DEPARTMENT OF WATER AND SEWERAGE SERVICES
THE METROPOLITAN GOVERNMENT OF
NASHVILLE AND DAVIDSON COUNTY

AUDITED FINANCIAL STATEMENTS
AND OTHER FINANCIAL INFORMATION

JUNE 30, 2011

DEPARTMENT OF WATER AND SEWERAGE SERVICES
THE METROPOLITAN GOVERNMENT OF NASHVILLE AND DAVIDSON COUNTY

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CROSSLIN
&ASSOCIATES
CERTIFIED PUBLIC ACCOUNTANTS

Independent Auditors' Report

The Honorable Mayor and Members of Council
The Metropolitan Government of Nashville and
Davidson County, Tennessee

We have audited the accompanying statement of net assets of the Department of Water and Sewerage Services (the "Department"), an enterprise fund of The Metropolitan Government of Nashville and Davidson, County, Tennessee (the "Metropolitan Government"), as of June 30, 2011, and the related statement of revenue, expenses and changes in net assets and cash flows for the year then ended. These financial statements are the responsibility of the Department's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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. Those auditing standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note A, the financial statements present only the Department of Water and Sewerage Services Enterprise Fund and do not purport to, and do not, present fairly the financial position of the Metropolitan Government of Nashville and Davidson County, Tennessee, as of June 30, 2011, and the changes in its financial position, or, where applicable, its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Department (an enterprise fund of the Government) as of June 30, 2011, and the changes in its financial position and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

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The Honorable Mayor and Members of Council
The Metropolitan Government of Nashville and
Davidson County, Tennessee

In accordance with *Government Auditing Standards*, we have also issued our report dated October 31, 2011, on our consideration of the Department's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, 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.

Management's Discussion and Analysis on pages 3 - 9 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. This supplementary information is the responsibility of the Department's management. 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.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplementary information on pages 34 - 36 is presented for purposes of additional analysis and is not a required part of the basic financial statements. This supplementary information is marked "unaudited" and has not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on it.

Crosslin + Associates, P.C.

Nashville, Tennessee
October 31, 2011

MANAGEMENT'S DISCUSSION AND ANALYSIS

Management of the Metropolitan Government of Nashville and Davidson County (the "Metropolitan Government"), Department of Water and Sewerage Services (the "Department") - (an enterprise fund of the Government), offers readers of the Department's financial statements this overview and analysis of the financial activities of the Department for the fiscal year ended June 30, 2011. This information should be read in conjunction with the financial statements.

FINANCIAL HIGHLIGHTS

The Department provides water and sewerage service to most of Davidson County, Tennessee, and small portions of the surrounding counties. It serves approximately 177,500 water accounts and 189,900 sewer accounts. Its activities are funded entirely from revenues generated from its operations, with no tax revenues from the Metropolitan Government. A covenant with the bondholders provides assurance that there will be adequate funds for necessary major repairs and replacement of facilities, by requiring revenues to equal at least 110% of the sum of the year's operating budget (exclusive of depreciation and certain other expenses) and the debt service on its outstanding revenue bonds. These monies, not required for normal operations, flow into the Extension and Replacement Fund to be used to finance the ongoing capital requirements of the Department, as supplemented with state loans and revenue bonds. Water rates were increased on May 1 of 2009, 2010, and 2011 by five percent each year. Sewerage rates were increased by nine percent on May 1 2009, by eight percent on May 1, 2010, and by seven percent on May 1, 2011.

On December 10, 2010, $321,660,000 of revenue bonds were issued through the Water and Sewer Revenue Bonds Series 2010 A, B C and D. The purpose of this bond issue was three-fold:

i. To issue $111,660,000 of Water and Sewer Revenue Bonds (Series A & Series D) in order to retire the outstanding loan debt and exit the loan program financed by the Tennessee Local Development Authority through a ten percent sewer surcharge fee charged to retail sewer customers and to capture the fee as part of the Department's revenue stream, and;
ii. To issue $135,000,000 of Taxable Build America Water and Sewer Revenue Bonds (Series B), and;
iii. To issue $75,000,000 of Taxable Recovery Zone Economic Recovery Build America Water and Sewer Revenue Bonds (Series C).

These bonds received ratings from Fitch Ratings, Moody's Investment Services, Inc., and Standard and Poor's Ratings Services of AA-, Aa3, AA- respectively.

MANAGEMENT'S DISCUSSION AND ANALYSIS - Continued

At June 30, 2011, the assets of the Department exceeded its liabilities by over $1.2 billion (total net assets). This was an increase of approximately $45.1 million as compared to 2010, resulting from net income and capital grants and contributions as reflected on the Statements of Revenue, Expenses, and Changes in Net Assets. In 2011, operating revenues increased, due to increases in consumption and the rate increase effective May 1 of 2010 and 2011, respectively. Operating expenses increases were due to contractual services and cost of repair materials. Investment income decreased by 36% as compared to 2010. Capital grants and contributions decreased by approximately $1.5 million as compared to 2010. The Department ended 2011 $616,000 under its operating budget.

In 2011, cash and cash equivalents increased by approximately $2.8 million as compared to 2010, while restricted cash and cash equivalents increased by approximately $117 million. The increase in restricted cash and cash equivalents resulted from the Series 2010 Bond Issue. Capital assets increased by approximately $101.6 million, before depreciation expense of $60.1 million, for a net increase of $41.9 million for 2011. These assets were acquired using revenues of the Department, revenue bonds, grants, contributions and loans from the State of Tennessee. The Department had construction funds available at June 30, 2011, of approximately $224.4 million and liabilities of approximately $19.9 million for a net of $204.5 million available for capital additions, less outstanding commitments.

The Water and Sewerage Services have gradually been expanded and include: improvements financed by revenues; improvements resulting from capital contributions in aid of construction by private developers; all improvements, additions and extensions financed with the proceeds of outstanding bonds and governmental grants; and facilities acquired from the Nashville Suburban Utility District, the First Suburban Water Utility District of Davidson County, Tennessee, the Parkwood Service Company, the Joelton Water Utility District, the City of Lakewood sewerage system, Rayon City Water Company, the Cumberland Utility District, and the sewerage service of the Nolensville/College Grove Utility District in Williamson County.

Under the Charter and Tennessee Code Annotated §7-3-302, the Metropolitan Government can assume and take over any water and/or sewer utility district located within its boundaries through ordinances adopted by the Metropolitan Council. Several such systems currently operate inside Davidson County and if a decision is made to consolidate these operations into the Department, the Metropolitan Government will take subject to or retire all debts and liabilities of the systems. By contract dated February 1996, the Metropolitan Government has agreed not to take over the Harpeth Valley Utility District before February 2026.

Historically, the Department managed and partially funded the stormwater operations of the Metropolitan Government. In 2009, the Metropolitan Government established a Stormwater Division of the Department as a stand-alone enterprise fund with its own set of service fees, which are now an itemized part of the water bill. Further funding of stormwater operations will not be required of the Department.

In December 2005, the Department received an inquiry from United States Environmental Protection Agency ("EPA"), pertaining to the Department's Operations, Capital Plan, and Stormwater Management. The Department's response was submitted in January 2006. The Department, TDEC and EPA agreed on a recommended consent decree on March 12, 2009 (the "Consent Decree") to address and correct deficiencies within the Department's sewer system that have caused violations of the Clean Water Act (CWA). The Consent Decree required that the Department fully develop, by March 12, 2011, a Corrective Action Plan/Engineering Report ("CAP/ER") for its separate sewer system and a Long Term Control Plan ("LTCP") for its combined sewer system to achieve the goals of the CWA. Upon submittal and approval of the plans, the Department would have an additional nine years to complete the work as developed by the plans.

On May 14, 2010, the Metropolitan Government petitioned EPA and TDEC for a time extension for the delivery of both plans and the final compliance with the Consent Decree based on the flood of May 2010. EPA and TDEC granted the requested time extensions to the Department. The deadline for the submittal of the CAP/ER and LTCP was September 12, 2011 and the deadline for final compliance with the Consent Decree is eleven years after the final approval of the plans by EPA and TDEC.

Failure to comply with the Consent Decree and meet future established deadlines could result in penalties up to $3,000 per occurrence, and up to $5,000 per day for failure to timely implement work. The Department has thus far been successful in meeting all the deadlines established by the Consent Decree, and is currently in compliance with the Consent Decree in all respects.

Over the weekend of May 1 and 2, 2010, the Middle Tennessee region received over 15 inches of rainfall resulting in a flood disaster event that severely impacted several of the Department's facilities. Two wastewater treatment facilities and one water treatment facility received significant damage and over 25 sewer lift stations were flooded and damaged. The cost of repairing and refurbishing the damaged facilities is expected to be approximately $70 million when complete in 2012. The region was declared as a federal disaster area and approved for assistance from the Federal Emergency Management Agency (FEMA). Federal and state assistance has been approved for approximately 30 percent of the damage total and the Department has appealed the eligibility of another 30 percent of the cost to date.

OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis is intended to serve as an introduction to the Department's basic financial statements. The Department's basic financial statements consist of the Statements of Net Assets, the Statements of Revenue, Expenses, and Changes in Net Assets and the Statements of Cash Flows. Data on these statements represent an enterprise fund of the Metropolitan Government as established by the master bond resolution and the Charter of the Metropolitan Government. These funds consist of the Revenue Fund, the Operating Fund, the Operating Reserve Fund, the Debt Service Fund, the Debt Service Reserve Fund, the Revolving Fund, and the Extension and Replacement Fund. All revenues of the Department are required to be used for the benefit of the ratepayers.

MANAGEMENT'S DISCUSSION AND ANALYSIS - Continued

	Condensed Financial Information as of June 30, 2011	2010
Statements of Net Assets		
ASSETS		
Total current assets	$ 98,899,296	$ 53,293,326
Total capital and other noncurrent assets	1,946,741,041	1,706,186,440
Total assets	2,045,640,337	1,759,479,766
LIABILITIES and NET ASSETS		
Total current liabilities	89,220,866	103,788,711
Total noncurrent liabilities	688,233,028	432,609,590
Total net assets	$ 1,268,186,443	$ 1,223,081,465
Statement of Revenue, Expenses, and Changes in Net Assets		
Operating revenues	$ 195,544,617	$ 171,307,441
Depreciation (expense)	(60,144,713)	(60,048,639)
Other operating (expenses)	(95,411,856)	(89,408,598)
Operating income	39,988,048	21,850,204
Nonoperating revenues (expenses):		
Investment income	176,347	274,593
Interest expense	(28,706,224)	(21,760,337)
Other	546,851	383,997
Capital grants and contributions	39,467,594	40,958,104
Transfers to other funds of the Metropolitan Government, net	(6,367,638)	(7,225,939)
Extraordinary Item (flood loss)	-	(7,000,000)
Change in net assets	45,104,978	27,480,622
Net Assets, beginning of year	1,223,081,465	1,195,600,843
Net Assets, end of year	$ 1,268,186,443	$ 1,223,081,465

Current assets in 2011 exceed 2010 by approximately $45.6 million, due to increased cash and cash equivalents. Current liabilities decreased by $14.5 million yielding a current ratio of 1.11. Capital assets, net of depreciation increased by $101.6 million in 2011 from 2010. These increases are from a combination of infrastructure being deeded to the Department by developers, recovery efforts as a result of the 2010 flood event, and the Department's efforts to maintain and improve the system. The Department has an ongoing program to improve both the water and sewer infrastructure by cleaning and/or relining existing pipes, as well as replacing and extending facilities.

CAPITAL ASSETS AND BONDS AND NOTES PAYABLE

Capital Assets - The Department's investment in capital assets as of June 30, 2011 is $1.6 billion, which is an increase of 2.7 percent from the year ending June 30, 2010. Depreciation expense for FY 2011 totaled $60.1 million.

	June 30, 2011	June 30, 2010
Utility plant in service	$ 2,285,736,748	$ 2,233,084,570
Land	10,010,297	10,010,297
Buildings and improvements	38,586,346	38,227,990
Improvements other than buildings	40,983,879	38,691,894
Furniture, machinery and equipment	34,229,225	32,566,557
Construction work in progress	78,282,422	33,628,975
Less accumulated depreciation	(870,354,455)	(810,687,904)
	$ 1,617,474,462	$ 1,575,522,379

Utility plant in service increased $52.6 million and construction work in progress increased $44.6 million during the year ending June 30, 2011. The primary reason for the increases were due to flood recovery activities at treatment plants, pumping stations, reservoirs, and water distribution or sewer collection lines.

Additional information on the Department's capital assets can be found in Note C beginning on page 21 of this report.

Bonds and Notes Payable - At June 30, 2011, the Department had total outstanding bond debt, including deferred charges/premiums, net, of $575.7 million. The revenues of the Department collateralize all bond debt. The Department had 26 outstanding state construction loans totaling $159.4 million and one outstanding state economic and development loan totaling $242,574.

MANAGEMENT'S DISCUSSION AND ANALYSIS – Continued

	June 30, 2011	June 30, 2010
Revenue bonds payable	$ 567,565,000	$ 309,255,000
Deferred charges / premiums, net	8,142,912	2,062,028
State construction loans	159,438,661	165,044,454
State economic and development loan	242,574	286,933
Total	$ 735,389,147	$ 476,648,415

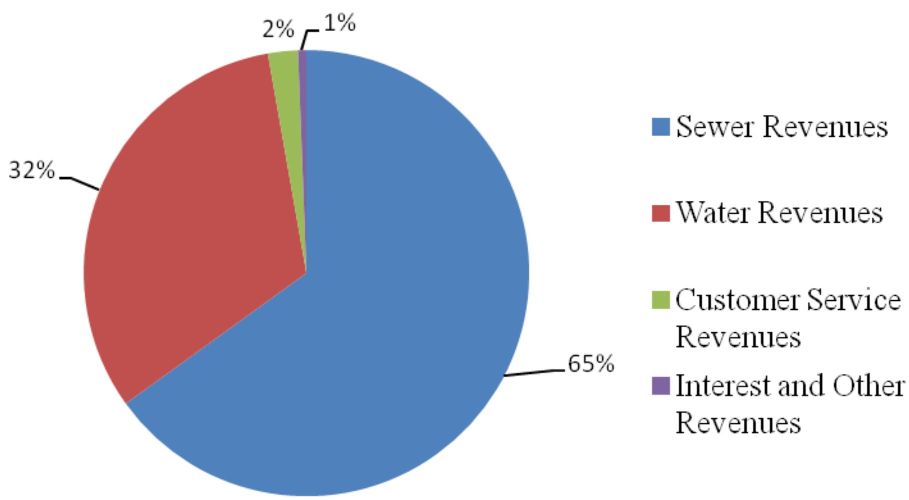
Additional information on the Department's bonds and note payable can be found in Note D beginning on page 22 of this report.

Commercial Paper - In November 2009, the Metropolitan Government instituted a Water and Sewer revenue bond commercial paper program to provide interim and short-term financing for various authorized capital projects of the Department. There was no outstanding commercial paper under the Water and Sewer program at June 30, 2011.

OTHER INFORMATION

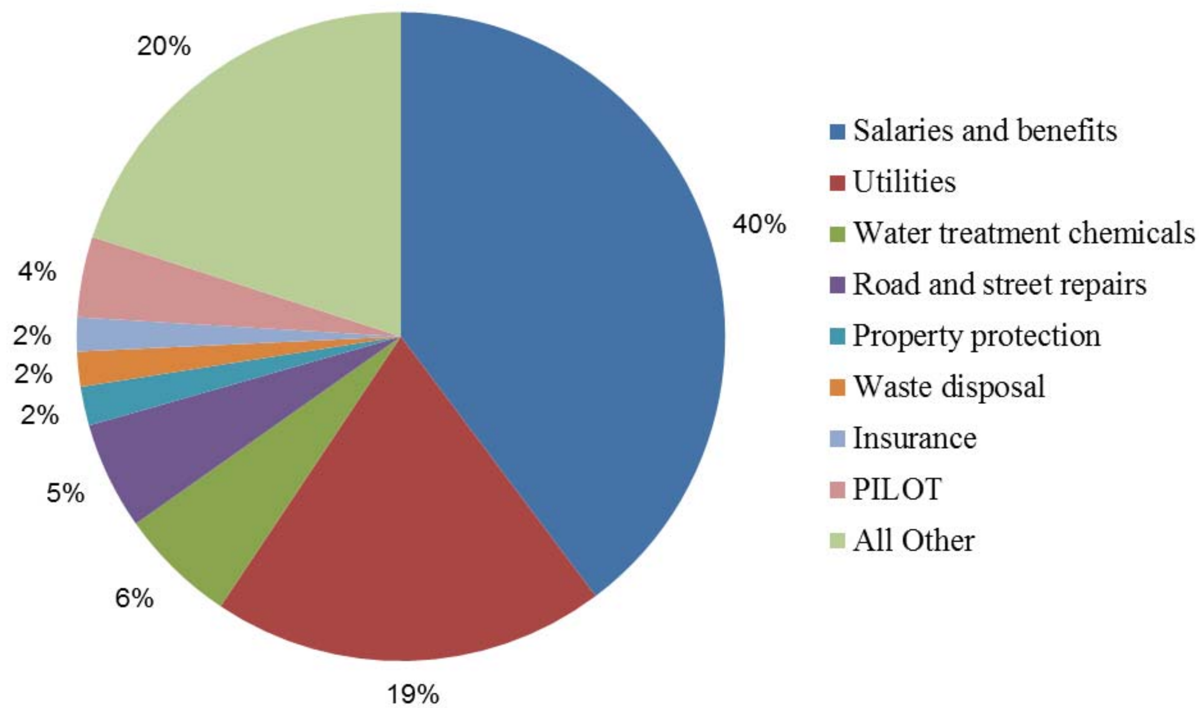
Sources of Revenues

The Department collects it's primary revenues from charges for water and sewerage services provided to customers. In addition, these revenues are invested to earn interest. Customers are charged fees (Customer Service Revenue) to establish service, for late payment and for insufficient funds checks. The Department also charges a fee to tap onto the water system, a similar fee to connect to the sewerage system and a sewer capacity fee. These are illustrated in the chart below as a percentage of total revenues:



Major Expenses

In addition to the salaries and benefits of its employees, the major expenses incurred by the Department include electricity, payment in lieu of taxes to the Government (PILOT), water treatment chemicals, biosolids disposal, insurance, and property protection. Other expenses include the materials, supplies, and outside labor to maintain the system. These expense categories are charted below as a percentage of total operating expenses, excluding depreciation, and amortization:



REQUESTS FOR INFORMATION

This financial report is designed to provide a general overview of the Department's finances for citizens, taxpayers, customers, investors, creditors and all others with an interest in the Department's finances. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the Metropolitan Government of Nashville and Davidson County, Department of Finance, Division of Accounts, cafr@nashville.gov.

DEPARTMENT OF WATER AND SEWERAGE SERVICES
THE METROPOLITAN GOVERNMENT OF NASHVILLE AND DAVIDSON COUNTY
STATEMENT OF NET ASSETS
JUNE 30, 2011

ASSETS

Current Assets:	
Cash and cash equivalents	$ 31,869,620
Accounts receivable	27,684,588
Allowance for doubtful accounts	(3,406,134)
Accrued interest receivable	12,964
Due from other funds of the Metropolitan Government	1,136,341
Inventories of supplies	2,069,421
Other current assets	1,000
Restricted Assets:	
Debt service and reserve funds:	
Accrued interest receivable	2,725
Other current assets	157,706
Construction funds:	
Cash and cash equivalents	1,029,085
Accounts receivable	34,500
Accrued interest receivable	12,328
Due from other funds of the Metropolitan Government	37,928,974
Due from other governmental agencies	366,178
Total current assets	98,899,296
Capital and Other Noncurrent assets:	
Capital assets:	
Utility plant in service	2,285,736,748
Land	10,010,297
Buildings and improvements	38,586,346
Improvements other than buildings	40,983,879
Furniture, machinery and equipment	34,229,225
Construction in progress	78,282,422
Less accumulated depreciation	(870,354,455)
Capital assets, net	1,617,474,462
Restricted Assets:	
Debt service and reserve funds:	
Cash and cash equivalents	59,259,815
Construction funds:	
Cash and cash equivalents	185,051,227
Other noncurrent assets	84,955,537
Total capital and other noncurrent assets	1,946,741,041
Total assets	2,045,640,337

See accompanying notes to financial statements.

DEPARTMENT OF WATER AND SEWERAGE SERVICES
THE METROPOLITAN GOVERNMENT OF NASHVILLE AND DAVIDSON COUNTY
STATEMENT OF NET ASSETS - Continued
JUNE 30, 2011

LIABILITIES AND NET ASSETS

Current Liabilities:	
Accounts payable	$ 5,458,532
Accrued payroll	2,241,212
Due to other funds of the Metropolitan Government	865,938
Customer deposits	2,943,555
Other current liabilities	3,285,752
Liabilities payable from restricted assets:	
Debt service and reserve funds:	
Accrued interest payable - revenue bonds	16,674,729
Current portion of revenue bonds, net	37,830,000
Construction funds:	
Accounts payable	9,808,227
Accrued payroll	84,304
Current portion of state construction loans	9,326,119
Due to other funds of the Metropolitan Government	702,498
Total current liabilities	89,220,866
Noncurrent Liabilities:	
Revenue bonds, net	537,877,912
State construction loans	150,355,116
Total noncurrent liabilities	688,233,028
Total liabilities	777,453,894
Net Assets:	
Invested in capital assets, net of related debt	1,175,481,552
Restricted for debt retirement	42,745,517
Unrestricted	49,959,374
Total net assets	$1,268,186,443

See accompanying notes to financial statements.

DEPARTMENT OF WATER AND SEWERAGE SERVICES
THE METROPOLITAN GOVERNMENT OF NASHVILLE AND DAVIDSON COUNTY
STATEMENT OF REVENUE, EXPENSES AND CHANGES IN NET ASSETS
JUNE 30, 2011

Operating revenues:	
Charges for services	$ 195,388,916
Other	155,701
Total operating revenues	195,544,617
Operating expenses:	
Personal services	41,623,952
Contractual services	38,841,256
Supplies and materials	9,915,683
Depreciation	60,144,713
Amortization	934,204
Other	4,096,761
Total operating expenses	155,556,569
Operating income	39,988,048
Nonoperating revenue (expense):	
Investment income	176,347
Interest expense	(28,706,224)
Gain on sale of capital assets	301,731
Other	245,120
Nonoperating expense, net	(27,983,026)
Income before capital grants and contributions and transfers	12,005,022
Capital grants and contributions	39,467,594
Transfers to other funds of the Metropolitan Government	(6,367,638)
Net increase in net assets	45,104,978
Net assets, beginning of year	1,223,081,465
Net assets, end of year	$ 1,268,186,443

See accompanying notes to financial statements.

DEPARTMENT OF WATER AND SEWERAGE SERVICES
THE METROPOLITAN GOVERNMENT OF NASHVILLE AND DAVIDSON COUNTY
STATEMENT OF CASH FLOWS
YEAR ENDED JUNE 30, 2011

Cash flows from operating activities:	
Receipts from customers and users	$ 189,460,036
Payments to suppliers	(43,092,087)
Payments to employees	(41,511,776)
Other payments	(5,436,972)
Net cash provided by operating activities	99,419,201
Cash flows from noncapital financing activities:	
Transfers out	(6,367,638)
Net cash used in noncapital financing activities	(6,367,638)
Cash flows from capital and related financing activities:	
Acquisition of capital assets	(67,955,908)
Proceeds from the sale of capital assets	301,731
Proceeds from borrowings	248,801,119
Principal payments on borrowings	(104,115,414)
Interest subsidy	2,890,562
Interest paid	(21,057,067)
Capital contributions received	4,960,174
Advances to other funds of the Metropolitan Government	(36,984,163)
Net cash provided by capital and related financing activities	26,841,034
Cash flows from investing activities:	
Interest received	159,586
Net cash provided by investing activities	159,586
Net increase in cash and cash equivalents	120,052,183
Cash and cash equivalents at beginning of year	157,157,564
Cash and cash equivalents at end of year	$ 277,209,747
Cash and cash equivalents are classified as;	
Current assets	$ 31,869,620
Current restricted assets construction funds	1,029,085
Noncurrent restricted assets debt service and reserve fund	59,259,815
Noncurrent restricted assets construction funds	185,051,227
	$277,209,747

See accompanying notes to financial statements.

DEPARTMENT OF WATER AND SEWERAGE SERVICES
THE METROPOLITAN GOVERNMENT OF NASHVILLE AND DAVIDSON COUNTY
STATEMENTS OF CASH FLOWS - Continued
YEAR ENDED JUNE 30, 2011

Reconciliation of operating income to net cash
provided by operating activities:

Operating income	$ 39,988,048
Adjustments to reconcile operating income to net cash provided by operating activities:	
Depreciation and amortization	61,078,917
Bad debt expense	(323,501)
Other receipts	245,120
Changes in assets and liabilities:	
Accounts receivable	(5,451,755)
Due from other funds of The Metropolitan Government	(1,367,544)
Inventories of supplies	9,283
Other current assets	58,505
Due from other governmental agencies	1,278,895
Accounts payable	5,655,569
Accrued payroll	112,176
Due to other funds of The Metropolitan Government	(1,517,079)
Customer deposits	(153,624)
Other current liabilities	(193,809)
Total adjustments	59,431,153
Net cash provided by operating activities	$ 99,419,201

Supplemental disclosure of non-cash items:	
Contributions of the capital assets	$34,103,388

See accompanying notes to financial statements.

A. SUMMARY SIGNIFICANT ACCOUNTING POLICIES

The accompanying financial statements encompass the financial activities of the Department of Water and Sewerage Services (the "Department"). The Department is an enterprise fund of The Metropolitan Government of Nashville and Davidson County, Tennessee (the Metropolitan Government) and, accordingly, is included in the basic financial statements of the Metropolitan Government. The accompanying financial statements do not purport to present fairly the financial position of The Metropolitan Government of Nashville and Davidson County, Tennessee and changes in its financial position and its cash flows. The Department provides water and sewerage services to customers in the Metropolitan Nashville area on a self-support basis utilizing a rate structure designed to produce revenues sufficient to fund debt service requirements and operating expenses and maintain adequate working capital.

Basis of Accounting

The financial statements are presented on the accrual basis of accounting in conformity with accounting principles generally accepted in the United States of America. The Department applies all relevant Government Accounting Standards Board (GASB) pronouncements. In addition, the Department has elected to apply all Financial Accounting Standards Board (FASB) pronouncements issued after November 30, 1989, except for those that may conflict with or contradict GASB pronouncements. Effective July 1, 2009, FASB pronouncements have been codified in a single source, FASB *Accounting Standard Codification* (ASC).

Estimates

Estimates used in the preparation of financial statements require management to make assumptions that affect the reported amounts of assets and liabilities, 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.

Cash and Cash Equivalents

Cash and cash equivalents include amounts in demand deposits and highly liquid short-term investments with maturity dates within three months of the date of acquisition. The Department participates in the centrally managed cash and investment pool of the Metropolitan Government, under which the Metropolitan Government remits payments on behalf of the Department. In fiscal 2011, the amount for "due to other funds of the Metropolitan Government" included in liabilities payable from restricted assets represents an unliquidated obligation as a result of an investment purchase that is held by the construction funds. Such obligation was settled subsequent to year-end. Investment income earned on funds invested in pooled accounts is allocated to the Department by the Metropolitan Government on the basis of relative balances.

A. SUMMARY SIGNIFICANT ACCOUNTING POLICIES - Continued

Inventories

Inventories, principally materials, supplies and replacement parts, are valued at the lower of cost (average cost method) or market. Inventory items are recorded as expenditures when used under the consumption method.

Capital Assets

Utility plant acquired prior to July 31, 1952, is stated at the estimated cost at that date, as determined by independent engineers, with subsequent additions recorded at cost. Net interest expense incurred during the construction of plant and equipment is capitalized as part of the cost of the related asset. Capitalized interest for the year ended June 30, 2011 was $37,500. Capital assets are generally defined as assets with an individual cost in excess of $5,000 and a useful life in excess of one year. Depreciation is provided on the straight-line method over the estimated useful lives of the respective assets. The estimated useful lives are as follows:

Utility plant in service	7 - 100 years
Building and improvements	3 - 50 years
Improvements other than buildings	20 - 100 years
Machinery and equipment	3 - 50 years

The Department closes completed construction projects to capital assets upon beneficial use.

Bond Premiums Discounts and Issuance Costs

Bond premiums, discounts and issuance costs are deferred and amortized on a straight-line basis over the term of the related bond issue.

Compensated Absences

General policy of the Metropolitan Civil Service Commission permits the accumulation, within certain limitations, of unused vacation days and sick leave. Vacation days may accumulate to an amount equal to three times the current vacation accrual rate. Accumulated unpaid vacation pay is recorded as a liability by the Department. Although sick pay may accumulate, no amounts are vested in the event of employee termination; therefore, no liability for sick pay has been accrued.

A. SUMMARY SIGNIFICANT ACCOUNTING POLICIES - Continued

Restricted Assets

Restricted assets represent amounts which are required to be maintained pursuant to Department bond resolutions relating to bonded indebtedness (construction and sinking funds) and funds received for specific purposes pursuant to U.S. Government grants (related primarily to construction projects).

Operating and Nonoperating Revenues and Expenses

Operating revenues and expenses generally result from providing services and providing and delivering goods and services in connection with the Department's principal ongoing operations and consist primarily of charges to customers or departments, cost of sales and services, administrative expense, and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as non-operating revenues and expenses. When both restricted and unrestricted resources are available for use, it is the Department's policy to use restricted resources first and then unrestricted resources, as they are needed.

Capital Grants and Contributions

Capital grants and contributions include funds received from federal and state agencies for certain sewer projects by the Department, contributions from local governments and other sources, tap and capacity fees, and deeds of conveyance. Utility plant contributed is recorded/presented in accordance with the provisions of GASB Statement No. 33, *Accounting and Financial Reporting for Non-exchange Transactions* and GASB Statement No. 34, *Basic Financial Statements and Management's Discussion and Analysis' for State and Local Governments*. These statements require that capital contributions be reported in the statement of revenue, expenses and changes in net assets as a separate line item after non-operating revenues and expenses, rather than as direct additions to contributed capital, as under previous standards.

A. SUMMARY SIGNIFICANT ACCOUNTING POLICIES - Continued

Impairment of Long-Lived Assets

The carrying value of long-lived assets held and used are reviewed whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. For purpose of evaluating the recoverability of long-lived assets, the recoverability test is performed using undiscounted net cash flows before consideration of interest expense. Should the sum of the expected future net cash flows be less than the carrying value of the asset being evaluated, an impairment loss would be recognized. The evaluation of asset impairment requires the Department to make assumptions about future cash flows over the life of the asset being evaluated. Assets to be disposed of are reported at the lower of their carrying amount or fair value less costs to sell, and are no longer depreciated. No impairment loss was considered necessary during fiscal year 2011.

Revenue Recognition

Revenues from services provided by the Department are recognized from meters read on a monthly cycle basis. At the end of each month, services rendered from the latest date of each meter-reading cycle to month end is accrued and included as accounts receivable, net of an estimated allowance for uncollectible accounts.

Fair Value Measurements

Assets and liabilities recorded at fair value in the statement of net assets are categorized based on the level of judgment associated with the inputs used to measure their fair value. Level inputs, as defined by ASC 820, *Fair Value Measurements*, are as follows:

Level 1 - Values are unadjusted quoted prices for identical assets and liabilities in active markets accessible at the measurement date.

Level 2 - Inputs include quoted prices for similar assets and liabilities in active markets, quoted prices from those willing to trade in markets that are not active, or other inputs that are observable or can be corroborated by market data for the term of the instrument. Such inputs include market interest rates and volatilities, spreads and yield curves.

Level 3 - Certain inputs are unobservable (supported by little or no market activity) and significant to the fair value measurement. Unobservable inputs reflect the best estimate of what hypothetical market participants would use to determine a transaction price for the asset or liability at the reporting date.

A. SUMMARY SIGNIFICANT ACCOUNTING POLICIES - Continued

The Department's financial instruments consist of cash equivalents, accounts receivable, accounts payable and bonds and notes payable. The carrying value of cash equivalents, accounts receivable and accounts payable approximate fair value because of the short-term maturity of these instruments. The aggregate fair value of the bonds and notes payable exceeded their recorded values by approximately $34,000,000 at June 30, 2011. The fair value was estimated using discounted cash flow analyses based on the Department's current incremental borrowing rates for similar types of borrowing arrangements.

Accounting Pronouncements

The Department plans to adopt GASB Statement No. 61, The Financial Reporting Entity: Omnibus, required for fiscal periods beginning after June 15, 2012, in fiscal 2013. This Statement is designed to improve financial reporting for governmental entities by amending the requirements of GASB Statements No. 14 and 34, to better meet user needs and address reporting entity issues that have come to light since those Statements were issued.

The Department plans to adopt GASB Statement No. 62, Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements, required for fiscal periods beginning after December 15, 2011, in fiscal 2013. This Statement is intended to enhance the usefulness of its Codification by incorporating guidance that previously could only be found in certain Financial Accounting Standards Board (FASB) and American Institute of Certified Public Accountants (AICPA) pronouncements.

The Department plans to adopt GASB Statement No. 63, Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position, required for fiscal periods beginning after December 15, 2011, in fiscal 2013. This Statement is intended to improve financial reporting by providing citizens and other users of state and local government reports with information about how past transactions will continue to impact a government's financial statements in the future.

B. CASH AND CASH EQUIVALENTS

Deposit Policy

The Department is authorized by policy to invest funds that are not immediately needed in: United States Treasury Bills, Bonds and Notes; the State of Tennessee Local Government Investment Pool; bonds issued by the Government; bonds of commercial entities; and other investments such as repurchase agreements and commercial paper. The Department is authorized to invest in these instruments either directly or through the Metro Investment Pool.

Deposits in financial institutions are required by State statute to be secured and collateralized by the institutions. The collateral must meet certain requirements and must have a total minimum market value of 105% of the value of the deposits placed in the institutions, less the amount protected by federal depository insurance. Collateral requirements are not applicable for financial institutions that participate in the State of Tennessee's collateral pool. As of June 30, 2011, most of the Department's deposits were held by financial institutions, which participate in the bank collateral pool administered by the Treasurer of the State of Tennessee or in the State of Tennessee Local Government Investment Pool. Participating banks determine the aggregated balance of their public fund accounts for the Department. The amount of collateral required to secure these public deposits must be at least 105% of the average daily balance of public deposits held. Collateral securities required to be pledged by the participating banks to protect their public fund accounts are pledged to the State Treasurer on behalf of the bank collateral pool. The securities pledged to protect these accounts are pledged in the aggregate rather than against each individual account. The members of the pool may be required by agreement to pay an assessment to cover any deficiency. Under this additional assessment agreement, public fund accounts covered by the pool are considered to be insured for purposes of credit risk disclosure. Accounts covered by the State collateral pool are classified as category A in accordance with *GASB Statement No. 3, Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*.

The Department's deposits are categorized below to give an indication of the level of risk assumed by the Department at fiscal year-end. Category A includes deposits that are insured or collateralized with securities held by the Department or by its agent in the Department's name. Category B includes deposits that are uninsured and uncollateralized. The carrying amount of the cash and cash equivalents totaled $277,209,747, and the corresponding bank balance was $277,179,229. The difference between the carrying amounts of cash and cash equivalents and the corresponding bank balances is due primarily to outstanding checks and deposits in transit. The entire balance of cash and cash equivalents was covered by the State collateral pool, federal depository insurance or collateralized with securities held by the government's agent in the government's name (Category A).

C. CAPITAL ASSETS

The following summarizes the changes in capital assets during the year ended June 30, 2011.

	Balances July 1, 2010	Increases	Decreases	Balance at June 30, 2011
Depreciable assets:				
Utility plant in service	$2,233,084,570	$ 52,901,695	$ 249,517	$2,285,736,748
Buildings and improvements	38,227,990	358,356	-	38,586,346
Improvements other than buildings	38,691,894	2,291,985	-	40,983,879
Furniture, machinery and equipment	32,566,557	1,733,250	70,582	34,229,225
Total depreciable assets	2,342,571,011	57,285,286	320,099	2,399,536,198
Nondepreciable assets:				
Land	10,010,297	-	-	10,010,297
Construction in progress	33,628,975	90,831,871	46,178,424	78,282,422
Total nondepreciable assets	43,639,272	90,831,871	46,178,424	88,292,719
Total at historical cost	2,386,210,283	148,117,157	46,498,523	2,487,828,917
Less accumulated depreciation for:				
Utility plant in service	724,076,704	57,017,220	137,536	780,956,388
Buildings and improvements	24,843,338	1,111,690	279,550	25,675,478
Improvements other than buildings	32,314,408	637,162	-	32,951,570
Furniture, machinery and equipment	29,453,454	1,378,641	61,076	30,771,019
Total accumulated depreciation	810,687,904	60,144,713	478,162	870,354,455
Capital assets, net	$1,575,522,379	$ 87,972,444	$46,020,361	$1,617,474,462

D. BONDS AND NOTES PAYABLE

Transaction Summary

Bonds and notes payable activity for the year ended June 30, 2011 was as follows:

	Balance July 1, 2010	Additions	Reductions	Balance June 30, 2011	Due Within One Year
Revenue bonds payable	$309,255,000	$321,660,000	$(63,350,000)	$567,565,000	$37,830,000
Deferred charges/ premiums, net	2,062,028	6,805,855	(724,971)	8,142,912	-
State construction loans	165,044,454	2,940,262	(8,546,055)	159,438,661	9,280,429
State economic and development loan	286,933	-	(44,359)	242,574	45,690
Total	$476,648,415	$331,406,117	$(72,665,385)	$735,389,147	$47,156,119

Description of Amount Payable

Amounts payable at June 30, 2011 are as follows:

	Interest Rate	Amount
Revenue bonds payable:		
Department of Water and Sewerage Revenue Refunding Bonds of 1986, due in varying amounts to January 1, 2016	7.30 - 7.70%	$ 26,370,000
Department of Water and Sewerage Revenue Bonds, Series 1993, due in varying amounts to January 1, 2013	5.20 - 6.50%	21,215,000
Department of Water and Sewerage Revenue Bonds Series 1998B, due in varying amounts to January 1, 2014	4.55 - 5.25%	17,685,000
Department of Water and Sewerage Revenue Refunding Bonds, Series 2007, due in varying amounts to January 1, 2016	4.25 - 5.00%	35,580,000
Department of Water and Sewerage Revenue Refunding Bonds, Series 2008A, due in varying amounts to January 1, 2022	3.25 - 5.25%	117,405,000
Department of Water and Sewerage Revenue Refunding Bonds, Series 2008B, due in varying amounts to January 1, 2016	3.45 - 4.84%	27,650,000
Department of Water and Sewerage Revenue Refunding Bonds, Series 2010A, due in varying amounts to July 1, 2027	3.00 - 5.00%	104,050,000

D. BONDS AND NOTES PAYABLE - Continued

Description of Amount Payable - Continued

	Interest Rate	Amount
Department of Water and Sewerage Revenue Bonds, Federally Taxable (BAB's), Series 2010B, due in varying amounts to July 1, 2037	6.393 - 6.568%	135,000,000
Department of Water and Sewerage Revenue Bonds, Federally Taxable, Series 2010C, due in varying amounts to July 1, 2041	6.693%	75,000,000
Department of Water and Sewerage Revenue Refunding Bonds, Federally Taxable, Series 2010D, due in varying amounts to July 1, 2018	4.255 - 4.791%	7,610,000
Deferred charge/premium, net		8,142,912
Total revenue bonds payable		575,707,912
State construction loans	1.62 - 4.90%	159,438,661
State economic and development loan	3.00%	242,574
Total		$735,389,147

The bonds and notes payable are classified in the Statement of Net Assets as follows:

Current Liabilities:	
Liabilities payable from restricted assets:	
Current portion of revenue bonds, net and state construction loans	$ 47,156,119
Noncurrent liabilities:	
Revenue bonds, net and state construction loans	688,233,028
Total	$735,389,147

Collateral

All bonds are collateralized by the revenues of the Department.

D. BONDS AND NOTES PAYABLE - Continued

Bond Covenants

The various revenue bond indentures contain significant limitations and restrictions on annual debt service requirements, maintenance of a flow of monies through various restricted accounts, minimum amounts to be maintained in various sinking funds, and minimum revenue bond coverages. As of June 30, 2011, the Department believes it is in compliance with all financial limitations and restrictions.

Annual Debt Service Requirements

The annual requirements to amortize all revenue bonds outstanding as of June 30, 2011 are as follows:

	Revenue Bonds	
Year Ending June 30,	Principal	Interest
2012	$ 37,830,000	$ 26,998,169
2013	40,195,000	23,827,027
2014	25,980,000	21,855,332
2015	53,350,000	20,224,664
2016	25,735,000	17,997,199
2017 - 2021	102,910,000	74,914,752
2022 - 2026	59,210,000	51,735,966
2027 - 2031	54,550,000	39,543,805
2032 - 2036	67,100,000	26,692,387
2037 - 2041	82,330,000	11,328,661
2042	18,375,000	338,206
	567,565,000	315,456,168
Deferred charge/premium	8,142,912	-
Total	$575,707,912	$315,456,168

Interest is reported net of the federal subsidies in the amount of $132,693,339 for the Series 2010B and 2010C revenue bonds.

D. BONDS AND NOTES PAYABLE - Continued

Commercial Paper

In November 2009, the Department instituted a revenue commercial paper (bond anticipation note) program. Commercial paper notes are issued to provide interim or short-term financing of various water and sewer capital projects. The notes may be refunded with new notes (rollover notes) until the Department is prepared to issue long-term bonds and thereby provide permanent financing for the capital projects financed under the commercial paper program. The Department entered into Standby Note Purchase Agreements with two banks to provide liquidity for the commercial paper program. If the commercial paper dealer was ever unable to market notes in the amount needed to pay the maturing notes, the liquidity providers would issue bank notes, the proceeds of which are applied to pay the principal of and interest on commercial paper notes on the respective maturity dates.

Revenue commercial paper is issued as federally tax-exempt notes. The commercial paper is sold at par as interest-bearing obligations in minimum denominations of $100,000 with interest payable at maturity. The commercial paper has varying maturities not to exceed 270 days, and all rollover commercial paper will not have a final maturity more than two years from the initial dates of issuance. The State has waived the two-year final maturity limitation and approved a final maturity not to exceed six years. Interest rates vary depending on the market. At June 30, 2011, the amount of principal outstanding could not exceed $183.4 million. The balance on the commercial payer obligations on June 30, 2011 was $-0-.

Commercial paper activity for the year ended June 30, 2011 was as follows:

	Balance July 1, 2010	Additions	Reductions	Balance June 30, 2011
Commercial paper payable	$30,000,000	$ -	$(30,000,000)	$ -

D. BONDS AND NOTES PAYABLE - Continued

Issuance of Bonds

On December 16, 2010, the Department issued $104,050,000 Water and Sewer Revenue Refunding Bonds, Series 2010A, maturing on July 1, 2027, with interest rates ranging from 3.00% to 5.00%, $135,000,000 Water and Sewer Revenue Bonds Federally Taxable, Series 2010B (Build America Bonds – Direct Payment), maturing on July 1, 2037, with interest rates of 6.393% and 6.568%, $75,000,000 Water and Sewer Revenue Bonds Federally Taxable, Series 2010C (Recovery Zone Economic Development Bonds), maturing on July 1, 2041, with an interest rate of 6.693%, and $7,610,000 Water and Sewer Revenue Refunding Bonds Federally Taxable, Series 2010D, maturing on July 1, 2018, with interest rates of 4.255% and 4.791%. The Build America Bonds (BAB's) are issued under an irrevocable election under Section 54 of the Internal Revenue Service Code. BAB's qualify for a 45% tax credit from the Federal Government on interest payable on the Bonds. The Metropolitan Government is required to file requests for these interest credits no earlier than 90 days prior to each scheduled interest payment. Future interest payments included in the annual debt service requirements are reduced for the anticipated credits. All the bonds are subject to federal arbitrage regulations.

The 2010B and 2010C Revenue Bonds totaled $210,000,000 and provided funding to pay principal and interest on certain of the Department's Water and Sewerage maturing commercial paper notes, funding for Water and Sewerage capital improvements, and funding for debt service reserves. The 2010A and 2010D Revenue Refunding Bonds totaled $111,660,000 and refunded certain maturities of various outstanding Water and Sewerage Revenue Bond Series, prepaid a portion of the Department's outstanding loan agreements with the Tennessee Local Development Authority, and funded debt service reserves.

The net proceeds of the Water and Sewer 2010 Bonds totaled $217,197,105 (net of original issue premium, underwriting fees and other issuance costs) which was deposited with the Department. $132,777,485 was made available to fund capital improvements, $60,000,000 was used to fund maturing commercial paper notes, $23,658,707 was deposited in debt service reserves, and $716,913 was used to cover other costs of issuance.

By issuing the 2010A and 2010D Revenue Refunding Bonds, the Department obtained an estimated economic gain (difference between the present values of the debt service payments on the defeased and new debt) of $866,454. The refunding will decrease the Department's debt service payments over the next 20 years by an estimated $32,151,272.

D. BONDS AND NOTES PAYABLE - Continued

Defeased Bonds

In the current and prior years, the Department has defeased certain other obligation bonds by placing the proceeds of new bonds in irrevocable trusts to provide for all future debt service requirements on the retired bonds. Accordingly, the trust account assets and the liability for the defeased bonds are not included in the Department's financial statements. As of June 30, 2011, $25,705,000 of revenue bonds are considered defeased.

Redemption Options

Certain bonds are subject to redemption prior to maturity at the option of the Department. The stated payments of principal and interest on the Department of Water and Sewerage Services Series 1992 and Series 2010A, B, C and D are insured by municipal bond insurance policies which cannot be canceled.

State Construction Loans

As of June 30, 2011, the Department has entered into 26 loan agreements with the Tennessee Department of Conservation and the Tennessee Local Development Authority under the State of Tennessee's Revolving Fund Loan Program to provide financing for all or a portion of certain water and wastewater improvement projects. Interest on the loans begins to accrue upon the first receipt of the loan proceeds and is computed at the rate established by the Authority (between 1.62% and 4.90% at June 30, 2011). The loans mature in monthly installments, as stipulated in the agreed-upon payment schedule, and are secured by the Department's unobligated state-shared taxes in an amount equal to the maximum annual debt service requirements under the agreements. In addition, the Department has pledged user fees and charges to be paid from the Department's Extension and Replacement Fund and/or from ad valorem taxes.

As of June 30, 2011, sixteen of the project loans have been fully funded and the Department has begun repaying the loans in accordance with the specified payment schedules. Principal on eight of the loans has been fully paid. The remaining two loans have been removed from the Revolving Fund Loan Program and those projects are being funded from other Department sources including the 2010 Revenue Bonds. The fully funded loans, which total $159,438,661 at June 30, 2011, call for monthly payments of principal and interest of approximately $1,177,166.

D. BONDS AND NOTES PAYABLE - Continued

State Construction Loans

State construction loan principal maturities as of June 30, 2011 are summarized below:

Year Ending June 30,	Principal	Interest
2012	$ 9,280,429	$ 4,816,221
2013	9,654,328	4,494,685
2014	9,966,487	4,159,507
2015	10,314,099	3,811,892
2016	10,430,555	3,456,448
2017 - 2021	45,975,314	12,451,969
2022 - 2026	42,436,548	6,130,464
2027 - 2031	21,374,596	842,388
2032	6,305	15
Total state construction loans	$159,438,661	$40,163,589

State Economic and Development Loan

In January 2009, the Department entered a loan agreement with the Tennessee Department of Economic Development for $330,000. The proceeds of the loan will be used to fund the installation of variable frequency drives on the raw water pumps at the K.R. Harrington water treatment plant. The energy savings resulting from the ability to gradually increase or decrease pump speeds rather than adding or dropping pumps at full capacity will be used to repay the loan. The loan is for seven years, and interest is calculated on the loan at 3%.

State economic and development loan principal maturities as of June 30, 2011 are summarized below:

Year Ending June 30,	Principal	Interest
2012	$ 45,690	$ 7,277
2013	47,061	5,907
2014	48,472	4,495
2015	49,927	3,041
2016	51,424	1,543
Total state economic and development loan	$242,574	$22,263

E. EMPLOYEE BENEFIT PLANS

Pension Plans

The Metropolitan Government sponsors or guarantees several single-employer pension plans, including (a) the closed City Plan (City Plan), (b) the Davidson County Employees' Retirement Fund (County Plan), both of which were closed to new members on April 1, 1963, and (c) The Metropolitan Employees' Benefit Trust Fund Division A or B (Metro Plan). Division A of the Metro Plan was established at the inception of The Metropolitan Government on April 1, 1963, and was closed to new members on July 1, 1995. Division B of the Metro Plan was established as of July 1, 1995.

All plans of the Metropolitan Government were established by or continue under the authority of the Metropolitan Charter, Article XIII, effective April 1, 1963. Approval of the Metropolitan Council is required to establish and amend benefit provisions. Article XIII also requires that all pension plans be actuarially sound. Administrative costs of the plans are financed by plan assets. The plans are administered by the Metropolitan Employee Benefit Board, an independent board created by the Metropolitan Charter. The financial position and results of operations of the pension plans are reported as fiduciary funds of the Metropolitan Government and, accordingly, are not included in the financial statements of the Department.

Substantially all employees of the Department are members of the Metropolitan Plan. Periodic contributions by the Department to the Metropolitan Plan are at actuarially determined rates that are designed to accumulate sufficient assets to pay benefits when due. Contributions to closed plans are made on a pay-as-you-go basis whereby contributions are made in amounts sufficient to cover benefits paid during the year. Actuarially required employer contributions are not computed because the plans are closed and there are few active employees. Employees do not contribute to any of the pension plans.

Normal retirement for employees occurs at age 65 – Division A, or 60 – Division B, and entitles employees to a lifetime monthly benefit as determined under the Plan. Benefits fully vest upon completing five years of service.

Amounts of actuarially determined net pension obligation are reported in the government-wide financial statement of the Metropolitan Government. Accordingly, no additional liability has been accrued in the financial statements of the Department.

Contributions to the various pension plans totaled $4,988,684 for the year ended June 30, 2011.

E. EMPLOYEE BENEFIT PLANS - Continued

Other Post-Employment Benefit (OPEB) Plans

Retirees in the Metropolitan, City or County Plans may elect to participate in the Metropolitan Employees' Medical Benefit Plan, a single-employer defined benefit healthcare plan. The Metropolitan Plan is administered by the Employee Benefit Board and provides medical, dental and life insurance. The other post-employment benefits for Metropolitan Government employees were authorized by the Metropolitan Government's charter and code. The Metropolitan Plan does not issue a stand-alone financial report.

The post-employment benefits for the Metropolitan plans were authorized by the Government's Charter. As the Metropolitan Government has assumed the responsibility for funding these benefits, the Department has accrued no liability as of June 30, 2011.

The contribution requirements of Metropolitan Employees' Medical Benefit Plan members and the Metropolitan Government are established and may be amended by the Employee Benefit Board. The required contribution is based on projected pay-as-you-go financing requirements under which contributions are made in amounts sufficient to cover benefits paid, administrative costs and anticipated inflationary increases. For health insurance, the Metropolitan Government contributes 75% of all premium payments, and the retirees contribute 25%. The Metropolitan Government also provides a 50% matching contribution on dental insurance for any retiree who elects to participate. Finally, the Government provides life insurance at no charge to the retirees.

Deferred Compensation Plan

The Metropolitan Government offers its employees a deferred compensation plan created in accordance with Internal Revenue Code Section 457. The plan, available to all employees, permits deferral of a portion of salary until future years. The deferred compensation is not available to employees until termination, retirement, death or unforeseeable emergency. Because the assets are not held in a trustee capacity by the Metropolitan Government, they are not included in the Metropolitan Government's financial statements. No contributions are made to this plan by the Metropolitan Government.

F. COMMITMENTS AND CONTINGENCIES

Litigation

The Department is a party to various litigation filed in the normal course of business. It is believed that the outcome of these cases will not have a material effect on the financial position of the Department.

Insurance and Benefits

The Department is subject to various risks of loss related to torts; theft of, damage to and destruction of assets; errors and omissions; illnesses or injuries to employees; and natural disasters. The Department is a member of the Metropolitan Government's self-insurance program with respect to the first $3,000,000 of liability claims and casualty losses in any one year. Liabilities for accidents are generally limited under the Governmental Tort Liability Act of Tennessee Code as follows; bodily injury - $300,000 per person, $700,000 per accident; and property damage - $100,000 per accident. Claims on real and personal property in losses to a $10,000 deductible.

The Department is also a member of the Metropolitan Government's self-insurance program with respect to medical benefits and employee blanket bond coverage. Premiums paid by the Department to the program were $5,771,335 for the year ended June 30, 2011.

Federal and State Financial Assistance

The Department has received federal and state financial assistance for specific purposes that is subject to review and audit by the grantor agencies. Although such audits could generate expenditure disallowances under terms of the programs, the Department believes that any required reimbursements would not be material to the Department's financial statements. Accordingly, no provision has been made for any potential reimbursements to the grantor agencies.

Prior to the issuance of the Water and Sewer Revenue Refunding Bonds, Series 2010A, on December 16, 2010, the full faith and credit of the Metropolitan Government was pledged for possible deficiencies in the collection of required state sewer user fees established in connection with certain grants received from the State Funding Board (TCA 68-221-202 through 68-221-214). The Department acted as a conduit with respect to sewer user fees imposed by the state. These user fees were set at an amount sufficient to recover the project costs, including related interest expense. A portion of the proceeds from the Series 2010A Bonds was used to fully prepay the Tennessee Local Development Authority (TLDA) loans. The amount of prepayment is $79,568,974 at June 30, 2011 and is reported as other noncurrent assets. Subsequent to the issuance of the Bonds, the user fees are considered a general sewer charge and reflected as revenue. The amounts received were recorded as capital grants and contributions by the Department.

F. COMMITMENTS AND CONTINGENCIES - Continued

At June 30, 2011, the Department had commitments of $63,896,283 for construction contracts.

The Department, the Metropolitan Council, the State of Tennessee Department of Environment and Conservation (TDEC), and the United States Environmental Protection Agency (EPA), have agreed on a consent decree to address and correct deficiencies within the Department's sewer system that have caused violations of the Clean Water Act (CWA). The consent decree was approved by the Federal Court in March 2009. Per the decree, the Department is required to fully develop, in two years, a Corrective Action Plan/Engineering Report (CAP/ER) for its sanitary sewer system and a Long-term Control Plan (LTCP) for its combined sewer system to achieve the goals of the CWA and meet water quality requirements in the Cumberland River. Upon submittal and approval of the Plans, the Department will have an additional nine years to complete the work as developed by the Plans.

Due to the historic floods that occurred in Nashville in May 2010, the Department petitioned EPA and TDEC for a six-month extension for developing the CAP/ER and LTCP and a two year extension for completing the work (final compliance) under the force majeure clause of the consent decree. Approval has been granted for both extensions. The due date for the CAP/ER and LTCP was September 11, 2011, and the due date for all work coming out of those two plans (final compliance) is eleven years after approval of the plans by EPA and TDEC. The Department submitted both plans on Friday, September 9, 2011, and is waiting for feedback from EPA and TDEC. The Department has hired an internal program director as well as an external engineering consulting firm for program management. The construction manager as well as the project set designers are the next levels of procurement being sought.

The future related capital expenditures are expected to be between $1 billion and $1.5 billion. Continuing to have sewer overflows along with failure to comply with the mandate and meet future established deadlines could result in stipulated penalties of up to $3,000 per occurrence for sanitary sewer overflows, and up to $5,000 per day for failure to implement the improvements on a timely basis. EPA sent a demand letter for $147,000 in stipulated penalties for sanitary overflow on September 9, 2011. This was for a negotiated 147 violations for 2010 and the first quarter of 2011. The Department is in the process of paying half of the fine to EPA and the other half to TDEC. No penalties have been demanded for any delays in submitting reports and deliverables nor from the failure to timely implement work. Proposed plans to fund capital expenditures for the next few years include internally generated cash and borrowings.

F. COMMITMENTS AND CONTINGENCIES - Continued

Due to the historic floods that occurred in Nashville in May 2010, several of the Department's facilities were damaged. Two wastewater treatment facilities and one water treatment facility received significant damage and over 25 sewer lift stations were flooded and damaged. The cost of repairing and refurbishing the damaged facilities is expected to be approximately $70 million when complete in 2012. The region was declared as a federal disaster area and approved for assistance from the Federal Emergency Management Agency (FEMA). Federal and state assistance has been approved for approximately 30 percent of the damage total and the Department has appealed the eligibility of another 30 percent of the cost to date.

G. RELATED PARTY TRANSACTIONS

The Department supplies water and sewerage services to the other departments of the Metropolitan Government, for which standard rates are charged.

The Metropolitan Government performs certain administrative functions for the Department. The cost of such services included in operating expenses is $8,381,604 for the year ended June 30, 2011.

In addition, in February 1996, the Metropolitan Government adopted a resolution which requires the Department to make an annual payment to the Metropolitan Government of $4,000,000, representing a payment in lieu of ad valorem taxes. This payment is included in operating expenses for the year ended June 30, 2011.

H. SUBSEQUENT EVENTS

The Department has evaluated subsequent events through October 31, 2011, the date the financial statements were available for issuance, and has determined that there are no items requiring disclosure.

SUPPLEMENTARY INFORMATION

DEPARTMENT OF WATER AND SEWERAGE SERVICES
THE METROPOLITAN GOVERNMENT OF NASHVILLE AND DAVIDSON COUNTY
SCHEDULE OF UTILITY RATES (UNAUDITED)
JUNE 30, 2011

The rate structure is composed of a meter charge and a volume charge.

The Department had the following rate structure in effect at June 30, 2011:

METER:

	Water				Sewer			
Meter Size	Residential	Small Commercial	Intermediate Commercial	Large Commercial	Residential	Small Commercial	Intermediate Commercial	Large Commercial
5/8"	$3.13	$3.98	$13.85	$597.23	$7.62	$8.51	$27.89	$1,076.37
3/4"	10.62	11.32	19.64	603.69	21.63	24.22	39.55	1,088.01
1"	12.77	13.63	21.51	605.80	26.05	29.17	43.33	1,091.79
1 1/2"	18.77	20.03	26.71	611.60	38.29	42.89	53.81	1,102.25
2"	25.29	26.97	32.63	618.22	51.57	57.75	65.73	1,114.18
3"	33.38	35.61	40.84	624.04	68.04	76.21	82.26	1,124.65
4"	54.41	58.03	64.65	650.65	110.88	124.18	130.22	1,172.65
6"	85.42	91.12	99.81	689.96	174.12	195.01	201.05	1,243.48
8"	133.59	142.50	155.38	755.41	272.29	304.96	312.96	1,361.43
10"	133.59	142.50	155.38	755.41	272.29	304.96	312.96	1,361.43

VOLUME:

Water usage charges per 100 cubic feet (For usage over 200 cubic feet)				Sewer usage charges per 100 cubic feet (For usage over 200 cubic feet)			
$2.33	$2.48	$2.14	$1.81	$4.74	$5.30	$4.32	$3.26

See accompanying accountants’ report.

DEPARTMENT OF WATER AND SEWERAGE SERVICES
THE METROPOLITAN GOVERNMENT OF NASHVILLE AND DAVIDSON COUNTY
SCHEDULE OF NUMBER OF CUSTOMERS (UNAUDITED)
JUNE 30, 2011

The rate structure is composed of a meter charge and a volume charge.

	Residential	Commercial	Unclassified (2)	Total
Water:				
Billed by Department	162,423	15,050	-	177,473
Total Water Customers	162,423	15,050	-	177,473
Sewer:				
Billed by Department	155,652	12,805	-	168,457
Note Billed by Department(1)	5,413	-	16,020	21,433
Total Water Customers	161,065	12,805	16,020	189,890

(1) Not Billed by Department represents sewer services provided to customers of other water utility districts that bill their customers and then pay the Department.

(2) Unclassified represents sewer services provided to customers of another water utility district that does not differentiate between residential and commercial customers.

See accompanying accountants' report.

DEPARTMENT OF WATER AND SEWERAGE SERVICES
THE METROPOLITAN GOVERNMENT OF NASHVILLE AND DAVIDSON COUNTY
SCHEDULE OF UNACCOUNTED FOR WATER (UNAUDITED)
JUNE 30, 2011

(All amounts in gallons)

Water Treated and Purchased:		
Water Pumped (potable)	32,070,355,000	
Water Purchased	77,538,000	
Total Water Treated and Purchased		32,147,893,000
Accounted for Water:		
Water Sold	22,571,077,000	
Metered for Consumption (in house usage)	33,942,000	
Fire Departments Usage	68,927,000	
Flushing	29,854,000	
Tank Cleaning/Filling	7,000,000	
Street/Sewer Cleaning	3,530,000	
Bulk Sales	-	
Water Bill Adjustments	-	
Total Accounted for Water		22,714,330,000
Unaccounted for Water		9,433,563,000
Percent Unaccounted for Water		29.34%

See accompanying accountants' report.

Independent Auditors' 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 Honorable Mayor and Members of Council
The Metropolitan Government of Nashville and
Davidson County, Tennessee

We have audited the financial statements of the Department of Water & Sewerage Services (the "Department"), an enterprise fund of the Metropolitan Government of Nashville and Davidson County, Tennessee (the "Metropolitan Government"), as of and for the year ended June 30, 2011, and have issued our report thereon dated October 31, 2011. 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

In planning and performing our audit, we considered the Department's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Department's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Department's internal control over financial reporting.

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 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.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

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Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Department'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 no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the Department, the Metropolitan Government of Davidson, County, Tennessee, and the State of Tennessee, management, and federal and state agencies and is not intended to be and should not be used by anyone other than these specified parties.

Crosslin + Associates, P.C.

Nashville, Tennessee
October 31, 2011