



**CITY OF DETROIT
SEWAGE DISPOSAL FUND**

Basic Financial Statements
and Required Supplementary Information

June 30, 2006 and 2005

(With Independent Auditors' Report Thereon)

**CITY OF DETROIT
SEWAGE DISPOSAL FUND**

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KPMG LLP
Suite 1200
150 West Jefferson
Detroit, MI 48226-4429

Independent Auditors' Report

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

We have audited the accompanying basic financial statements of the Sewage Disposal Fund (the Fund), an enterprise fund of the City of Detroit, Michigan (the City), as of and for the years ended June 30, 2006 and 2005, as listed in the table of contents. These basic financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these basic financial statements based on our audits.

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

As discussed in Note 1, the financial statements referred to above present only the Sewage Disposal Fund of the City and are not intended to present fairly the financial position of the City as of June 30, 2006 and 2005, and the changes in its financial position, and, where applicable, cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

In our opinion, the basic financial statements referred to above present fairly, in all material respects, the financial position of the Sewage Disposal Fund of the City as of June 30, 2006 and 2005, and the changes in its net assets 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 also audited the financial statements of the City, as described above in this report on the Fund's financial statements. This report does not include the results of our testing of internal control over financial reporting and on our tests of the City's compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters that are reported on separately by us for the City. 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.

The Fund has not presented Management's Discussion and Analysis, which U.S. generally accepted accounting principles have determined is necessary to supplement, although not required to be part of, the basic financial statements.

The schedule of funding progress on page 30 is not a required part of the basic financial statements but is supplementary information required by U.S. generally accepted accounting principles. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

KPMG LLP

Detroit, Michigan
August 20, 2007

**CITY OF DETROIT
SEWAGE DISPOSAL FUND**

Statements of Net Assets

June 30, 2006 and 2005

Assets	<u>2006</u>	<u>2005</u>
Current assets:		
Cash and cash equivalents	\$ 5,418,283	—
Investments	47,205,044	47,948,538
Due from other funds	52,798,669	66,388,078
Accounts receivable (including \$50,156,538 and \$41,695,332 for unbilled sewage services and net of allowance for doubtful accounts of \$85,033,590 and \$64,482,340 for June 30, 2006 and 2005, respectively)	101,428,204	88,501,230
Rate adjustments receivable from customers	46,062,009	12,174,737
Prepaid expenses	5,423,804	381,847
Inventories	10,456,963	11,173,380
Restricted cash and cash equivalents	39,168,566	21,666,661
Restricted investments	312,884,409	266,046,651
Restricted due from other funds	5,541,786	37,638,549
Total current assets	<u>626,387,737</u>	<u>551,919,671</u>
Noncurrent assets:		
Restricted long-term investments	111,020,313	308,770,507
Net pension asset	8,371,380	7,850,281
Noncurrent rate adjustments receivable from customers	30,820,615	44,946,430
Issuance costs – pension obligation certificates of participation	509,674	286,646
Unamortized bond issuance costs	33,720,782	35,433,200
Capital assets:		
Land	13,834,957	13,876,751
Structures	1,703,001,142	1,143,914,922
Interceptors, regulators, and improvements	474,689,271	542,769,689
Equipment	1,385,071,312	708,031,859
Construction work in progress	310,502,398	1,219,986,063
Total capital assets	3,887,099,080	3,628,579,284
Less accumulated depreciation	<u>(750,972,844)</u>	<u>(681,127,715)</u>
Net capital assets	<u>3,136,126,236</u>	<u>2,947,451,569</u>
Total noncurrent assets	<u>3,320,569,000</u>	<u>3,344,738,633</u>
Total assets	<u>\$ 3,946,956,737</u>	<u>3,896,658,304</u>

**CITY OF DETROIT
SEWAGE DISPOSAL FUND**

Statements of Net Assets

June 30, 2006 and 2005

Liabilities and Net Assets	2006	2005
Current liabilities:		
Current liabilities payable from current assets:		
Book cash overdraft	\$ —	758,762
Accounts and contracts payable	13,303,914	7,683,870
Due to other funds	57,747,466	53,133,721
Accrued salaries and wages	1,246,496	1,629,152
Rate adjustments payable to customers	7,054,465	4,938,657
Accrued workers' compensation	811,538	895,155
Accrued compensated absences	2,281,068	5,556,011
Other current accrued liabilities	958,353	754,691
Total current liabilities payable from current assets	83,403,300	75,350,019
Current liabilities payable from restricted assets:		
Revenue bonds and revolving loan payable within one year	53,205,000	50,035,000
Accrued bond interest payable	41,115,497	38,654,433
Other liabilities	—	89,017
Accounts and contracts payable	35,307,217	62,465,874
Due to other funds	10,262,102	11,074,002
Total current liabilities payable from restricted assets	139,889,816	162,318,326
Total current liabilities	223,293,116	237,668,345
Long-term liabilities:		
Revenue bonds and revolving loan payable	2,611,323,633	2,609,004,255
Pension obligation certificates of participation payable	9,031,280	8,760,811
Deferred swap termination fees	2,504,243	2,286,256
Rate adjustments payable to customers	2,610,365	7,054,465
Accrued workers' compensation	4,321,980	3,832,814
Accrued compensated absences	11,618,703	8,361,795
Total long-term liabilities	2,641,410,204	2,639,300,396
Total liabilities	2,864,703,320	2,876,968,741
Net assets:		
Invested in capital assets, net of related debt	532,734,469	646,808,681
Restricted	303,465,827	166,369,102
Unrestricted	246,053,121	206,511,780
Total net assets	1,082,253,417	1,019,689,563
Total liabilities and net assets	\$ 3,946,956,737	3,896,658,304

See accompanying notes to basic financial statements.

**CITY OF DETROIT
SEWAGE DISPOSAL FUND**

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

Years ended June 30, 2006 and 2005

	2006	2005
Operating revenues:		
General customers	\$ 160,510,586	146,456,155
Suburban customers	188,762,961	158,120,913
City departments	530,845	281,062
Sewage surcharge	774,798	5,914,639
Miscellaneous	3,876,014	2,815,506
Total operating revenues, net	354,455,204	313,588,275
Operating expenses before depreciation:		
Sewage treatment plant	123,392,482	103,536,940
Interceptors and regulators	1,237,752	740,870
Sewer pumping stations	2,963,775	3,122,298
Sewer maintenance and engineering	15,775,123	12,348,658
Combined sewage overflow control basins	1,697,068	511,252
Commercial	5,870,839	5,698,629
Administrative and general	46,666,958	37,441,707
Total operating expenses before depreciation	197,603,997	163,400,354
Operating income before depreciation	156,851,207	150,187,921
Depreciation	69,951,016	44,053,316
Total operating income	86,900,191	106,134,605
Nonoperating revenues (expenses):		
Earnings on investments	18,920,649	14,930,952
Interest expense, net of capitalized interest	(43,912,587)	(44,205,957)
Miscellaneous	655,601	(7,038)
Total nonoperating expenses	(24,336,337)	(29,282,043)
Increase in net assets	62,563,854	76,852,562
Net assets – beginning of year	1,019,689,563	942,837,001
Net assets – end of year	\$ 1,082,253,417	1,019,689,563

See accompanying notes to basic financial statements.

**CITY OF DETROIT
SEWAGE DISPOSAL FUND**

Statements of Cash Flows

Years ended June 30, 2006 and 2005

	<u>2006</u>	<u>2005</u>
Cash flows from operationing activities:		
Receipts from customers	\$ 320,864,453	326,617,651
Internal activity – Payments to other funds	49,488,016	(18,598,461)
Payments to suppliers	(156,302,328)	(124,774,098)
Payments to the General Retirement System in excess of annual required contributions	—	(7,850,281)
Payments to employees	(69,072,910)	(68,354,091)
Net cash provided by operating activities	<u>144,977,231</u>	<u>107,040,720</u>
Cash flows from non–capital and related financing activities:		
Proceeds from issuance of personal obligation certificates of participator	—	8,760,811
Issuance costs–pension obligation certificates of participation	170,460	(286,646)
Bank overdraft	—	758,762
Net cash provided by non–capital and related financing activities	<u>170,460</u>	<u>9,232,927</u>
Cash provided by capital and related financing activities:		
Contributions received from customers	655,600	—
Acquisition and construction of capital assets, net	(204,612,868)	(364,680,084)
Principal paid on revenue bond maturities and revolving loar	(27,840,000)	(32,590,000)
Interest paid on revenue bonds	(95,464,337)	(82,010,501)
Principal paid on refunded debt	—	(108,765,000)
Proceeds from bond issuance and increase in revolving note payable, ne	31,459,549	426,848,891
Swap termination fee	—	(11,750,000)
Unamortized discount and bond issuance cost	3,756,736	2,542,333
Net cash used in capital and related financing activities	<u>(292,045,320)</u>	<u>(170,404,361)</u>
Cash flows from investing activities:		
Proceeds from sales and maturities of investments	622,765,697	651,726,904
Purchase of investments	(471,109,766)	(623,524,459)
Interest received on investments	18,920,649	14,930,952
Net cash provided by investing activities	<u>170,576,580</u>	<u>43,133,397</u>
Net increase in cash	23,678,951	(10,997,317)
Cash at beginning of year	20,907,898	31,905,215
Cash at end of year	<u>\$ 44,586,849</u>	<u>20,907,898</u>
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	\$ 86,900,191	106,134,605
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	69,951,016	44,053,316
Provision for uncollectible accounts	20,551,250	21,580,685
Changes in certain assets and liabilities:		
(Increase) decrease in accounts receivable	(33,478,223)	2,510,949
(Increase) in rate refund receivable from customers	(19,761,457)	(21,982,296)
(Increase) in prepaid expenses	(5,041,957)	(375,967)
(Increase) decrease in inventories	716,417	(282,877)
(Increase) in Net Pension Asset	(521,099)	(7,850,281)
(Decrease) in accounts and contracts payable	(21,538,613)	(22,701,285)
Increase (decrease) in accrued salaries and wages	(382,656)	173,323
Increase (decrease) in rate refund payable to customers	(2,328,292)	2,615,338
Increase in other accrued liabilities and accrued compensated absences and accrued workers' compensation	422,638	1,763,672
Net change in due from (to) other funds	49,488,016	(18,598,462)
Net cash provided by operating activities	<u>\$ 144,977,231</u>	<u>107,040,720</u>

See accompanying notes to basic financial statements.

**CITY OF DETROIT
SEWAGE DISPOSAL FUND**

Notes to Basic Financial Statements

June 30, 2006 and 2005

(1) Summary of Significant Accounting Policies

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

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

(a) Basis of Accounting

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

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

(b) Cash and Cash Equivalents

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

(c) Investments

Investments are stated at fair value based on quoted market price.

(d) Inventories

Inventories consist of operating and maintenance and repair parts for sewage lines and are valued at the lower of cost or market, with cost being determined on an average cost method.

**CITY OF DETROIT
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Notes to Basic Financial Statements

June 30, 2006 and 2005

(e) Capital Assets

Capital assets are recorded at historical cost, together with interest capitalized during construction. Depreciation is computed using the straight-line method over the estimated useful lives of the related assets as follows:

Improvements to land	67 years
Structures	40 years
Interceptors and regulators	100 years
Equipment	3 – 20 years

(f) Workers' Compensation

The Fund has no insurance coverage for workers' compensation claims. Workers' compensation expenses are recorded when the occurrence of the liability is probable and the amount is reasonably estimable. The amounts recorded as of June 30, 2006 and 2005 are based on compensation expected to be paid, along with estimated medical costs, for all claims known as of the balance sheet date, and historical data are used in computing the liability for estimated incurred but unknown claims as of the balance sheet date.

	June 30		
	2006	2005	2004
Balance at beginning of year	\$ 4,727,969	5,206,684	4,844,529
Current year claims and changes in estimates	964,548	475,827	1,543,501
Claims payments	(558,999)	(954,542)	(1,181,346)
Balance at end of year	\$ 5,133,518	4,727,969	5,206,684

(g) Capitalized Interest

The Fund capitalizes qualifying net interest costs of the System on bonds issued for capital construction in accordance with Statement of Financial Accounting Standards Statement No. 34 *Capitalization of Interest Cost* and Statement No. 62 *Capitalization of Interest Cost in situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants an Amendment of FASB Statement No. 34*. Accordingly, capitalized interest for the years ended June 30, 2006 and 2005 was \$54,012,814 and \$50,767,951, respectively.

(h) Taxes and City Services

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

**CITY OF DETROIT
SEWAGE DISPOSAL FUND**

Notes to Basic Financial Statements

June 30, 2006 and 2005

(i) ***Shared Costs***

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

(j) ***Compensated Absences***

The Fund records as a liability estimated vested vacation, sick pay, and banked overtime in accordance with GASB Statement No. 16, *Accounting for Compensated Absences*. Unused vacation pay accumulates until termination of employment, while there is no vesting of sick pay until an employee reaches age 60 or completes 25 years of service.

(k) ***Accrued Revenue***

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

(l) ***Net Assets***

Net assets are categorized as follows:

Invested in capital assets: This consists of capital assets, net of accumulated depreciation and related debt.

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

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

(m) ***Classification of Revenues***

The Fund has classified its revenues as either operating or nonoperating revenues according to the following criteria:

Operating revenues: Operating revenues include activities that have the characteristics of exchange transactions, such as revenue from charges for sewage service.

Nonoperating revenues: Nonoperating revenues include activities that have the characteristics of nonexchange transactions, which are defined as nonoperating revenues by GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Government Entities That Use Proprietary Fund Accounting*, and GASB Statement No. 34, *Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments*, such as investment income and interest expense.

**CITY OF DETROIT
SEWAGE DISPOSAL FUND**

Notes to Basic Financial Statements

June 30, 2006 and 2005

(n) Use of Estimates

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

(o) New Accounting Pronouncements

The Fund adopted GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*. This Statement establishes accounting and financial reporting standards for impairment of capital assets. The Fund implemented Statement No. 42 with the year ended June 30, 2006.

The Fund adopted GASB Statement No. 46, *Net Assets Restricted by Enabling Legislation – an amendment of GASB Statement No. 34*. This Statement clarifies that a legally enforceable enabling legislation restriction is one that a party external to a government – such as citizens, public interest groups, or the judiciary – can compel a government to honor. This statement also specifies the accounting and financial reporting requirements if new enabling legislation replaces existing legislation or if legal enforceability is reevaluated. The Fund implemented Statement No. 46 with the year ended June 30, 2006.

In July 2004, the GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. This Statement establishes accounting and financial reporting standards for employers that participate in a defined-benefit “other postemployment benefit” (OPEB) plan. The Fund will implement Statement No. 45 beginning with the year ended June 30, 2007. The Fund is currently evaluating the impact of adopting Statement No. 45.

(2) Deposits and Investments

The following is a complete listing of deposits and investments held by the Fund at June 30, 2006:

Deposits	\$ 8,833,849
Investments	<u>506,862,766</u>
Total deposits and investments	<u><u>\$ 515,696,615</u></u>

CITY OF DETROIT
SEWAGE DISPOSAL FUND

Notes to Basic Financial Statements

June 30, 2006 and 2005

The deposits and investments of the Fund at June 30, 2006 are reflected in the basic financial statements as follows:

Unrestricted:		
Deposits	\$	1,418,283
Investments		51,205,044
Restricted:		
Deposits		7,415,566
Investments – current		344,637,409
Investments – noncurrent		111,020,313
		Total cash and investments
	\$	515,696,615

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

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

Custodial Credit Risk of Bank Deposits

Custodial credit risk is the risk that in the event of bank failure, the Fund's deposits may not be returned by the bank. The Fund does not have a deposit policy for custodial credit risk. At June 30, 2006 and 2005, the Fund had deposits of \$8,436,281 and \$12,918,713, respectively, that were exposed to custodial credit risk, as they were uninsured and uncollateralized.

Custodial Credit Risk of Investments

Custodial credit risk is the risk that in the event of failure of the counterparty, the Fund will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party. The Fund does not have a policy for custodial credit risk. As of June 30, 2006 and 2005, the Fund had no investments subject to custodial credit risk.

**CITY OF DETROIT
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Notes to Basic Financial Statements

June 30, 2006 and 2005

Interest Rate Risk

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

<u>Investment</u>	<u>Fair value</u>	<u>Investment maturities in years</u>	
		<u>Less than one year</u>	<u>one to five years</u>
U.S. government agency securities	\$ 257,920,511	161,876,955	96,043,556
Certificate of deposit	23,421,649	23,421,649	—
Commercial paper	34,981,735	34,981,735	—
Repurchase agreements	19,985,604	5,008,847	14,976,757
Money market	170,553,267	170,553,267	—
Total investments	<u>\$ 506,862,766</u>	<u>395,842,453</u>	<u>111,020,313</u>

Credit Risk

The Fund's investment policy complies with state law. The Fund limits its investments in commercial paper, mutual funds, and external investment pools that purchase commercial paper to the top two rating classifications issued by two nationally recognized statistical rating organizations (NRSROs).

As of June 30, 2006, the Fund had the following investments, maturities, and credit quality ratings of debt securities:

<u>Investment</u>	<u>Fair value</u>	<u>Rating</u>	<u>Rating organization</u>
U.S. government agency securities	\$ 161,876,955	AAA, Aaa	S & P and Moody's
U.S. government agency securities	96,043,556	AAA, Aaa	S & P and Moody's
Repurchase agreements	14,976,757	AAA, Aaa	S & P and Moody's
Repurchase agreements	5,008,847	AAA, Aaa	S & P and Moody's
Money market	60,160,500	Aaa	Moody's
Money market	21,834,727	Not rated	N/A
Money market	88,558,040	AAAm, Aaa	S & P and Moody's
Certificates of Deposit	23,421,649	Not rated	N/A
Commercial paper	34,981,735	Not rated	N/A
Total investments	<u>\$ 506,862,766</u>		

**CITY OF DETROIT
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Notes to Basic Financial Statements

June 30, 2006 and 2005

Concentration of Credit Risk

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

More than 5% of the Fund's investments are in Federal Home Loan Bank and Federal National Mortgage Association securities. These investments are 28% and 22%, respectively, of the Fund's total investments.

(3) Restricted Assets

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

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

The Fund's statement of net assets reports \$303,996,408 of restricted net assets, of which \$299,071,259 is restricted by enabling legislation.

**CITY OF DETROIT
SEWAGE DISPOSAL FUND**

Notes to Basic Financial Statements

June 30, 2006 and 2005

(4) Capital Assets

Capital asset activity for the fiscal years ended June 30, 2006 and 2005 is as follows:

	Balance, June 30, 2005	Additions	Disposals	Balance, June 30, 2006
Nondepreciable assets:				
Land	\$ 13,876,751	—	(41,794)	13,834,957
Construction in progress	1,219,986,063	284,368,969	(1,193,852,634)	310,502,398
	1,233,862,814	284,368,969	(1,193,894,428)	324,337,355
Depreciable assets:				
Interceptors, regulators, and land improvements	542,769,689	106,574,102	(174,654,520)	474,689,271
Structures	1,143,914,922	964,622,796	(405,536,576)	1,703,001,142
Equipment	708,031,859	910,940,701	(233,901,249)	1,385,071,311
Accumulated depreciation	(681,127,715)	(69,951,016)	105,887	(750,972,844)
	1,713,588,755	1,912,186,583	(813,986,458)	2,811,788,880
Total	\$ 2,947,451,569	2,196,555,552	(2,007,880,886)	3,136,126,235
	Balance, June 30, 2004	Additions	Disposals	Balance, June 30, 2005
Nondepreciable assets:				
Land	\$ 13,876,751	—	—	13,876,751
Construction in progress	1,203,738,078	439,665,001	(423,417,016)	1,219,986,063
	1,217,614,829	439,665,001	(423,417,016)	1,233,862,814
Depreciable assets:				
Interceptors, regulators, and land improvements	532,455,750	10,313,939		542,769,689
Structures	891,488,855	252,665,492	(239,425)	1,143,914,922
Equipment	572,095,371	136,220,745	(284,257)	708,031,859
Accumulated depreciation	(637,571,035)	(44,053,316)	496,636	(681,127,715)
	1,358,468,941	355,146,860	(27,046)	1,713,588,755
Total	\$ 2,576,083,770	794,811,861	(423,444,062)	2,947,451,569

**CITY OF DETROIT
SEWAGE DISPOSAL FUND**

Notes to Basic Financial Statements

June 30, 2006 and 2005

(5) Impaired Capital Assets

Beginning fiscal year ended June 30, 2006, the Fund implemented GASB Statement No. 42-*Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*. As of June 30 2006, the Fund did not have any impaired assets reportable under Statement No. 42.

(6) Revenue Bonds

The outstanding indebtedness of the Fund was \$2,657,446,122 and \$2,653,826,572 at June 30, 2006 and 2005, respectively. The interest rates on the outstanding bonds range from 4.2% to 6.5%. Net revenues of the Fund are pledged to repayment of bonds.

Future debt service requirements at June 30, 2006 are as follows:

	<u>Principal</u>	<u>Bond interest</u>	<u>Swap interest</u>	<u>Total requirements</u>
Year ending June 30:				
2007	\$ 53,205,000	98,382,197	32,993,250	184,580,447
2008	53,704,128	100,782,453	33,554,365	188,040,946
2009	56,925,000	107,542,236	32,780,631	197,247,867
2010	59,795,000	105,879,518	33,307,497	198,982,015
2011	62,270,000	102,905,996	32,646,118	197,822,114
2012 – 2016	330,454,096	515,844,103	178,428,909	1,024,727,108
2017 – 2021	375,230,225	490,294,825	198,035,091	1,063,560,141
2022 – 2026	431,147,673	417,634,980	205,211,098	1,053,993,751
2027 – 2031	614,335,000	222,394,897	97,112,842	933,842,739
2032 – 2036	620,380,000	68,643,718	19,553,665	708,577,383
	<u>\$ 2,657,446,122</u>	<u>2,230,304,923</u>	<u>863,623,466</u>	<u>5,751,374,511</u>

In fiscal 2005, the Fund issued \$273,355,000 of City of Detroit, Michigan, Sewage Disposal System Revenue Second Lien Bonds, Series 2005-A; \$40,215,000 of City of Detroit, Michigan Sewage Disposal System Revenue Refunding Second Lien Bonds, Series 2005-B; and \$63,160,000 of City of Detroit, Michigan Sewage Disposal System Revenue Refunding Second Lien Bonds, Series 2005-C. The net proceeds were used to refund a portion of the City's outstanding Sewage Disposal System Revenue Bonds and Revenue Refunding Bonds and to pay costs of issuance associated with the 2005 bonds.

The net proceeds of the Sewage Disposal System Revenue Second Lien Bonds, Series 2005-A, will be used (a) to deposit into the Construction Fund and (b) for the payment of the related costs of issuance, including the premium for the municipal bond insurance.

CITY OF DETROIT
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The net proceeds of the Sewage Disposal System Revenue Refunding Second Lien Bonds, Series 2005-B, will be used (a) to advance-refund the \$22,355,000 principal amount of the City's Sewage Disposal System Senior Lien Bonds, Series 1997-A, comprising serial bonds maturing in the year 2022 (the Advance Refunded 1997-A Bonds), with an average interest rate of 5%, (b) to advance-refund \$115,000 of 1999-A Sewage Disposal System Senior Lien Bonds, maturing in 2011, and \$3,425,000 1999-B Sewage Disposal System Senior Lien Bonds, maturing in 2012 (the Advance Refunded 1999-A Bonds), with an average interest rate of 5.20% and 5.25%, respectively, (c) to advance-refund \$8,215,000 of 2003-A Sewage Disposal System Senior Lien Bonds, maturing in 2014, and \$8,470,000 Sewage Disposal System Senior Lien Bonds, maturing in 2015 (the Advance Refunded 2003-A Bonds), with an average interest rate of 5.0%, and (d) the payment of the related costs of issuance, including the premium for the municipal bond insurance.

The proceeds of the Sewage Disposal System Revenue Refunding Second Lien Bonds, Series 2005-C, will be used (a) to currently refund \$6,770,000 principal amount of the City's Sewage Disposal System Senior Lien Bonds, Series 1995-A bonds, maturing in the year 2025, with an average interest rate of 5%, (b) to currently refund the following amounts of the City's Sewage Disposal System Senior Lien Bonds, Series 1995-B bonds, \$2,400,000 principal amount maturing in the year 2008, with an average interest rate of 5.25%, \$20,410,000 principal amount of term bonds maturing in the year 2015, with an average interest rate of 5.25%, and \$36,605,000 principal amount of term bonds, maturing in the year 2021, with an average interest rate of 5.25% (together with the "Currently Refunded 1995-A/B Bonds"), and (c) for the payment of the related costs of issuance, including the premium for the municipal bond insurance.

Proceeds of the Refunding Bonds were deposited into an irrevocable trust with an escrow agent to provide for all future principal and interest payments on the Currently Refunded 1995-A/B Bonds when due to and including July 1, 2005 at 100% and 101%; the Advance Refunded 1997-A Bonds when due to and including July 1, 2007 at 101%; the Advance Refunded 1999-A Bonds when due to and including July 1, 2010 at 101%; and the Advance Refunded 2003-A Bonds when due to and including July 1, 2013 at 100%.

The advance refunding resulted in a difference between the reacquisition price and net carrying amount of the old debt of \$8,987,394. This difference, reported in the basic financial statements as a deduction from bonds payable, is being charged to operations through the year 2024 using the straight-line method. The fund completed the advance refunding to reduce its total debt service payments over the next 20 years and to obtain an economic gain (difference between the present values of the old and new debt service payments) of \$6,143,299.

In prior years, the Fund defeased certain bonds by placing the proceeds of new bonds in an irrevocable trust to provide for all future debt service payments on the old bonds. Accordingly, the trust account assets and liabilities for the defeased bonds are not included in the Fund's financial statements. Similarly, the interest expense related to the defeased bonds and the related interest income earned on the escrow fund investments have not been recognized in the statements of revenues, expenses, and changes in fund net assets. As of June 30, 2006 and 2005, approximately \$400,800,000 and \$593,330,000 of bonds outstanding are considered defeased.

Bonds outstanding at June 30, 2006 include \$2,439,587,743 of bonds callable at various dates after June 30, 2006. These bonds are callable at varying premiums, depending on the issue and length of time to maturity.

**CITY OF DETROIT
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Notes to Basic Financial Statements

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(7) Pension Obligation Certificates of Participation (POC's)

2005 Issuance

In June 2005, the Detroit Retirement Systems Funding Trust issued \$1,440,000,000 (\$640 million of fixed rate, Series A, and \$800 million of floating rate, Series B) of taxable Pension Obligation Certificates of Participation (COPs). The Trust was created by the General Retirement System Service Corporation (GRSSC) and the Police and Fire Retirement System Service Corporation (PFRSSC), both blended component units of the City. The City entered into service contracts with the GRSSC and PFRSSC to facilitate the transaction.

The POC's were issued for the purpose of funding certain unfunded accrued actuarial liabilities (UAAL) of the two retirement systems of the City, which include the General Retirement System (GRS) and the Police & Fire Retirement System (PFRS), and a portion of the then current year normal contribution. The GRS includes employees and retirees of certain governmental funds, proprietary funds (Transportation Fund, Sewage Disposal Fund and Water Fund) and the Detroit Public Library, a discretely presented component unit.

A proportionate amount of the liability was recorded on the books of the City's Governmental Activities, Transportation Fund, Sewage Disposal Fund and Water Fund, based on each fund's portion of the overall UAAL liquidated by the use of the 2005 POC net proceeds. In connection with the 2005 transactions, the Service Corporations entered into interest rate exchange agreements (swap agreements) to hedge the variable rate interest exposure associated with the issuance of the 2005 Series-B Certificates.

The original Series A and Series B certificates were not specifically related to either of the Service Corporations. The amount of proceeds from the 2005 issuance recorded on each Service Corporation's books was based on the respective proportion of UAAL funding required for the corresponding Pension System.

Fiscal Year 2006 Events

Michigan law entitles each Retirement System to have its UAAL funded over a specified period (Amortization Period), which may be duly changed up to a 30-year maximum. Each 2005 Service Contract required the City to make 2005 COP service payments over a period that was limited to the PFRS or GRS Amortization Period (13 years for PFRS and 20 years for the GRS). The funding Ordinance anticipated the possible future extension of the PFRS and GRS Amortization Periods and authorized the Service Corporations, in that event, to assist the City in gaining the financial benefits of making its 2005 COP Service payments over a similarly lengthened period.

On February 8, 2006, the governing board of the GRS extended the Amortization Period for GRS UAAL from 20 to 30 years. On March 30, 2006, the governing board of the PFRS UAAL extended the amortization period for PFRS UAAL from 13 to 30 years. Accordingly, the Detroit Retirement Systems Funding Trust 2006 issued \$948,540,000 of taxable Certificates of Participation Series 2006. The City also terminated the Swap agreements entered into in the 2005 transaction and received \$48,932,455 as a result of the swap termination.

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The Taxable Certificates of Participation Series 2006 were issued to enable the City to replace certain scheduled payment obligations that it incurred to provide funding for the 2005 Subject UAAL with new scheduled payment obligations payable over the extended 30-year periods under the 2006 Service Contracts. This will enable the City to achieve financial benefits from the lengthened payment periods compared to the payment period included within the 2005 Series A and B payment schedules.

The 2006 Certificates were issued to fund the optional redemption \$104,055,000 aggregate principal amount of Series 2005-A COPs of certain maturities and the purchase and cancellation of \$800,000,000 aggregate principal amount of Series 2005-B COPs of certain maturities.

The City did not pay off the \$104,055,000 of optionally redeemed Series A 2005 COPs until July 13, 2006. At June 30, 2006 the portion of the 2006 COP proceeds to pay the \$104,055,000 COPs were in irrevocable trust investment accounts and on July 13, 2006 were disbursed to pay the COP service obligation and accrued interest from June 15, 2006 (the last interest payment date) to July 13, 2006. For financial reporting purposes, this disbursement was treated as if it had occurred on June 30, 2006.

In economic substance, the City paid off \$904,055,000 of 2005 Series Certificates with the net proceeds from the \$948,540,000 received from the issuance of Certificates of Participation Series 2006. The net effect of this on the City's balance sheet is to add on additional \$44,485,000 of Certificates of Participation obligations to the government-wide balance sheet. The refunding resulted in an increase of approximately \$992 million in required aggregate future cash outflows for debt service. This resulted in an economic loss (difference between the present values of the old and new debt service requirements) of \$89,265,111.

Certain maturities of the Series 2005-A COPs still remain outstanding concurrently with the 2006 Certificates. The 2005 COPs and the 2006 Certificates are wholly independent of each other.

The redemption dates and a summary of the aggregate principal and interest amounts for the remaining 2005 POC's are as follows:

Maturity (June 15)	Primary Government Principal				Totals
	Governmental Activities	Business-type Activities			
		Sewer Disposal Fund	Transportation Fund	Water Fund	
2007	-	-	-	-	-
2008	-	-	-	-	-
2009	-	-	-	-	-
2010	3,861,370	28,880	340,053	519,698	4,750,000
2011	8,905,539	66,606	784,268	1,198,587	10,955,000
2012-2016	113,686,862	850,288	10,011,862	15,300,989	139,850,000
2017-2021	153,857,304	1,150,731	13,549,481	20,707,484	189,265,000
2022-2025	155,369,335	1,162,040	13,682,639	20,910,986	191,125,000
Total	\$ 435,680,409	\$ 3,258,546	\$ 38,368,303	\$ 58,637,742	\$ 535,945,000

**CITY OF DETROIT
SEWAGE DISPOSAL FUND**

Notes to Basic Financial Statements

June 30, 2006 and 2005

Primary Government					
Interest					
Business Type Activities					
Maturity (June 15)	Governmental Activities	Sewer Disposal Fund	Transportation Fund	Water Fund	Totals
2007	20,942,804	156,636	1,844,333	2,818,669	\$ 25,762,441
2008	20,942,804	156,636	1,844,333	2,818,669	25,762,441
2009	20,942,804	156,636	1,844,333	2,818,669	25,762,441
2010	20,942,804	156,636	1,844,333	2,818,669	25,762,441
2011	20,776,224	155,390	1,829,663	2,796,249	25,557,526
2012-2016	93,492,246	699,248	8,233,418	12,583,018	115,007,929
2017-2021	60,177,138	450,077	5,299,514	8,099,174	74,025,904
2022-2025	20,083,887	150,212	1,768,692	2,703,068	24,705,859
Total	<u>\$ 278,300,709</u>	<u>\$ 2,081,470</u>	<u>\$ 24,508,620</u>	<u>\$ 37,456,183</u>	<u>\$ 342,346,982</u>

The redemption dates and a summary of the aggregate principal and interest amounts for Series 2006 Pension Obligation Certificates are as follows:

Primary Government					
Principal					
Business-type Activities					
Maturity (June 15)	Governmental Activities	Sewer Disposal Fund	Transportation Fund	Water Fund	Totals
2007	\$ -	\$ -	\$ -	\$ -	\$ -
2008	-	-	-	-	-
2009	-	-	-	-	-
2010	-	-	-	-	-
2011	-	-	-	-	-
2012-2016	-	-	-	-	-
2017-2021	33,557,338	250,982	2,955,235	4,516,445	41,280,000
2022-2026	84,689,193	633,408	7,458,175	11,398,224	104,179,000
2027-2031	318,531,321	2,382,363	28,051,539	42,870,777	391,836,000
2032-2035	334,309,285	2,500,370	29,441,030	44,994,315	411,245,000
Total	<u>\$ 771,087,137</u>	<u>\$ 5,767,123</u>	<u>\$ 67,905,979</u>	<u>\$ 103,779,761</u>	<u>\$ 948,540,000</u>

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Notes to Basic Financial Statements

June 30, 2006 and 2005

Maturity (June 15)	Primary Government Interest Business Type Activities					Totals
	Governmental Activities	Sewer Disposal Fund	Transportation Fund	Water Fund		
		\$	\$	\$	\$	
2007	\$ 40,020,806	\$ 299,324	\$ 3,524,442	\$ 5,386,356	\$ 49,230,928	
2008	44,079,824	329,682	3,881,901	5,932,655	54,224,061	
2009	47,826,551	357,705	4,211,857	6,436,922	58,833,035	
2010	47,826,551	357,705	4,211,857	6,436,922	58,833,035	
2011	47,826,551	357,705	4,211,857	6,436,922	58,833,035	
2012-2016	239,132,754	1,788,524	21,059,285	32,184,612	294,165,175	
2017-2021	236,954,334	1,772,231	20,867,442	31,891,421	291,485,428	
2022-2026	223,400,997	1,670,863	19,673,864	30,067,292	274,813,016	
2027-2031	165,038,717	1,234,359	14,534,175	22,212,378	203,019,629	
2032-2035	52,643,635	393,733	4,636,075	7,085,248	64,758,691	
Total	<u>\$ 1,144,750,722</u>	<u>\$ 8,561,832</u>	<u>\$ 100,812,754</u>	<u>\$ 154,070,728</u>	<u>\$ 1,408,196,036</u>	

(8) Deferred Swap Termination Proceeds and Payments

During the year ended June 30, 2004, the Fund and its counterparty terminated a forward starting swap agreement related to the future issuance of debt in fiscal year 2005. The Fund received a termination payment in the amount of \$14,056,137 that has been deferred to offset future debt service. The proceeds will be recognized over the life of the debt using the straight-line method.

During the year ended June 30, 2005, the Fund and its counterparty terminated a forward starting swap agreement related to the issuance of debt in fiscal year 2005. The Fund paid a termination payment in the amount of \$11.75 million that has been reserved to offset future debt service. The expense will be recognized over the life of the debt that was issued in fiscal year 2005 using straight-line method.

During the year ended June 30, 2006, The City terminated the Swap agreements entered into in the 2005 transaction and received \$48,932,455. The Fund's allocated share is \$297,509. The proceeds will be recognized over the life of the debt using the straight-line method.

During fiscal year ended June 30, 2006, the amount of amortization expense was \$79,522. The remaining balance of the Sewer Swap Termination Fee as of June 30, 2006 and 2005 is \$2,504,243 and 2,286,256, respectively.

**CITY OF DETROIT
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Notes to Basic Financial Statements

June 30, 2006 and 2005

(9) Long-Term Liabilities

Long-term liability activity for the years ended June 30, 2006 and 2005 is as follows:

	<u>Balance, June 30, 2005</u>	<u>Increase</u>	<u>Decrease</u>	<u>Balance, June 30, 2006</u>	<u>Amount due within one year</u>
Revenue bonds payable	\$ 2,653,826,572	53,654,550	(50,035,000)	2,657,446,122	53,205,000
Total revenue bond payable	2,653,826,572	53,654,550	(50,035,000)	2,657,446,122	53,205,000
Add:					
Unamortized premium	83,676,956	—	(5,128,099)	78,548,857	—
Less:					
Deferred charges on refunding	63,094,656	10,013,373	(3,707,707)	69,400,322	—
Discount	15,369,617	—	(13,303,593)	2,066,024	—
Net revenue					
bonds payable	<u>2,659,039,255</u>	<u>43,641,177</u>	<u>(38,151,799)</u>	<u>2,664,528,633</u>	<u>53,205,000</u>
Pension obligation certificates payable	<u>8,760,811</u>	<u>270,469</u>	<u>—</u>	<u>9,031,280</u>	<u>—</u>
Other liabilities:					
Accrued workers' compensation	4,727,969	964,548	(558,999)	5,133,518	811,538
Accrued compensated absences	13,917,806	3,256,908	(3,274,943)	13,899,771	2,281,068
Deferred swap termination	<u>2,286,256</u>	<u>297,509</u>	<u>(79,522)</u>	<u>2,504,243</u>	<u>—</u>
Total other liabilities	<u>20,932,031</u>	<u>4,518,965</u>	<u>(3,913,464)</u>	<u>21,537,532</u>	<u>3,092,606</u>
Total	<u>\$ 2,688,732,097</u>	<u>48,430,611</u>	<u>(42,065,263)</u>	<u>2,695,097,445</u>	<u>56,297,606</u>

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Notes to Basic Financial Statements

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	<u>Balance, June 30, 2004</u>	<u>Increase</u>	<u>Decrease</u>	<u>Balance, June 30, 2005</u>	<u>Amount due within one year</u>
Revenue bonds payable	\$ 2,375,152,600	420,028,972	(141,355,000)	2,653,826,572	50,035,000
Add:					
Unamortized premium	70,051,130	17,150,459	(3,524,633)	83,676,956	—
Less:					
Deferred charges on refunding	62,230,146	4,456,953	(3,592,443)	63,094,656	—
Discount	16,297,959	—	(928,342)	15,369,617	—
Net revenue					
bonds payable	<u>2,366,675,625</u>	<u>432,722,478</u>	<u>(140,358,848)</u>	<u>2,659,039,255</u>	<u>50,035,000</u>
Pension obligation certificates payable	<u>—</u>	<u>8,760,811</u>	<u>—</u>	<u>8,760,811</u>	<u>—</u>
Other liabilities:					
Accrued workers' compensation	5,206,684	475,827	(954,542)	4,727,969	895,155
Accrued compensated absences	12,158,263	2,255,075	(495,532)	13,917,806	5,556,011
Deferred swap termination	<u>14,056,137</u>	<u>—</u>	<u>(11,769,881)</u>	<u>2,286,256</u>	<u>—</u>
Total other liabilities	<u>31,421,084</u>	<u>2,730,902</u>	<u>(13,219,955)</u>	<u>20,932,031</u>	<u>6,451,166</u>
Total	<u>\$ 2,398,096,709</u>	<u>444,214,191</u>	<u>(153,578,803)</u>	<u>2,688,732,097</u>	<u>56,486,166</u>

(10) Derivatives Not Reported at Fair Value

The Fund is party to derivative financial instruments consisting of interest rate swaps that are intended to effectively convert variable-rate financings to fixed-rate financings. These are not reported at fair value on the statement of net assets at June 30, 2006.

Objective of the swaps. In order to better manage its interest rate exposure and to reduce the overall costs of its financings, the Fund has entered into nine separate fixed-payor interest rate swaps. The Fund is also a party in the City's POC's related to the GRS. The City has entered into two separate fixed-payor interest rate swaps related to the POC's and the GRS.

Market access risk. The City is exposed to market access risk on its hedge swaps or forward starting swaps in the event that it will not be able to enter credit markets or in the event that credit will become more costly.

Terms, fair values, and credit risk. Certain key terms, fair market values, and counterparty credit ratings relating to the outstanding swaps as of June 30, 2006 are presented below. The notional amounts of the swaps, except those with effective dates of September 1, 2006 and March 1, 2007, match the principal amounts of the outstanding financings. The swaps with effective dates of September 1, 2006 and March 1, 2007, were entered into to hedge future interest rate risk and will be associated with financings expected to be issued prior to the effective dates. Except as discussed under rollover risk, the Fund's swap agreements

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contain scheduled reductions to outstanding notional amounts that match scheduled or anticipated amortization of associated financings.

<u>Associated financing issue</u>	<u>Notional amounts (1)</u>	<u>Effective date</u>	<u>Fixed rate paid</u>	<u>Variable rate received</u>	<u>Fair values</u>	<u>Sweep termination date</u>	<u>Final maturity of bonds</u>	<u>Counterparty credit rating</u>
Sewage 1998-A	\$ 68,000,000	12/10/1998	4.51%	BMA (2)	\$ (3,258,018)	7/1/2023	7/1/2023	Aa2/AA-/NR
Sewage 1998-B	67,900,000	12/10/1998	4.51	BMA	(3,260,270)	7/1/2023	7/1/2023	Aa2/AA-/NR
Sewage 1999-A	27,900,000	10/22/1999	7.48	IMT+.28%	(9,227,590)	7/1/2029	7/1/2029	Aa1/AA-/AA+
Sewage 2001 C-1	156,500,000	10/23/2001	4.43	BMA	(7,116,931)	7/1/2027	7/1/2027	Aa2/AA+/AAA
Sewage 2001 C-2	124,500,000	10/23/2001	4.47	BMA	(6,565,848)	7/1/2029	7/1/2029	Aa2/AA+/AAA
Sewage 2003-B	150,000,000	5/22/2003	4.14	BMA	1,924,401	7/1/2033	7/1/2033	Aa2/AA+/AAA
Sewage Hedge Swap	125,000,000	9/1/2006	4.96	BMA	7,867,616	7/1/2036	N/A	Aa2/AA+/AAA
Sewage Hedge Swap	56,250,000	3/1/2010	4.93	BMA	1,320,373	7/2/2039	N/A	Aa3/A+/AA-
Sewage Hedge Swap	168,750,000	3/1/2010	4.93	BMA	(4,141,786)	7/3/2039	N/A	Aa3/A+/AA-
Pension Obligation Certificates - GRS	99,621,000	6/7/2006	4.99	3 MTH LIBOR + .34%	(183,936)	6/15/2034	6/15/2034	Aa3/A+/AA-
Pension Obligation Certificates - GRS	42,252,000	6/7/2006	4.99	3 MTH LIBOR + .30%	(84,084)	6/15/2029	6/15/2029	Aa3/A+/AA-

(1) Notional amount balance as of July 1, 2006

(2) The Bond Market Association Municipal Swap Index™

(3) Denotes the the swap termination date does not match the final maturity of the financings

Fair value. Because interest rates have generally declined since the time the swaps were negotiated, most of the Fund's swaps have a negative fair value as of June 30, 2006. The negative fair values may be countered by lower total interest payments required under the variable-rate financings, creating lower synthetic interest rates.

Credit risk. As of June 30, 2006, the Fund was not significantly exposed to net credit risk, as the majority of the swaps had net negative fair values. However, should interest rates change and fair values of the swaps become positive, the Fund would be exposed to credit risk in the amount of the derivatives' positive fair value.

The swap agreements contain varying collateral agreements with the counterparties. The swaps require full collateralization of the fair value of the swap should the counterparty's credit rating fall below certain rating levels by Fitch Ratings, Standard & Poor's, and/or Moody's Investors Service. Collateral on all swaps is to be in the form of U.S. government securities held by a third-party custodian.

Basis risk. The Fund is not exposed to significant basis risk on its swaps because most of the variable payments received are based on the Bond Market Association (BMA) index. The Consumer Price Index (CPI) indexed swaps are associated with CPI indexed financings and thus create no basis risk. The London Interbank Offered Rate (LIBOR)-based swap has basis risk on \$28.3 million of swaps.

Termination risk. The Fund or counterparty may terminate any of the swaps if the other party fails to perform under the terms of the contract. In such cases, the Fund may owe or be due a termination payment, depending on the value of the swap at that time. In addition, the Fund is exposed to termination risk, but not termination payments, on certain of the Fund's swaps related to Sewer Series 1998-A, Sewer Series 1998-B, Sewer Series 1999-A, Sewer Series 2001-C-1, Sewer Series 2001-C-2, and Sewer Series 2003-B. These

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swaps provide the counterparty with the option to terminate the swap agreement beginning on January 1, 2010, July 2, 2011, July 1, 2008, July 1, 2008, January 1, 2010, January 1, 2010, and July 1, 2013, respectively, upon the passing of certain BMA thresholds. If any of these swaps were terminated, the associated variable-rate financings would no longer carry synthetic interest rates, but there would be no termination payment.

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

(11) Employee Benefit Plan

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

Plan Description

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

Funding Policy

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

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

Based upon the June 30, 2005 actuarial valuation, which was the most recent actuarial data available when the budget was developed for the year ended June 30, 2006, the actuary recommended the Sewage Disposal Fund contribution rate of 2.04%. Contributions for the Sewage Fund totaled \$4,185,887.

Employees may elect to contribute 3%, 5%, or 7% of the first \$87,900 of annual compensation and 5% or 7% of any excess over \$87,900 for annuity savings. Contributions are voluntary for all union and nonunion

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employees. Contributions received from Sewer Fund employees during the year ended June 30, 2006 amounted to \$2,638,158.

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

(a) Administrative Expenses

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

	<u>Fiscal year ended</u>	<u>Annual pension cost (APC)</u>	<u>Percentage of APC contributed</u>	<u>Net pension asset</u>
General Retirement System	June 30, 2004	\$ 2,559,591	100%	\$ —
	June 30, 2005	6,359,722	223%	7,850,281
	June 30, 2006	3,795,979	—	8,240,189

The annual pension cost and net pension asset as of June 30, 2006 are as follows:

Annual required contributions	\$ 3,975,424
Interest on net pension asset	(620,172)
Adjustment to annual required contribution	440,727
	<hr/>
Annual pension cost	3,795,979
Contributions made—employer	4,185,887
	<hr/>
Changes in net pension asset	389,908
Net pension asset, beginning of year	7,850,281
	<hr/>
Net pension asset, end of year	<u><u>\$ 8,240,189</u></u>

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The actuarial methods and significant assumptions used to determine the annual required contributions for June 30, 2006 were as follows:

Valuation date	June 30, 2005
Actuarial cost method	Entry age
Amortization method	Level percent
Remaining amortization period for unfunded accrued liabilities	30 years
Asset valuation method	3-year smoothed market
Actuarial assumptions:	
Investment rate of return	7.9%
Projected salary increases*	4% – 9.5%
Cost-of-living adjustments*	2.25%

*Includes inflation rate of 4%

(12) Other Post-employment Benefits

In addition to the pension benefits described above, the City provides post-retirement benefits to its retirees, which include hospitalization, dental care, eye care, and life insurance. The number of City retirees at June 30, 2006 is 22451. Costs are accounted for in accordance with GASB Statement No. 12, Disclosure of Information on Post-retirement Benefits Other Than Pension Benefits by State and Local Governmental Employers. The benefits are provided in accordance with the City Charter and union contracts. The costs of benefits, which are financed on a pay-as-you-go basis, for the year ended June 30, 2006, are as follows:

Benefits	City cost	Retiree cost	Total cost
Hospitalization	\$ 139,306,757	14,933,508	154,240,265
Dental	6,160,524	—	6,160,524
Eye care	1,969,690	—	1,969,690
Life insurance	143,579	26,740	170,319
	\$ 147,580,550	14,960,248	162,540,798

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(13) Due from (to) Other Funds

During the course of operations, numerous transactions occur between individual funds and other City of Detroit funds for goods provided or services rendered. Related receivables and payables are classified as “due from other funds” or “due to other funds” on the balance sheets and are summarized as follows:

	<u>2006</u>	<u>2005</u>
Due from other funds (unrestricted):		
General	\$ 30,513	11,887,394
Water	<u>52,768,156</u>	<u>54,500,684</u>
Total due from other funds (unrestricted)	<u>\$ 52,798,669</u>	<u>66,388,078</u>
Due from other funds (restricted):		
General	\$ 33,067	37,355,552
Water	<u>5,508,719</u>	<u>282,997</u>
Total due from other funds (restricted)	<u>\$ 5,541,786</u>	<u>37,638,549</u>
Due to other funds (unrestricted):		
General	\$ 5,824,511	4,921,074
General Fiduciary	411,500	
Water	<u>51,511,455</u>	<u>48,212,647</u>
Total due to other funds (unrestricted)	<u>\$ 57,747,466</u>	<u>53,133,721</u>
Due to other funds (restricted):		
General	\$ 30,605	48,509
Water	<u>10,231,497</u>	<u>11,025,493</u>
Total due to other funds (restricted)	<u>\$ 10,262,102</u>	<u>11,074,002</u>

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Notes to Basic Financial Statements

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(14) Capital Improvement Programs

The Fund is engaged in a variety of projects that are a part of its five-year Capital Improvement Program (the Program). The total cost of this Program is anticipated to be approximately \$1.81 billion through fiscal year 2011. The Program is being financed primarily from revenues of the Fund and proceeds from the issuance of revenue bonds.

The total amount of construction contract commitments outstanding at June 30, 2006 and 2005 was approximately \$356 million and \$453 million, respectively.

(15) Rate Adjustments

The U.S. Environmental Protection Agency (EPA), in attempting to ensure that user charges are proportional in effect as well as in their design, requires grantees to compare budgeted wastewater contributions, revenues from users, and user classes to actual results and make appropriate rate adjustments in the second succeeding year. The accompanying financial statements reflect management's estimates of the current and noncurrent amounts receivable from and refundable to customers in accordance with the regulations. Although subsequent adjustments to these amounts may occur, management does not believe the impact would be material to the Fund's financial position or results of operations.

(16) Contingencies

The operation of the Fund's Waste Water Treatment Plant (WWTP) is subject to extensive regulation pursuant to the Federal Water Pollution Control Act, as amended by the Clean Water Act of 1977 and the Water Quality Act of 1987 (collectively, the Clean Water Act). Included in the regulatory framework established by the Clean Water Act is the National Pollutant Discharge Elimination System (NPDES) permit program, which requires operation of wastewater treatment facilities according to discharge limitations and other requirements as set forth in permits issued to each facility. The U.S. EPA has authorized the State of Michigan Department of Environmental Quality (MDEQ) to implement and enforce the federal NPDES permit program.

The Fund and the City's Legal Department operate the WWTP pursuant to an NPDES permit that took effect on January 1, 2004 and which is due to expire on October 1, 2007.

The Fund is also a defendant in numerous other alleged claims and lawsuits. The Fund and its legal counsel have estimated a reserve for the potential outcome of such claims or the amount of potential damages in the event of an unfavorable outcome for each of the above contingencies, which is included in the accompanying financial statements. The Fund's management and the City's Legal Department estimate that any differences in reserved amounts, and other potential claims against the Fund not covered by the Fund's insurance, resulting from such litigation will not materially impact the Fund's financial position or results of operations.

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

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(17) Subsequent Events

On August 4, 2006, the Fund issued \$401,560,000 of bonds that comprised: (1) Sewage Disposal System Revenue Second Lien Bond Series 2006-A (Variable Rate Demand) of \$125,000,000, (2) Sewage Disposal System Revenue Second Lien Bond Series 2006-B for \$250,000,000 and, (3) Sewage Disposal System Refunding Senior Lien Bonds, Series 2006-C for \$26,560,000. The bonds begin to mature July 1, 2009 and will be fully matured in the year 2036.

The proceeds (includes offering premium less cost of issued) of the Sewage Disposal System Refunding Senior Lien Bonds, Series 2006-C is used to refund Sewage Disposal System Senior Lien Bond, Series 2003-A of various maturities with aggregate principal of \$27,470,000 plus defeasement cost.

In September 2005, several customers of the Fund challenged the method of allocating costs associated with the 800 MHz project. In early 2007, the court issued a preliminary ruling acknowledging that the Fund had been overcharged, but is yet to issued a final ruling. In management's opinion, the final resolution will not have a material effect on the Fund's financial statements.

REQUIRED SUPPLEMENTARY INFORMATION

**CITY OF DETROIT
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Required Supplementary Information (Unaudited)

June 30, 2006

Schedule of Funding Progress (in thousands) for the General Retirement System (unaudited):

Actuarial valuation date, June 30		Actuarial value of assets	Actuarial accrued liability (AAL)	Funded ratio		Unfunded AAL (UAAL)	Covered payroll	UAAL as a percentage of payroll
2004	\$	190,985	174,546	109.42%	\$	(16,442)	—	—
2005		220,900	167,291	132.05%		(53,609)	—	—
2006		239,972	181,684	132.08		(58,288)	—	—

See accompanying independent auditors' report.