Series A Bonds at a premium of approximately \$2.3 million and approximately \$33.3 million of Series B Bonds. The net proceeds of the 2001 Series A and B Bonds of approximately \$381.1 million, after payment of the cost of issuance of approximately \$9.6 million and approximately \$1.6 million, set aside to cover capitalized interest, were used by PFC to purchase the outstanding promissory note of the Authority from GDB.

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

On June 28, 2004, \$321.4 million of the Authority's share of the 2001 Series A and B Bonds was advanced refunded upon the issuance by PFC of its 2004 Series A and B Refunding Bonds.

As of June 30, 2011, the outstanding balance of 2001 Series B Bonds was \$8.9 million. On July, 2011, the amount of \$8.9 million was paid in full. There was no outstanding balance as of June 30, 2012.

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.

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

10. Bonds Payable (continued)

Act 164 PFC Bonds (continued)

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

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

The 2004 Series A and B Bonds are secured by promissory notes payments made by the Commonwealth to PFC pursuant to Supplemental Debt Restructuring and Assignment Agreements, between the debtors, including the Authority, and PFC. In accordance with various Appropriation Acts, principal and interest payments on such notes shall be funded by

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Notes to Financial Statements (continued)

10. Bonds Payable (continued)

Act 164 PFC Bonds (continued)

Commonwealth appropriations approved annually for the number of fiscal years specified in such Appropriation Acts. The Commonwealth is not legally bound to appropriate funds for such repayments. Until the fiscal year beginning July 1, 2005, the Authority's promissory note payments were made by Commonwealth appropriations authorized by J.R. 523 and Act 164. Payments of principal and interest on bonds are due on or before July 15 of each fiscal year.

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

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

On August 18, 2011, December 8, 2011 and June 28, 2012, PFC issued 2011 Series A, 2011 Series B and 2012 Series A Refunding Bonds for the amount of \$242.4 million, \$437.6 million, and \$410.6 million, respectively for the purpose of refunding its outstanding bonds. The net proceeds from the refunding bonds, after payment of the cost of issuance and bond premium, were used to advance refund of PFC's previously issued bonds in order to obtain lower interest rates.

The Authority's share of 2011 Series A, 2011 Series B and 2012 Series A PFC Refunding Bonds of approximately \$90.1 million, \$264.9 million and \$56.2 million, respectively was recorded in Authority's balance sheets.

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

10. Bonds Payable (continued)

Act 164 PFC Bonds (continued)

On December 13, 2011, COFINA, issued its Sales Tax Revenue Bonds Series 2011C, 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). As a result of this issuance, approximately \$121.5 million of the Authority's share of the Act 164 PFC Bonds were considered legally defeased.

As of June 30, 2011, the Authority's share of the Act 164 PFC Bonds was approximately \$341.6 million. As of June 30, 2012, after 2011 Series A and B, 2012 Series A PFC Refunding Bonds and COFINA 2011 Series C Refunding Bonds there was no outstanding balance of Act 164 PFC Bond.

2004 Series A PFC Refunding Bonds

On June 28, 2004, PFC restructured debt related to 2001 Series A and B Bonds. As a result of this refunding process, \$326.8 of 2004 Series A and B Bonds were issued and \$321.4 million from 2001 Series A Bonds were reduced. Additionally, net debt issuance cost of \$1.2 million, net premium of \$23.2 million and deferred refunding losses for \$27.3 million were recorded by the Authority. The issuance cost and the deferred loss are amortized for the term of the debt. Maturity dates ranges from August 1, 2013 to August 1, 2031.

On December 8, 2011, PFC issued 2011 Series B Refunding Bond for the amount of \$437.6 million, for the purpose of refunding a portion of certain of its 2004 Series A outstanding bonds. The net proceeds from the refunding bonds, after payment of the cost of issuance and bond premium, were used to advance refund a portion of PFC's previously issued bonds in order to obtain lower interest rates.

The Authority's share of the 2011 Series B Refunding Bonds is approximately \$162.7 million.

On December 13, 2011, COFINA, issued its 2011 Series C Sales Tax Revenue Bonds to refinance certain of the 2004 Series A PFC bonds outstanding. As a result of this issuance, the outstanding balance of approximately \$195.1 million of the 2004 Series A PFC Bonds were considered legally defeased.

As of June 30, 2011, the Authority's share of the 2004 Series A PFC Bonds was approximately \$326.8 million. As of June 30, 2012 the outstanding balance of \$326.8 million was in part refunded with 2011 Series B PFC Refunding Bonds and in part defeased with COFINA 2011 Series C Sales Tax Revenue Refunding Bonds.

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

10. Bonds Payable (continued)

2011 Series A and B and 2012 Series A PFC Refunding Bonds

On August 18, 2011, December 8, 2011 and June 28, 2012 PFC issued 2011 Series A, 2011 Series B and 2012 Series A Refunding Bonds for the amount of \$242.4 million, \$437.6 million, and \$410.6 million, respectively for the purpose of refunding a portion of certain of its outstanding bonds.

The net proceeds from the refunding bonds, after payment of the cost of issuance and bond premium, were used to advance refund a portion of PFC's previously issued bonds. These bonds issuances refunded previous Act 164 and 2004 Series A PFC Bonds. Authority's share on these previous bond issuances was removed from balance sheets.

As of June 30, 2012, the Authority's share for the 2011 Series A, 2011 Series B and 2012 Series A Refunding Bonds is approximately \$90.1 million, \$264.9 million and \$56.2 million, respectively.

2008 Series A and B Revenue Bonds

On March 18, 2008, the Authority issued approximately \$1,338.6 million of 2008 Series A and B Revenue Bonds (the 2008 Revenue Bonds).

The 2008 Series A and B Revenue Bonds net proceeds were used to repay certain outstanding bond anticipation notes, accrued interest and principal amount of lines of credit and to finance a portion of the Authority's capital improvement program.

The 2008 Series A Revenue Bonds 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 date of 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, 2028 to July 1, 2047. As of June 30, 2012 and 2011, the outstanding balance for the 2008 Revenue Bonds Series A was approximately \$1,344.2 million, which included approximately \$28.0 million of accreted value.

The 2008 Series B Revenue Bonds consist of \$22.4 million term bond bearing interest at 6.15% per annum with maturity date of July 1, 2038.

The 2008 Series A and B Revenue Bonds are considered senior debt.

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Notes to Financial Statements (continued)

10. Bonds Payable (continued)

2008 Series A and B Revenue Refunding Bonds

On March 18, 2008, the Authority issued approximately \$284.8 million of Series A and B Revenue Refunding Bonds, (the 2008 Revenue Refunding Bonds), guaranteed by the Commonwealth to refund the Authority's outstanding Revenue Refunding Bonds, 1995 Series (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 2008 Series A and B Revenue Refunding Bonds 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 1995 Series 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 using 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.

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Notes to Financial Statements (continued)

10. Bonds Payable (continued)

2012 Series A and B Revenue Bonds

On February 29, 2012, the Authority issued approximately \$2,095.7 million of Series A and B Revenue Bonds (the 2012 Revenue Bonds).

The 2012 Series A Revenue Bonds of approximately \$1,800.4 was issued to (1) repay certain lines of credit provided by Government Development Bank to the Authority as interim financing for a portion of its capital improvement program, (2) finance a portion of the Capital Improvement Program, (3) make a deposit to a Budgetary Reserve Fund, (4) pay capitalized interest on the 2012 Series A Revenue Bonds through July 1, 2013, and (4) pay the costs of issuance and underwriters discounts.

The 2012 Series A Revenue Bonds consist of (1) \$418.4 million of serial bonds bearing interest at rates ranging from 4.0% to 5.25% per annum with maturity dates ranging from July 1, 2015 to July 1, 2030, and (2) \$1,382.0 million of term bonds bearing interest at rates ranging from 5% to 6% per annum with maturity dates ranging from July 1, 2033 to July 1, 2047.

The 2012 Series B Revenue Bonds of approximately \$295.2 million was issued to (1) provide funds to repay a bond anticipation note issued by the Authority in the aggregate principal amount of \$241.0 million, the proceeds of were used to repay certain of the Authority outstanding indebtedness, (2) provide funds to repay certain lines of credit provided by Government Development Bank to the Authority to finance operating expenses and as interim financing for a portion of its capital improvement program, (3) pay capitalized interest on Series B Bonds through July 1, 2013, and (4) pay the cost of issuance and underwriters discounts.

The 2012 Revenue Bonds Series B consist of (1) \$188.1 million of serial bonds bearing interest at rates ranging from 3.35% to 5.00% per annum with maturity dates ranging from July 1, 2014 to July 1, 2023, and (2) \$107.1 million of term bonds bearing interest at 5.35% per annum with maturity date of July 1, 2027.

In connection with the 2012 Revenue Bond issuance, on January 24, 2012 PRASA's Board of Directors authorized the execution of an amended and restated Master Agreement of Trust (2012 MAT) by and between PRASA and Banco Popular de Puerto Rico as Trustee. The 2012 MAT change from a net revenue pledge to a gross revenue pledge for Senior, Senior Subordinated, and Subordinated lien levels and updated the rate covenant requirements as explained on Note 13.

The 2012 Revenue Bonds are considered senior debt.

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Notes to Financial Statements (continued)

10. Bonds Payable (continued)

Rural Development Serial Bonds

United States Department of Agriculture (USDA) Rural Development Program assists the Authority in the financing and construction of aqueduct and sewer facilities in rural areas by purchasing revenue bonds from the Authority, the proceeds of which are used by the Authority to finance such projects. GDB provides interim financing for these projects through short-term lines of credit.

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

As of June 30, 2012, the USDA Rural Development Program Bonds consisted of twenty-five (25) separate series, issued from 1983 through 2011, bearing interest from 4.25% to 5% due in semiannual installments through 2051. The outstanding balance of the USDA Rural Development Program Serial Bonds as of June 30, 2012 and 2011 was approximately \$368.5 million and \$306.0 million, respectively.

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

The USDA Rural Development Program Bonds are subordinate to all senior and senior subordinated debt.

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Notes to Financial Statements (continued)

10. Bonds Payable (continued)

Debt Service Payments

Future principal and interest payments on all bonds payable outstanding at June 30, 2012 was as follows (in thousands):

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
Fiscal year:			
2013	\$ 15,923	\$ 214,013	\$ 229,936
2014	20,424	242,070	262,494
2015	52,438	240,549	292,987
2016	62,191	238,069	300,260
2017	63,411	235,302	298,713
2018 – 2022	368,355	1,125,879	1,494,234
2023 – 2027	527,328	1,011,657	1,538,985
2028 – 2032	954,438	804,833	1,759,271
2033 – 2037	756,560	570,244	1,326,804
2038 – 2042	860,388	353,403	1,213,791
2043 – 2047	699,839	127,305	827,144
2048 – 2052	145,595	5,011	150,606
Total	4,526,890	<u>\$ 5,168,335</u>	<u>\$ 9,695,225</u>
Plus unamortized premium	27,762		
Less:			
Unamortized discount	(16,547)		
Deferred loss on debt refunding	(42,907)		
Bonds payable, net	<u>\$ 4,495,198</u>		

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

11. Notes Payable

Notes payable consisted of the following (in thousands):

	June 30	
	2012	2011
Puerto Rico Water Pollution Control Revolving Fund	\$ 304,799	\$ 266,964
Puerto Rico Safe Drinking Water Treatment Revolving Loan Fund	145,245	146,485
Notes with commercial banks	-	241,744
	\$ 450,044	\$ 655,193

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, 2012 and 2011, the Authority had outstanding approximately \$450.0 million and \$413.4 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 net 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.

Puerto Rico Aqueduct and Sewer Authority
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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 commercial banks. The proceeds were used to repay various lines of credit with GDB and pay costs and fees associated with the term loan. During fiscal year 2012 and 2011, the loan bore interest at 3.25%. The loan is payable in quarterly installments commencing on September 1, 2008 and due on September 1, 2011.

The outstanding balance as of June 30, 2011 was approximately \$241.7 million. The net revenue of the Authority, as defined in the Term Loan Agreement, was pledged toward payment of debt service on this term loan. The notes are considered senior subordinated debt and are subordinated to the senior debt.

On August 17, 2011, the maturity date of this term loan was extended from September 1, 2011 to January 16, 2012. The Authority was required to make quarterly principal payments of \$736,000 on September 1, 2011 and December 1, 2011.

The outstanding balance of \$240.6 million of the term loan was paid with 2012 Series A Bond Anticipation Notes issued for \$241.0 million by Bank of America Merrill Lynch on January 17, 2012.

On February 29, 2012, the outstanding balance of \$241.0 million of the 2012 A Bond Anticipation Notes was paid in full with the proceeds of the issuance of 2012 Series B Revenue Bonds.

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Notes to Financial Statements (continued)

11. Notes Payable (continued)

The combined future aggregate amount of debt service for these loans as of June 30, 2012 was as follows (in thousands):

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2013	\$ 19,658	\$ 5,647	\$ 25,305
2014	19,605	5,412	25,017
2015	19,941	5,018	24,959
2016	19,500	4,619	24,119
2017	19,399	4,232	23,631
2018 – 2022	85,939	15,726	101,665
2023 – 2027	79,409	7,470	86,879
2028 – 2032	31,660	1,041	32,701
	<u>295,111</u>	<u>\$ 49,165</u>	<u>\$ 344,276</u>
Interim construction loans:			
Puerto Rico Water Pollution Control Revolving Fund	100,446		
Puerto Rico Safe Drinking Water Treatment Revolving Loan Fund	<u>54,487</u>		
Total	<u>\$ 450,044</u>		

12. Lines of Credit

On November 13, 2006, the Authority entered into a line of credit agreement with GDB. This agreement provides the Authority with an available maximum amount of \$190 million to be used to provide funding for the capital improvement program of the Authority. On February, 2010, an increase of \$60 million for a maximum amount of \$250 million was approved. On November, 2010 the line was increased by \$19.5 million to \$269.5 million to capitalize unpaid accrued interest payable. As of June 30, 2011, the Authority had an outstanding balance of \$269.5 million. On February 29, 2012, the outstanding balance of \$269.5 million was paid in full with the proceeds of the issuance of 2012 Series A Revenue Bonds.

On March 18, 2008, the Authority entered into a revolving line of credit agreement with GDB. This agreement provides the Authority with an available maximum amount of \$150 million to be used to satisfy the Operating Reserve Requirement pursuant to the Master Agreement of Trust dated as of March 1, 2008 between the Authority and the bond trustee related to the 2008 Revenue Bonds. On February 29, 2012, the maximum amount was increased to \$180.0 million. This line of credit is due on June 30, 2016. There was no outstanding balance as of June 30, 2012 and 2011.

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Notes to Financial Statements (continued)

12. Lines of Credit (continued)

On May 4, 2009, the Authority entered into a revolving line of credit agreement with GDB. This agreement provides the Authority with an available maximum amount of \$87.6 million to be used to provide funding for the capital improvement program of the Authority. As of June 30, 2011, the Authority had an outstanding balance of approximately \$87.6 million. On February 29, 2012, the outstanding balance of \$94.1 million, including capitalized interests, was paid in full with the proceeds of the issuance of 2012 Series A Revenue Bonds.

On November 12, 2009, the Authority entered into a revolving line of credit agreement with GDB. This agreement provides the Authority with an available maximum amount of \$125 million to be used to provide funding for the capital improvement program of the Authority. As of June 30, 2011, the Authority had an outstanding balance of \$125.0 million. On February 29, 2012, the outstanding balance of \$125.0 million was paid in full with the proceeds of the issuance of 2012 Series A Revenue Bonds.

On December 8, 2009, the Authority entered into a line of credit agreement with GDB. This agreement provides the Authority with an available maximum amount of approximately \$37.6 million for the purpose of providing interim financing for the construction of aqueduct and sewer facilities in rural areas. As of June 30, 2011, the Authority had an outstanding balance of approximately \$13.4 million. On September 14, 2011, the outstanding balance of \$13.4 million was paid in full with the proceeds of bond issuance by USDA Rural Development Series HH.

On December 30, 2009, the Authority entered into a line of credit agreement with GDB. This agreement provides the Authority with an available maximum amount of \$150 million to be used to provide funding for the capital improvement program of the Authority. As of June 30, 2011, the Authority had an outstanding balance of \$150 million. On February 29, 2012, the outstanding balance of \$150 million was paid in full with the proceeds of the issuance of 2012 Series A Revenue Bonds.

On March 10, 2010, the Authority entered into a revolving line of credit agreement with GDB. This agreement provides the Authority with an available maximum amount of \$70 million to be used to provide funding for the capital improvement program of the Authority. The proceeds will be applied only to projects approved and to be funded by the State Revolving Funds pursuant to federal regulations under the Clean Water Act, the Safe Drinking Water Act, and the American Recovery Act ("ARRA"). The Authority will pay this interim financing with moneys received from State Revolving Funds, as reimbursements on payments done by the Authority for the projects. As of June 30, 2012 and 2011, the Authority had an outstanding balance of approximately \$37.4 million and \$48.3 million on this line of credit, respectively.

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Notes to Financial Statements (continued)

12. Lines of Credit (continued)

On April 16, 2010, the Authority entered into a revolving line of credit agreement with GDB. This agreement provides the Authority with an available maximum amount of \$50 million to be used to provide funding for the capital improvement program of the Authority. On June 7, 2010, the maximum available amount was increased to \$113.9 million. On August 3, 2010 the maximum available amount was increased to \$200 million. As of June 30, 2011, the Authority had an outstanding balance of \$200 million. On February 29, 2012, the outstanding balance of \$200 million was paid in full with the proceeds of the issuance of 2012 Series A Revenue Bonds.

On November 30, 2010, the Authority entered into a line of credit agreement with GDB. This agreement provides the Authority with an available maximum amount of approximately \$21.7 million for the purpose of providing interim financing for the construction of aqueduct and sewer facilities in rural areas. As of June 30, 2011, the Authority had an outstanding balance of approximately \$10.5 million under this line of credit agreement. On September 14, 2011, the outstanding balance of \$10.5 million was paid in full with the proceeds of the issuance of Series HH USDA Rural Development Bonds.

On March 8, 2011, the Authority entered into a line of credit agreement with GDB. This agreement provides the Authority with an available maximum amount of \$250 million to be used to provide funding for the capital improvement program of the Authority. As of June 30, 2011, the Authority had an outstanding balance of \$250 million. On February 29, 2012, the outstanding balance of \$250 million was paid in full with the proceeds of the issuance of 2012 Series A Revenue Bonds.

On August 17, 2009, the Authority entered into an Asset Purchase Agreement with the Puerto Rico Industrial, Tourism, Educational, Medical and Environmental Facilities Financing Authority (AFICA), a public corporation of the Commonwealth of Puerto Rico, to purchase certain assets that were being used to develop the Southern Gas Pipeline Project for the total purchase price of approximately \$23.5 million and assumed the rights and obligations of PREPA under Subordinated Loan Agreement between AFICA and PREPA and a Subordinated Note and Loan Agreement of approximately \$31 million. As established in the Asset Purchase Agreement the abovementioned transfers occurred two years after the date of the Agreement, on August 16, 2011, and the transaction was recorded on the Authority's books during fiscal year 2012. On February 29, 2012, the outstanding balance of \$31 million was paid in full with the proceeds of the issuance of 2012 Series B Revenue Bonds.

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Notes to Financial Statements (continued)

12. Lines of Credit (continued)

On February 29, 2012, the Authority entered into a line of credit agreement with GDB. This agreement provides an available maximum amount of \$150 million for the purpose of assisting with the Authority's cash flows needs during the transition period after amending and restating the Master Agreement of Trust as a result of the issuance of 2012 Revenue Bonds Series A and B. As of June 30, 2012, the Authority had an outstanding balance of approximately \$72.4 million.

Future amounts required to pay principal balances at June 30, 2012 are as follows (in thousands):

Fiscal year:	
2013	\$ -
2014	109,788
	<hr style="border-top: 1px solid black;"/>
	\$ 109,788
	<hr style="border-top: 3px double black;"/>

13. Financial Covenants

The amended and restated Master Agreement of Trust (the MAT) governing the Authority's Revenue Bonds contain financial covenants requiring the maintenance of certain debt service coverage ratios.

As stated in the MAT, PRASA has covenanted to establish and collect rates, fees and charges so that it meets the following four independent requirements:

- Operating Revenues (as defined per the MAT) shall be at least equal to 250% of annual debt service with respect to Senior Indebtedness for the current fiscal year;
- Operating Revenues shall be at least equal to 200% of annual debt service with respect to Senior Indebtedness and Senior Subordinate Indebtedness for the current fiscal year;
- Operating Revenues shall be at least equal to 150% of annual debt service with respect to all Bonds and Other System Indebtedness for the current fiscal year; and
- Authority Revenues (as defined per the MAT), shall be sufficient to pay current expenses, annual debt service on its indebtedness and to fund other amounts that may be due under the MAT

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Notes to Financial Statements (continued)

13. Financial Covenants (continued)

Indebtedness, as defined in the MAT, includes Commonwealth Guaranteed Indebtedness and Commonwealth Supported Obligations.

As of June 30, 2012 and 2011, the Authority was in compliance with the senior annual debt service coverage requirements.

14. Capital Contributions

Capital contributions for the fiscal years ended June 30, 2012 and 2011 were as follow (in thousands):

	June 30	
	2012	2011
Appropriations from Commonwealth	\$ —	\$ 212
Other contributions from Commonwealth	3,769	2,265
Contributions from governmental agencies and municipalities	200	—
Federal grants:		3,947
USDA Rural Development Program	23,648	3,235
Federal Emergency Management Agency	7,571	1,247
American Recovery and Reinvestment Act Funds	15,672	19,698
Developer contributions	71	2,477
Other contributions	1,165	1,194
	\$ 52,096	\$ 34,275

15. Related Party Transactions

Operating revenues for services provided to the Commonwealth and its component units amounted to approximately \$87.9 million and \$79.7 million during the years ended June 30, 2012 and 2011, respectively. Further, operating, administrative, and general expenses during the fiscal years ended June 30, 2012 and 2011 included approximately \$200.2 million and \$156.6 million, respectively, of charges from Puerto Rico Electric Power Authority (PREPA), a component unit of the Commonwealth.

As of June 30, 2012 and 2011, the Authority had approximately \$46.7 million and \$46.6 million, respectively, of receivables from the Commonwealth and its component units, which were reported in accounts receivable in the accompanying basic financial statements.

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Notes to Financial Statements (continued)

15. Related Party Transactions (continued)

The Authority had approximately \$2.2 million and \$1.6 million of excess of collections over billings from the Commonwealth, recorded as unearned revenue in the basic financial statements as of June 30, 2012 and 2011, 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 needs. As of June 30, 2012 and 2011, the Authority had an outstanding balance of approximately \$109.8 million and \$1,029.9 million, respectively, under these lines of credit.

On July 1, 2011, Joint Resolution No. 57 was approved by the Puerto Rico Legislature. This Resolution assigned to the Authority the amount of \$183.8 million, of which \$70.2 was received, to subsidize operating expenses and payment of debt service, as needed for fiscal year ended June 30, 2012. On July 2, 2010, Joint Resolution No. 68 was approved by the Puerto Rico Legislature. This Resolution assigned to the Authority the amount of \$85 million to subsidize operating expenses and payment of debt service, as needed for fiscal year ended June 30, 2011.

On August 17, 2009, the Authority entered into an Asset Purchase Agreement with the Puerto Rico Industrial, Tourism, Educational, Medical and Environmental Facilities Financing Authority (AFICA), a public corporation of the Commonwealth of Puerto Rico to purchase certain assets that were being used to develop the Southern Gas Pipeline Project for the total purchase price of approximately \$23.5 million and assumed the rights and obligations of PREPA under Subordinated Loan Agreement between AFICA and PREPA and a Subordinated Note and Loan Agreement of approximately \$31 million. As established in the Asset Purchase Agreement the abovementioned transfers occurred two years after the date of the Agreement, on August 16, 2011, and the transaction was recorded on the Authority's books during fiscal year 2012. On February 29, 2012, the outstanding balance of \$31 million was paid in full with the proceeds of the issuance of 2012 Series B Revenue Bonds.

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.

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

16. Pension Plan (continued)

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 non-occupational disabilities are available to members enrolled in the plan before January 1, 2000. Benefits vest after ten years of plan participation.

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

Participants who have completed at least thirty years of creditable service are entitled to receive a Merit Annuity. Such participants who have not attained fifty-five years of age will receive 65% of the average compensation or if they have attained fifty-five years of age will receive 75% of the average compensation.

Disability retirement benefits are available to members for occupational and nonoccupational disability. However, for nonoccupational disability a member must have at least ten years of service. No benefits are payable if participants receive a refund of their accumulated contributions.

Commonwealth legislation requires that employees hired before April 1, 1990 contribute 5.775% of the first \$550 of their monthly gross salary and 8.275% of their gross monthly salary in excess of \$550. Employees hired after April 1, 1990 contribute 8.275% of their gross monthly salary. The Authority's contributions during fiscal year 2012 were 10.275% of the gross monthly salary.

Total employer contributions during years ended June 30, 2012, 2011, and 2010 amounted to approximately \$9.2 million, \$8.5 million, and \$10 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.

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Notes to Financial Statements (continued)

16. Pension Plan (continued)

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

System 2000 reduces the retirement age from 65 years to 60 for those employees who joined the ERS on or after April 1, 1990. Disability pensions are not granted under System 2000. The employers' contributions (10.275% of the employee's salary during fiscal year 2012) were used to fund the defined benefit plan.

Total employer contributions during the fiscal years ended June 30, 2012, 2011 and 2010, amounted to approximately \$5.4 million, \$3.9 million, and \$4 million, respectively, which represented 100% of required contributions.

Additional information on the ERS is provided in its financial statements for the years ended June 30, 2012 and 2011, 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"

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

17. Other Postemployment Benefits (continued)

Plan Description (continued)

(HIEPAAA) and employees under Managers' Regulation, all of which are Authority employees. All employees with more than 20 years of rendered service within the Authority are eligible for the healthcare benefit upon retirement age. Normal retirement age is as follows:

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

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

Funding Policy

The contribution requirements of the Authority are established and may be amended, by the Authority's Board of Directors. 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, 2012 and 2011 was approximately \$2.4 million and \$2.3 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, 2012, in accordance with parameters of GASB Statement No. 45 based on current years' demographic data. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal cost each year and amortize any unfunded actuarial accrued liabilities (UAAL) over a period of 12 years.

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)

The annual required contribution estimated for the years ended June 30, 2012 and 2011 amounted to (in thousands):

	<u>2012</u>	<u>2011</u>
Annual Required Contribution (ARC):		
Normal costs	\$ 2,379	\$ 1,715
Amortization of initial UAAL	3,225	4,100
Amortization of loss	3,555	1,738
GASB Statement No. 45 Annual Required Contribution	<u>\$ 9,159</u>	<u>\$ 7,553</u>

OPEB costs components for the years ended June 30, 2012 and 2011 are as follows (in thousands):

	<u>2012</u>	<u>2011</u>
Annual OPEB Costs		
ARC for fiscal year	\$ 9,159	\$ 7,553
Interest on Net OPEB Obligation	343	278
ARC Amortization Adjustment	(1,621)	(821)
Total Annual OPEB Costs	<u>\$ 7,881</u>	<u>\$ 7,010</u>

The net OPEB obligation change for the years ended June 30, 2012 and 2011 is as follows (in thousands):

	<u>2012</u>	<u>2011</u>
Change in net OPEB obligation		
Net OPEB obligation	\$ 17,148	\$ 12,453
Total annual OPEB costs	7,881	7,010
Actual benefit payments	(2,377)	(2,315)
Net OPEB obligation	<u>\$ 22,652</u>	<u>\$ 17,148</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, 2012 and 2011.

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

17. Other Postemployment Benefits (continued)

Funded Status

Funded status of the plan as of June 30, 2012, the most recent actuarial valuation date, is as follows (in thousands):

	2012	2011
Unfunded Actuarial Accrued Liability (UAAL):		
Active employees	\$ 31,718	\$ 24,274
Retirees	39,985	33,454
Actuarial accrued liability	71,703	57,728
Actuarial value of assets	—	—
UAAL	\$ 71,703	\$ 57,728

The schedule of funding progress included as required supplementary information presents information about the actuarial value of plan assets relative to the actuarial accrued liability for the benefits.

Actuarial Assumptions

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

Economic Assumptions

Discount Rate

The discount rate considered for years ended June 30, 2012 and 2011 was 2.0% and 3.5% respectively. For fiscal year 2012, U.S. Treasury Bond 10-year term investments represents the Authority's expected long-term return on internal assets used to finance the payment of plan benefits.

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

17. Other Postemployment Benefits (continued)

Economic Assumptions (continued)

Medical Increase Rate

As the retirement healthcare benefit is fixed, such that it will not increase the obligation under the plan (regardless of the claim experience) without negotiation of a new contract with the unions or an express Board of Directors' approval, the medical increase rate was zero for the years ended June 30, 2012 and 2011. If the fixed benefit level does indeed increase sometime in the future (by negotiation or plan amendment), the higher obligation will be recognized when the new contract or amendment is adopted.

Turnover

For the years ended June 30, 2012 and 2011, the turnover table used for the valuation was the Standard Hewitt Withdrawal Table for Hourly Union Employees – 5 years of service select period.

Healthy Mortality

The RP-2000 Combined Healthy Mortality Table projected to 2017 by Scale AA was used for the valuation of the benefit granted by the plan.

Disability Table

The Hunter disability table was used for the valuation.

Actuarial Cost Method

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

Amortization of Initial UAAL

Period

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

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

17. Other Postemployment Benefits (continued)

Amortization of Initial UAAL (continued)

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 180 professional employees, was signed effective May 31, 2012 until June 30, 2016.

The collective bargaining agreement with the UIA union, which covers approximately 3,570 blue-collar and clerical employees, was signed effective January 1, 2012 until December 31, 2015.

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 (\$0.3 million and \$28.5 million for the years ended June 30, 2012 and 2011, respectively) are reported under the caption of *Service contract – Superaqueduct* in the accompanying statements of revenues, expenses, and changes in net assets.

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

Actually, the Authority has an agreement with Caribbean Water Specialist Corp. and pays a management fee for the operation of the North Coast Aqueduct. This amount is reported under the caption of *Service Contract - Superaqueduct*. All other operational cost considered as pass-through cost under the Thames-Dick Agreement (electricity, chemicals, etc.) associated with the operation of the system were captioned in their respective expense category.

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

20. Commitments and Contingencies

Environmental Matters

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

- On July 1, 2003, the Authority entered into an agreement (Civil Action No. 01-1709) with EPA to attain compliance with the Clean Water Act in relation to the Authority's wastewater pump stations (WWPSs) in response to a significant number of sanitary sewer bypasses from these locations. The Clean Water Act prohibits discharges of sewage from any point in the collection and treatment system other than the authorized point at the treatment facility. The Authority completed all improvement projects required by EPA for these WWPSs on or before the established completion dates in the Agreement.

This agreement also required the Authority to invest \$1 million in the development and implementation of a Supplemental Environmental Project (SEP). This project consisted of the connection of three NON-PRASA communities to the Authority's drinking water system. The connection has been completed and is awaiting completion of adjacent systems to fully integrate these systems to PRASA's service. The agreement also required the implementation of the Preventive Maintenance Program (PMP) for all of PRASA's WWPSs. This was fully completed in December of 2010, and is still in place.

As part of the agreement, PRASA pays stipulated penalties for pump station bypass events on a quarterly basis. The penalty calculations are based on the pumping capacity of the pump station and the time taken to correct the deficiency causing the bypass event. The amount of penalties during fiscal years 2012 and 2011 was approximately \$0.5 million and \$0.4 million respectively.

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

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

20. Commitments and Contingencies (continued)

Environmental Matters (continued)

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

As part of the agreement, PRASA pays stipulated penalties on a yearly basis for exceedances to each of PRASA's facilities to their individual discharge permits. The penalty calculations are based on frequency of the exceedances as well as the percentage of the exceedances with its respective limit. The amount of penalties during fiscal years 2012 and 2011 was approximately \$0.6 million and \$.05 million, respectively; plus approximately \$0.3 million due to revision on 2008 penalties. These penalty payments are deposited into an escrow account from which a fraction of the deposited amount can be reimbursed to PRASA based on completion of specific projects and initiatives.

- On May 25, 2006, the Authority entered into a plea agreement with the U. S. Department of Justice related to violations of the Clean Water Act, as amended, Title 33, USC, Sections 11311(a) and 1319(c)(2)(A). As part of the agreement (Criminal Case No. 06-CR-00202-001), the Authority paid a \$9.0 million fine. This penalty was assessed by the Court as payment for the discharge permit violations of several treatment facilities to the Clean Water Act. The Authority was placed on probation for a period of five years. As part of the probation the Authority had to comply with several special conditions, such as: (i) upgrade the collection and wastewater treatment system in the Ponce de León Avenue area of San Juan for a cost of not less than \$10 million to prevent direct discharges to the Martin Peña Channel, (ii) upgrade nine waste water treatment plants for a cost not less than \$109 million, and (iii) comply with the consent decree signed by the Authority with the U.S. Government on June 22, 2006. The plea agreement also established stipulated penalties for violation of any of the deadlines or performance standards set forth in the agreement. As of today, the Authority is in compliance with the deadlines and requirements of this Consent Order and no penalties have been paid. Probation period expired on April, 19, 2012.

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

20. Commitments and Contingencies (continued)

Environmental Matters (continued)

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

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

During fiscal years ended June 30, 2012 and 2011, the penalties amounted approximately \$0.4 million and \$0.2 million, respectively. The Authority deposited \$0.05 million in an escrow account. These deposits in the escrow account are for parameters exceedances, and will be used for compliance projects with the approval of the Department of Health.

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

The Authority was assessed a civil penalty of approximately \$3.2 million, of which \$1.0 million was paid to the Treasurer of the United States of America as a civil penalty, and \$2.2 million was deposited in an escrow account with GDB for the design and construction of a SEP. This SEP consisted on the installation of an aeration system in the Toa Vaca Lake. The aeration system is expected to be in operation by October 2012.

The total amount of penalties paid under this agreement during the fiscal years 2012 and 2011 was approximately \$0.1 million. Stipulated penalties must be paid by the Authority for failing to comply with remedial measures deadlines, permit limit exceedances or fail to submit deliverables or Discharge Monitoring Reports.

The Authority is in the process of renegotiation of all the consent decrees and commitments mentioned above. The objective of this renegotiation is to establish a prioritization system that will smooth out the economic impact of the capital improvement projects on a yearly basis.

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

Notes to Financial Statements (continued)

20. Commitments and Contingencies (continued)

Risk Management

The Authority has 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	\$32.5 million plus a 2% deductible up to a maximum of \$7.5 million per location	\$150 million
Flood	\$28 million plus a 2% additional deductible up to a maximum of \$3 million per location	\$300 million
Earthquake	\$32.5 million plus a 5% 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
Pollution Liability	\$250 thousand per occurrence	\$5 million
Crime	\$10 thousand per occurrence	From \$500 thousand up to \$1 million

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

Notes to Financial Statements (continued)

20. Commitments and Contingencies (continued)

Risk Management (continued)

Coverage	Deductible	Policy Limit
Officers and Directors	\$100 thousand per occurrence	\$10 million
First Excess Directors and Officers	—	Additional \$10 million
Second Excess Officers and Directors	—	Additional \$20 million
Travel and Accident	—	\$500 thousand per occurrence \$2.5 million aggregate
Accident and Health Divers	—	\$250 thousand per occurrence \$1.7 million aggregate
EPLI	\$100 thousand per occurrence	\$5.0 million
Excess EPLI		Additional \$5.0 million

The Authority also has an Owner Controlled Insurance Program (OCIP). The OCIP is an insurance program under which Commercial General Liability, Excess General Liability, Builders Risk, and Contractors Pollution Liability coverage's are procured or provided on a project "wrap-up" basis for contractors and subcontractors of any tier, who have been properly enrolled, while performing operations at the Project Site.

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

20. Commitments and Contingencies (continued)

Risk Management (continued)

Each insurance policy maintained by the Authority contains specific policy limits and deductibles. A summary of the OCIP insurance policies maintained by the Authority is as follows:

<u>Coverage</u>	<u>Deductible</u>	<u>Policy Limit</u>
Comprehensive general liability:		
General liability	\$10 thousand per occurrence	\$2 million per occurrence \$4 million aggregate
First excess liability	\$10 thousand per occurrence	\$25 million per occurrence \$50 million aggregate
Second excess liability	—	\$25 million per occurrence \$50 million aggregate
Builder's Risk	\$20 thousand theft \$100 thousand - atmospheric events	\$100 million per occurrence
Contractor's Pollution Liability	\$25 thousand per occurrence	\$25 million per occurrence \$25 million aggregate
Professional Liability	\$250 thousand per occurrence	\$25 million per occurrence \$50 million aggregate

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

Construction Projects

The Authority enters in construction projects for the replacements or expansion of its facilities. As of June 30, 2012 and 2011, there were outstanding commitments for projects in process for approximately \$191.3 million and \$50.9 million, respectively.

Operating Leases

Certain commercial offices and warehouse facilities of the Authority are leased under operating lease agreements. During the years ended June 30, 2012 and 2011, the Authority incurred approximately \$4 million and \$5 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, 2012, which have an initial term of one year or more, are as follows (in thousands):

2013	\$	2,444
2014		1,608
2015		1,387
2016		1,212
2017		1,043
2018 - 2022		2,638
2023 - 2027		601
	<u>\$</u>	<u>10,933</u>

Litigation

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

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

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

20. Commitments and Contingencies (continued)

Litigation (continued)

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

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

21. Subsequent Events

On February 1, 2013, the Authority announced its intention to revise the actual rate structure to increase operating revenues for fiscal year 2014. Changes to the rate structure require the approval of the Authority's Board of Directors and a public hearing process required by law.

Required Supplementary Information

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

Required Supplementary Information
Schedule of Funding Progress for Postemployment Healthcare Benefits

(In thousands)

<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>Percentage of Covered Payroll</u>
June 30, 2012	\$ —	\$ 71,703	\$ 71,703	—%	\$ 163,753	44%

See accompanying independent auditors' report.

Other Report and Schedule

Report on Internal Control over Financial Reporting and on Compliance and
Other Matters Based on an Audit of Financial Statements Performed
in Accordance with *Government Auditing Standards*

The Board of Directors
Puerto Rico Aqueduct and Sewer Authority

We have audited the financial statements of the Puerto Rico Aqueduct and Sewer Authority (the Authority), a component unit of the Commonwealth of Puerto Rico, as of and for the year ended June 30, 2012, and have issued our report thereon dated February 1, 2013. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

Management of the Authority is responsible for establishing and maintaining effective internal controls over financial reporting. In planning and performing our audit, we considered the Authority's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Authority's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Authority's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies or material weaknesses and, therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as described below, we identified certain deficiencies in internal control over financial reporting that we consider to be material weaknesses.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the deficiency described as 2012-01 in the accompanying schedule of findings and responses to be material weakness.

A *significant deficiency* is a deficiency or a combination of deficiencies in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiency described as finding 2012-02 in the accompanying schedule of findings and responses to be a significant deficiency.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Authority's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed an instance of noncompliance or other matter that is required to be reported under *Government Auditing Standards*.

The Authority's responses to the findings identified in our audit are described in the accompanying schedule of findings and responses. We did not audit the Authority's responses and, accordingly, we express no opinion on the responses.

This report is intended solely for the information and use of Audit Committee, Board of Directors, management others within the entity, federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Ernst + Young LLP

February 1, 2013

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Puerto Rico Aqueducts and Sewer Authority

Schedule of Findings and Responses

Year Ended June 30, 2012

Financial Statements Findings

Finding No.: 2012-01

Topic

Accrued liabilities - Consorcio

Criteria or Specific Requirement

The Authority functions as an enterprise fund and maintain its accounting records on the accrual basis of accounting in conformity of US generally accepted accounting principles. Under the accrual basis of accounting current liabilities arise from present obligations of an entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. Accounts payables and accrued liabilities should generally be recognized at the time the obligating event occurs.

Condition Found

During our audit procedures related to the Authority's infrastructure accrual, we noted that certain invoices for services rendered by contractors during the month of June 2012 were not recorded as of the year-end.

Cause

Adequate controls were not in place to prevent or detect the omission of contractor's invoices for services rendered on or before June 30, 2012.

Effects

Management's analysis of the service contractors invoices not recorded as of June 30, 2012 resulted in a recorded audit difference of \$9.9 million which was adjusted in the financial statements.

Recommendation

We recommend that management obtain direct confirmation from contractors at either month-end close or year-end close of all outstanding invoices. This process will help the Authority have a better estimate of the amounts that should be accrued for services to be recorded. In addition, this process will ensure a proper cut off of liabilities at year-end.

Puerto Rico Aqueducts and Sewer Authority
Schedule of Findings and Responses (continued)

Finding No.: 2012-01 (continued)

Management's Response

Analytical and review procedures will be implemented by the Infrastructure Area to ensure that correct amounts should be accrued.

In addition, the Infrastructure Area will adopt the direct confirmation process in order to assure proper recording of the amounts.

Puerto Rico Aqueducts and Sewer Authority
Schedule of Findings and Responses (continued)

Finding No.: 2012-02

Topic

Amortization of bonds premiums and discounts

Criteria or Specific Requirement

As referenced in the authoritative guidance, the effective interest method should be used instead of the straight-line method for the amortization of bonds premiums and discounts, debt issuance costs, and deferred refunding costs.

Condition Found

During our procedures, we noticed that the Authority amortizes bond premiums and discounts debt issuance costs, and deferred refunding costs on a straight-line basis as opposed to appropriately using the effective interest method.

Cause

During 2012, the Public Finance Corporation (PFC) performed a refunding of the Series 2004 Bonds. Certain part of this refunding was assigned to the Authority by the Commonwealth. Consequently, the difference between straight-line and effective-interest methods of amortization grew significantly. The Authority has been preparing a comparative analysis between the effective interest method and the straight line method; however, since the differences in prior years were not significant, adjustments have not been made to the Authority's financial statements. During 2012, the difference between both methods became material and an adjustment was required.

Effects

This resulted in an audit adjustment amounting to approximately \$5.6 million to correct the overstatement of accumulated amortization and interest expense for the year ended June 30, 2012.

Recommendation

The Authority should implement proper procedures to ensure compliance with the correct method of amortizing bonds premiums and discounts, debt issuance costs, and deferred refunding costs which is the effective interest method to ensure timely recording of transactions and compliance with authoritative accounting principles.

Puerto Rico Aqueducts and Sewer Authority
Schedule of Findings and Responses (continued)

Finding No.: 2012-02 (continued)

Management's Response

The above mentioned adjustment was as a consequence of the refunding of PFC (Public Finance Corporation) Series 2004 Bonds. Due to this event, difference between straight line and effective interest methods of amortization was significant. The Authority adopted the effective interest method for the amortization of premiums, discounts, debt issuance cost and deferred refunding loss.