City of Lancaster Water Fund

Financial Statements and Required Supplementary Information

Years Ended December 31, 2012 and 2011
with Independent Auditor's Report

CITY OF LANCASTER WATER FUND

YEARS ENDED DECEMBER 31, 2012 AND 2011

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Independent Auditor's Report

To the Honorable J. Richard Gray, Mayor
and Members of City Council
City of Lancaster, Pennsylvania

Report on the Financial Statements

We have audited the accompanying financial statements of the Water Fund of the City of Lancaster, as of and for the years ended December 31, 2012 and 2011, and the related notes to the financial statements, as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Water Fund of the City of Lancaster as of December 31, 2012 and 2011, and the changes in financial position and cash flows thereof for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter

As discussed in Note 1, the financial statements present only the Water Fund and do not purport to, and do not, present fairly the financial position of the City of Lancaster, as of December 31, 2012 and 2011, the changes in its financial position, or, where applicable, its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

Other Matters

Required Supplementary Information

Management has omitted the Management's Discussion and Analysis that accounting principles generally accepted in the United States of America require to be presented to supplement the basic financial statements. Such missing information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. Our opinion on the basic financial statements is not affected by this missing information.

Accounting principles generally accepted in the United States of America require that the schedules of funding progress and employer contributions on pages 27 and 28 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audits of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Maher Duessel

Harrisburg, Pennsylvania
July 25, 2013

CITY OF LANCASTER WATER FUND

BALANCE SHEETS

DECEMBER 31, 2012 AND 2011

	2012	2011
Assets		
Current assets:		
Cash and cash equivalents	$ 550	$ 4,021
Cash and cash equivalents - restricted	13,055,361	16,473,897
Receivables:		
Water rents	1,676,760	1,336,866
Unbilled water rents	1,691,176	1,714,465
Other	21,920	43,815
Due from other governments	45,685	-
Prepaid expenses	7,068	3,347
Total current assets	16,498,520	19,576,411
Long-term assets:		
Debt issuance costs, net of accumulated amortization of $291,301 and $214,005 in 2012 and 2011, respectively	1,055,351	1,132,647
Capital assets, not being depreciated	2,721,743	2,621,580
Capital assets, being depreciated, net	136,277,991	134,848,006
Total long-term assets	140,055,085	138,602,233
Total Assets	$ 156,553,605	$ 158,178,644
Liabilities and Net Position		
Liabilities:		
Current liabilities:		
Accounts payable	$ 1,372,960	$ 848,394
Accrued expenses	969,342	959,755
Due to City of Lancaster general fund	5,188,043	5,035,000
Compensated absences, current portion	17,954	27,197
Workers' compensation payable, current portion	5,197	6,265
Capital lease, current portion	73,615	79,589
Notes payable, current portion	959,549	933,373
Bonds payable, current portion	956,200	420,400
Total current liabilities	9,542,860	8,309,973
Long-term liabilities:		
Compensated absences, net of current portion	58,706	54,269
Workers' compensation payable, net of current portion	16,435	21,203
Net other post-employment liability	3,339,429	3,379,726
Capital lease, net of current portion	153,745	54,382
Notes payable, net of current portion	12,423,469	13,383,019
Bonds payable, net of current portion	105,826,443	106,604,924
Total long-term liabilities	121,818,227	123,497,523
Total Liabilities	131,361,087	131,807,496
Net Position:		
Net investment in capital assets	31,899,187	33,241,144
Unrestricted	(6,706,669)	(6,869,996)
Total Net Position	25,192,518	26,371,148
Total Liabilities and Net Position	$ 156,553,605	$ 158,178,644

The accompanying notes are an integral part of these financial statements.

CITY OF LANCASTER WATER FUND

STATEMENTS OF REVENUES, EXPENSES, AND CHANGES
IN FUND NET POSITION

YEARS ENDED DECEMBER 31, 2012 AND 2011

	2012	2011
Operating Revenues:		
Water rents	$ 20,307,303	$ 15,141,484
Meter labor reimbursement	220,076	218,443
Miscellaneous revenue	449,248	424,384
Total operating revenues	20,976,627	15,784,311
Operating Expenses:		
Susquehanna treatment plant	2,344,657	2,237,449
Conestoga treatment plant	2,064,395	2,154,524
Transmission and distribution	1,380,869	1,336,897
Meters and meter labor	628,789	624,124
Laboratory	246,233	243,596
Depreciation	3,408,732	3,212,930
Administration	4,720,204	4,901,227
Grounds maintenance	380,870	336,999
Total operating expenses	15,174,749	15,047,746
Operating Income	5,801,878	736,565
Non-Operating Revenues (Expenses):		
State pension contribution	139,983	145,758
Grant income	15,115	-
Investment income	27,825	45,985
Amortization expense	(77,296)	(65,610)
Interest expense	(5,491,934)	(5,123,095)
Total non-operating revenues (expenses)	(5,386,307)	(4,996,962)
Income (loss) before transfers and capital contributions	415,571	(4,260,397)
Transfers out	(2,300,000)	(2,300,000)
Capital contributions	705,799	5,281,664
Change in Net Position	(1,178,630)	(1,278,733)
Net Position:		
Beginning of year	26,371,148	27,649,881
End of year	$ 25,192,518	$ 26,371,148

The accompanying notes are an integral part of these financial statements.

CITY OF LANCASTER WATER FUND

STATEMENTS OF CASH FLOWS

YEARS ENDED DECEMBER 31, 2012 AND 2011

	2012	2011
Cash Flows From Operating Activities:		
Cash received from users	$ 20,681,917	$ 14,779,931
Cash paid to suppliers	(7,187,142)	(7,784,076)
Cash paid to employees	(4,548,753)	(3,868,260)
Net cash provided by operating activities	8,946,022	3,127,595
Cash Flows From Investing Activities:		
Investment income received	27,825	45,985
Net cash provided by investing activities	27,825	45,985
Cash Flows From Capital and Related Financing Activities:		
Proceeds from bonds payable	-	11,354,600
Principal payments on capital lease	(125,996)	(85,460)
Principal payments on notes payable	(933,374)	(982,237)
Principal payments on bonds payable	(420,400)	(50,000)
Interest paid	(5,402,390)	(4,968,462)
Grant income received	15,115	235,297
Acquisition of capital assets	(3,521,835)	(6,845,872)
Payment for debt issuance costs	-	(170,464)
Net cash used in capital and related financing activities	(10,388,880)	(1,512,598)
Cash Flows From Non-Capital Financing Activities:		
Transfers out	(2,300,000)	(2,300,000)
Due to City of Lancaster General Fund	153,043	2,460,044
State pension contribution	139,983	145,758
Net cash provided by (used in) non-capital financing activities	(2,006,974)	305,802
Net Increase (Decrease) in Cash and Cash Equivalents	(3,422,007)	1,966,784
Cash and Cash Equivalents:		
Beginning of year	16,477,918	14,511,134
End of year	$ 13,055,911	$ 16,477,918

(Continued)

CITY OF LANCASTER WATER FUND

STATEMENTS OF CASH FLOWS

YEARS ENDED DECEMBER 31, 2012 AND 2011
(Continued)

	2012	2011
Reconciliation of Operating Income to Net Cash Provided by Operating Activities:		
Operating income	$ 5,801,878	$ 736,565
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation expense	3,408,732	3,212,930
Loss on disposal of capital assets	-	7,501
Changes in assets and liabilities:		
Receivables	(294,710)	(1,004,380)
Prepaid expenses	(3,721)	123,534
Accounts payable	65,627	(733,257)
Accrued expenses	19,155	8,070
Compensated absences	(4,806)	7,126
Workers' compensation payable	(5,836)	4,210
Net other post-employment liability	(40,297)	765,296
Total adjustments	3,144,144	2,391,030
Net cash provided by operating activities	$ 8,946,022	$ 3,127,595
Noncash Capital Financing Activities:		
Proceeds from capital lease	$ 219,385	$ 112,838
Developer contributions	705,799	5,281,664

(Concluded)

The accompanying notes are an integral part of these financial statements.

1. Significant Accounting Policies

The accompanying financial statements include the transactions of the Water Fund of the City of Lancaster, Pennsylvania (Water Fund). It does not include any other funds of the City of Lancaster (City) and, therefore, does not present fairly the financial position and the changes in financial position of the City in conformity with accounting principles generally accepted in the United States of America.

Basis of Presentation and Accounting

The Water Fund's financial statements are presented on the full accrual basis in accordance with accounting principles generally accepted in the United States of America. All activities of the Water Fund are accounted for within a single proprietary (enterprise) fund. Proprietary funds are used to account for operations that are (a) financed and operated in a manner similar to private business enterprises where the intent of the governing body is that the cost (expenses, including depreciation) of providing goods or services to the general public on a continuing basis be financed or recovered primarily through user charges or (b) where the governing body has decided that periodic determination of revenues earned, expenses incurred, and/or net income is appropriate for capital maintenance, public policy, management control, accountability, or other purposes.

Proprietary funds distinguish operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with a proprietary fund's principal ongoing operations. The principal operating revenue of the Water Fund is charges for water. Operating expenses include the cost of sales and services, administrative expenses, and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.

The accounting and financial reporting treatment applied to the Water Fund is determined by its measurement focus. The transactions of the Water Fund are accounted for on a flow of economic resources measurement focus. With this measurement focus, all assets and all liabilities associated with the operations are included on the balance sheets. Net position (i.e., total assets, net of total liabilities) is segregated into "net investment in capital assets," "restricted," and "unrestricted" components.

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

Cash and Cash Equivalents

For the purposes of reporting cash flows, the Water Fund considers money market funds and all highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents.

Capital Assets

The water system's capital assets are recorded at their estimated historical cost.

Depreciation is computed on a straight-line basis utilizing the following estimated useful lives:

Water systems	50 years
Equipment and vehicles	5 - 30 years

The Water Fund capitalizes system assets valued over $25,000 with a useful life longer than three years and general assets valued over $10,000 with a useful life longer than three years.

Capitalization of Interest

Interest expense that relates to the cost of acquiring or constructing capital assets by the City is capitalized. Interest capitalized for the years ended December 31, 2012 and 2011 totaled $78,607 and $94,697, respectively.

Restricted Assets

The unexpended 2007 and 2011 bond proceeds as of December 31, 2012 and 2011 are included in the restricted assets.

Debt Issuance Costs/Deferred Loss on Refunding

Debt issuance costs and deferred loss on refunding are amortized on the effective interest method over the life of the bonds.

Net Position

Net position is classified in the following categories:

Net Investment in Capital Assets – This category groups all capital assets into one component of net position. Accumulated depreciation and the outstanding balances of debt that are attributable to the acquisition, construction, or improvement of these assets reduce this category. Debt related to unspent proceeds or other restricted cash and investments is excluded from the determination.

Restricted Net Position – This category presents external restrictions imposed by creditors, grantors, contributors, or laws or regulations of other governments and restrictions imposed by law through constitutional provisions or enabling legislation.

Unrestricted Net Position – This category represents the net position of the Water Fund, which is not restricted for any project or other purpose.

Use of Estimates

The process of preparing financial statements in conformity with accounting principles generally accepted in the United States of America requires the use of estimates and assumptions regarding certain types of assets, liabilities, revenues, and expenses. Such estimates primarily relate to unsettled transactions and events as of the date of the financial statements. Accordingly, upon settlement, actual results may differ from estimated amounts.

Pension Plans

The City sponsors and administers a defined benefit plan and defined contribution plan, which cover the Water Fund employees.

Pending Changes in Accounting Principles

The Governmental Accounting Standards Board (GASB) has issued Statement No. 65, *"Items Previously Reported as Assets and Liabilities,"* effective for periods beginning after December 15, 2012. This Statement reclassifies certain items currently being reported as assets and liabilities as deferred outflows of resources and deferred inflows of resources. In addition, this Statement recognizes certain items currently being reported as assets and liabilities as outflows of resources and inflows of resources. The effect of implementation of this Statement has not yet been determined.

The GASB has issued Statement No. 67, *"Financial Reporting for Pension Plans,"* effective for periods beginning after June 15, 2013, and has also issued Statement No. 68, *"Accounting and Financial Reporting for Pensions,"* effective for periods beginning after June 15, 2014. These Statements revise existing guidance for the financial reports of most pension plans, and establish new financial reporting requirements for most governments that provide their employees with pension benefits. The effect of implementation of these Statements has not yet been determined.

2. DEPOSITS

Pennsylvania statutes provide for investment of governmental funds into certain authorized investment types including U.S. Treasury obligations, other short-term U.S. and Pennsylvania government obligations, and insured or collateralized time deposits and certificates of deposit. The statutes do not prescribe regulations related to demand deposits; however, they do allow the pooling of governmental funds for investment purposes.

The deposit and investment policy of the City adheres to state statutes, the Third Class City Code, and prudent business practice.

A. Deposits

Custodial Credit Risk – Deposits. Custodial credit risk is the risk that in the event of a bank failure, the government's deposits may not be returned to it. The Water Fund does not have a deposit policy for custodial credit risk.

The Water Fund pools certain of its deposits and investments with the City. At December 31, 2012 and 2011, the book balance of the pooled deposits was $48,374,435 and $55,347,513, respectively, and the bank balance was $48,645,882 and $55,529,504, respectively. The Water Fund's position in the pooled deposits was $13,055,361 and $16,477,918 at December 31, 2012 and 2011, respectively. At December 31, 2012 and 2011, the entire balance was collateralized under Act No. 72 (Act) of the 1971 Session of the Pennsylvania General Assembly, in which financial institutions were granted the authority to secure deposits of public bodies by pledging a pool of assets, as defined in the Act, to cover all public funds deposited in excess of federal depository insurance limits.

3. Capital Assets

Capital asset activity for the years ended December 31, 2012 and 2011 is as follows:

	December 31, 2011	Increase/ Transfers In	Decrease/ Transfers Out	December 31, 2012
Capital assets not being depreciated:				
Land	$ 2,564,600	$ -	$ -	$ 2,564,600
Construction-in-progress	56,980	157,143	(56,980)	157,143
Total capital assets, not being depreciated	2,621,580	157,143	(56,980)	2,721,743
Capital assets being depreciated:				
Water system	172,360,764	4,420,580	-	176,781,344
Equipment and vehicles	3,731,121	418,137	(44,362)	4,104,896
Total capital assets, being depreciated	176,091,885	4,838,717	(44,362)	180,886,240
Less accumulated depreciation for:				
Water system	(38,965,273)	(3,207,785)	-	(42,173,058)
Equipment and vehicles	(2,278,606)	(200,947)	44,362	(2,435,191)
Total accumulated depreciation	(41,243,879)	(3,408,732)	44,362	(44,608,249)
Capital assets being depreciated, net	134,848,006	1,429,985	-	136,277,991
Capital assets, net	$ 137,469,586	$ 1,587,128	$ (56,980)	$ 138,999,734

	December 31, 2010	Increase/ Transfers In	Decrease/ Transfers Out	December 31, 2011
Capital assets not being depreciated:				
Land	$ 2,564,600	$ -	$ -	$ 2,564,600
Construction-in-progress	502,766	56,980	(502,766)	56,980
Total capital assets, not being depreciated	3,067,366	56,980	(502,766)	2,621,580
Capital assets being depreciated:				
Water system	164,120,955	8,239,809	-	172,360,764
Equipment and vehicles	3,237,078	608,049	(114,006)	3,731,121
Total capital assets, being depreciated	167,358,033	8,847,858	(114,006)	176,091,885
Less accumulated depreciation for:				
Water system	(35,917,333)	(3,047,940)	-	(38,965,273)
Equipment and vehicles	(2,220,121)	(164,990)	106,505	(2,278,606)
Total accumulated depreciation	(38,137,454)	(3,212,930)	106,505	(41,243,879)
Capital assets being depreciated, net	129,220,579	5,634,928	(7,501)	134,848,006
Capital assets, net	$ 132,287,945	$ 5,691,908	$ (510,267)	$ 137,469,586

4. LONG-TERM LIABILITIES

A summary of long-term liabilities for the year ended December 31, 2012 is as follows:

Date of Issue/ Maturity	Amount of Original Issue	Description and Interest Rates	Balance Outstanding December 31, 2012
2007/2046	$ 96,460,000	General Obligation Bonds, 4.00% - 5.00%	$ 96,035,000
2002/2022	692,533	Note Payable to Financing Agency, 2.77%	378,018
2009/2030	15,785,000	General Obligation Notes, 2.50% - 4.875%	13,005,000
2010/2028	690,800	General Obligation Bonds, 2.00% - 4.00%	614,800
2011/2041	11,260,000	General Obligation Bonds, 1.75% - 5.00%	11,260,000
			$ 121,292,818

Bonds Payable

In 1998, the City issued $61,915,000 of general obligation bonds. The portion allocable to the Water Fund amounted to $26,185,000, bearing interest at rates ranging from 3.60% to 5.05%. The proceeds of the bond issuance were used to (i) finance the acquisition of the water system through the refunding of the Metropolitan Lancaster Authority's outstanding: (a) Water Revenue Bonds, Series of 1990; (b) Water Revenue Bonds, Series of 1992; (c) Water Project Notes, Series of 1997; and (d) Water Revenue Notes, Series of 1998. These bonds were currently refunded through the issuance of General Obligation Notes, Series of 2009.

In 2003, the City issued $9,995,000 of general obligation bonds. The portion allocable to the Water Fund amounted to $800,000, bearing interest at rates ranging from 2.00% to 4.45%. The proceeds of the bond issuance were used to fund transmission and distribution projects. These bonds were currently refunded through the issuance of General Obligation Bonds, Series of 2010.

In 2007, the City issued $125,315,000 of general obligation bonds. The portion allocable to the Water Fund amounted to $96,460,000, bearing interest at rates ranging from 4.00% to 5.00%. The proceeds of the bond issuance were used to fund the construction of the membrane filtration plant and refund the City’s 2004 note payable.

In 2010, the City issued $8,635,000 of general obligation bonds. The portion allocable to the Water Fund amounted to $690,800. The bonds bear interest at rates ranging from 2.00% to

4.00%. The proceeds of the bond issuance were used to currently refund the General Obligation Bonds, Series of 2003.

In 2011, the City issued $38,860,000 of general obligation bonds. The portion allocable to the Water Fund amounted to $11,260,000, bearing interest rates ranging from 1.75% to 5.00%. The proceeds of the bond issuance were used for improvements and upgrades to the water plant and various miscellaneous capital projects.

Notes Payable

In 2002, the City issued $692,533 of notes, bearing interest at 2.77%. The proceeds of the note issuance were used to construct a water main in Manor Township and to reinforce the water supply to the Borough of Millersville.

In 2009, the City issued $43,990,000 of general obligation notes. The portion allocable to the Water Fund amounted to $15,875,000, bearing interest at rates ranging from 2.50% to 4.875%. The proceeds of the note issuance were used to currently refund the City's outstanding General Obligation Bonds, Series A of 1998, and to pay the termination costs of the Swaption agreement with Wachovia Bank.

Principal and interest maturities on the bonds and notes payable are as follows:

Year Ended December 31,	Principal Maturity	Interest Maturity	Total
2013	$ 1,915,749	$ 5,364,940	$ 7,280,689
2014	1,972,367	5,309,692	7,282,059
2015	2,029,027	5,251,490	7,280,517
2016	2,096,132	5,183,056	7,279,188
2017	2,193,283	5,088,637	7,281,920
2018-2022	12,607,460	23,801,168	36,408,628
2023-2027	15,719,600	20,687,697	36,407,297
2028-2032	18,499,200	16,912,685	35,411,885
2033-2037	18,570,000	12,861,000	31,431,000
2038-2042	23,140,000	8,289,225	31,429,225
2043-2046	22,550,000	2,592,675	25,142,675
	$ 121,292,818	$ 111,342,265	$ 232,635,083

Capital Lease

In 2008, the City purchased three trucks under long-term lease agreements that are classified as capital leases, with one of the truck leases being paid in full during 2011 and the remaining trucks being paid in full in 2012. As of December 31, 2012 and 2011, the Water Fund includes these vehicles at a cost of $231,419 and $272,905 and accumulated depreciation of $61,766 and $58,500, respectively.

In 2011, the City purchased multiple vehicles and equipment under long-term lease agreements that are classified as capital leases. As of December 31, 2012 and 2011, the Water Fund includes these vehicles and equipment at a cost of $123,370 and accumulated depreciation of $13,184 and $4,560, respectively.

In 2012, the City purchased two vehicles and two dump trucks under long-term lease agreements that are classified as capital leases. As of December 31, 2012, the Water Fund includes these vehicles and equipment at a cost of $219,385 and accumulated depreciation of $8,894.

The future minimum payments under these capital leases and the present value of the minimum lease payments at December 31, 2012 are as follows:

Year Ended December 31,	Total
2013	$ 84,134
2014	64,896
2015	54,325
2016	47,835
Total minimum lease payments	251,190
Less amount representing interest	(23,830)
Present value of future minimum lease payments	$ 227,360

Changes in long-term liabilities for the years ended December 31, 2012 and 2011 are as follows:

	December 31, 2011	Increase	Decrease	December 31, 2012	Amount Due Within One Year
Bonds payable	$ 108,330,200	$ -	$ (420,400)	$ 107,909,800	$ 956,200
Unamortized premium	1,130,734	-	(61,656)	1,069,078	-
Deferred loss on refunding	(2,435,610)	-	239,375	(2,196,235)	-
Notes payable	14,316,392	-	(933,374)	13,383,018	959,549
Capital lease	133,971	219,385	(125,996)	227,360	73,615
Compensated absences	81,466	477,391	(482,197)	76,660	17,954
Workers' compensation payable	27,468	-	(5,836)	21,632	5,197
	$ 121,584,621	$ 696,776	$ (1,790,084)	$ 120,491,313	$ 2,012,515

	December 31, 2010	Increase	Decrease	December 31, 2011	Amount Due Within One Year
Bonds payable	$ 97,120,200	$ 11,260,000	$ (50,000)	$ 108,330,200	$ 420,400
Unamortized premium	1,091,152	94,600	(55,018)	1,130,734	-
Deferred loss on refunding	(2,685,370)	-	249,760	(2,435,610)	-
Notes payable	15,298,629	-	(982,237)	14,316,392	933,373
Capital lease	106,593	112,838	(85,460)	133,971	79,589
Compensated absences	74,340	517,623	(510,497)	81,466	27,197
Workers' compensation payable	23,258	11,309	(7,099)	27,468	6,265
	$ 111,028,802	$ 11,996,370	$ (1,440,551)	$ 121,584,621	$ 1,466,824

In conjunction with the Basis Swap transaction described in Note 5, the City received an upfront cash payment. This upfront cash payment received by the City was considered to be a borrowing at a rate of 4.4%. As of December 31, 2012 and 2011, the borrowing had an outstanding balance of $1,565,850 and $1,742,590, respectively, which is reflected in the governmental activities portion of the City's financial statement. Payments on the borrowing commenced on May 1, 2009, the date the Basis Swap became effective, and are scheduled to mature on May 1, 2028. Interest is currently being accreted to the principal amount annually. Accreted interest on the borrowing was $650,261 and $580,405 at December 31, 2012 and 2011, respectively.

A summary of principal and interest maturities on the borrowing at December 31, 2012 is as follows:

Year Ended December 31,	Principal	Interest	Total
2013	$ 166,053	$ 61,174	$ 227,227
2014	152,758	54,564	207,322
2015	138,245	48,582	186,827
2016	122,402	43,286	165,688
2017	116,794	38,234	155,028
2018-2022	526,211	120,835	647,046
2023-2027	328,330	22,346	350,676
2028	15,057	-	15,057
	$ 1,565,850	$ 389,021	$ 1,954,871

As noted above, this borrowing is reflected in the governmental activities section of the City's financial statement, and as such, the Water Fund does not report a portion of the City's borrowing.

5. Derivative Agreements

Objective of the interest rate swap agreements. During the year ended December 31, 1998, the City issued its $61,915,000, aggregate principal amount, General Obligation Bonds, Series A of 1998 (the "Series A Bonds"). During the year ended December 31, 2004, because of the market conditions, the City entered into a forward interest rate swap agreement (Basis Swap) in connection with the Series A Bonds commencing May 1, 2009 through the final maturity of the Series A Bonds (May 1, 2028).

Terms. With respect to its Series A Bonds, the City entered the Basis Swap with PNC Bank, N.A., as the counterparty. Beginning on May 1, 2009 and ending on the final maturity date of May 1, 2028, the City will pay a variable interest rate equal to the SIFMA index based on the notional amount remaining on the Series A Bonds and receive a variable interest rate equal to 67% of the 1-Month LIBOR rate. The Basis Swap agreement contains an embedded interest rate cap, providing that the floating rate to be paid by the City shall not exceed 25%. PNC Bank, N.A. paid a premium to the City in the amount of $1,715,700 for the Basis Swap.

The Basis Swap became effective on May 1, 2009 and has been assigned to a proportionate share of the City's General Obligation Notes, Series of 2009, which refunded the Series A Bonds. The final maturity date of May 1, 2028 remains unchanged.

Fair value. As of December 31, 2012, the Basis Swap had a fair value of ($777,304). As the Basis Swap is considered to be an investment type derivative instrument per accounting standards, it is reported as a derivative asset and as a borrowing on the City's government-wide statement of net position. The change in fair market value of $333,149 during the year ended December 31, 2012 is recorded as a component of investment income on the City's government-wide statement of activities. The fair value is calculated using the zero-coupon method.

Credit risk. The City solicited competitive bids in connection with the Basis Swap agreement. The City solicited bids only from counterparties with an excellent credit rating (see – The City's Interest Rate Management Plan). PNC Bank, N.A. is rated A+ by Fitch Ratings, A by Standard & Poor's, and A2 by Moody's Investors Service as of December 31, 2012. To mitigate the potential for credit risk, if PNC Bank's credit rating falls below A-/A3 (threshold ratings) the counterparty will be obligated to post a certain amount of collateral or the City will have the right to terminate the swap agreement; PNC Bank negotiated a credit support annex with the City at the time the transaction was entered into, which would require PNC Bank to collateralize its obligations with direct obligations guaranteed by the United States of America if its respective credit ratings fell below the predetermined threshold ratings.

Termination risk. The City or the counterparty may terminate the Basis Swap agreement if the other party defaults under the terms of the Agreement. In addition, the City may terminate the Basis Swap Agreement without cause at any time with notice to the counterparty of not less than two days. The termination value would be determined by the Calculation Agent (counterparty) using commercially reasonable judgment, or if disputed, the Calculation Agent shall seek bids from Reference Market-makers consistent with Section 6 of the Agreement. If the Basis Swap is terminated and has a negative fair value, the City would be liable to the counterparty for the termination payment. If the Basis Swap

Agreement is terminated and has a positive fair value, the counterparty would be liable to the City for the termination payment.

Basis risk. The City is subject to basis risk because the interest index on the variable rate receipt arm of the swap is based on one-month LIBOR and the variable interest rate payment arm is based on a different index. Although expected to correlate, the relationships between different indexes vary and that variance could adversely affect the City's calculated payments and, as a result, cost savings or synthetic interest rates may not be realized. As of December 31, 2012, the interest rate the City is paying under the Basis Swap was .13%, whereas the interest the City is receiving at 67% of the one-month LIBOR rate was .14%.

Contingent feature. If the City's credit rating is below A- by Standard & Poor's or A3 by Moody's Investors Service, as well as fails to deliver eligible collateral, then the swap transaction may be terminated. In the event that the collateral is called, the City would have to post eligible collateral up to the fair value of the Basis Swap at that time. Eligible collateral includes cash, negotiable debt obligations issued by the U.S. Treasury Department, securities guaranteed by the Government National Mortgage, Federal National Mortgage Association, or Federal Home Loan Mortgage Corporation, and agency notes issued directly by any of the Federal Home Loan Banks, Federal National Mortgage Association, or Federal Home Loan Mortgage Corporation. As of December 31, 2012, the City's rating is not below the rating threshold and, therefore, the City had not posted any collateral due to a ratings trigger.

6. PENSION PLANS

The City administers a single-employer defined benefit pension plan for its nonuniformed employees – the Cash Balance Pension Plan (CBPP).

The CBPP does not issue stand-alone financial reports.

A. Summary of Significant Accounting Policies

Basis of Accounting

The Plan's financial statements are prepared using the accrual basis of accounting. Plan member contributions are recognized in the period in which the contributions are due. Employer contributions to each plan are recognized when due and the employer has made a formal commitment to provide the contributions. Benefits and refunds are recognized when due and payable in accordance with the terms of each plan.

Method Used to Value Investments

Investments are reported at fair value. Securities traded on a national or international exchange are valued at the last reported sales price at current exchange rates. Investments that do not have an established market are reported at estimated fair values.

B. Plan Description and Contribution Information

Cash Balance Pension Plan

Membership of CBPP consisted of the following at January 1, 2012, the date of the latest actuarial valuation:

Retirees and beneficiaries currently receiving benefits	44
Terminated employees entitled to benefits	33
	77
Active plan participants:	
Fully-vested	180
Non-vested	117
	297
Total	374

Plan Description

CBPP is a single-employer defined benefit pension plan that covers all full-time, nonuniformed employees of the City. CBPP provides retirement, disability, and death benefits to plan members and their beneficiaries. Plan provisions are established and may be amended by the Nonuniformed Pension Board.

Contributions

Plan members are not required to contribute to the CBPP. The City is required to make actuarial determined periodic contributions at rates that for individual employees increases over time so that sufficient assets will be available to pay benefits when due.

The annual required contribution is determined annually during the budgeting process. The results of actuarial valuations are used in budgeting for future years.

The City contributed $516,512 and $504,280 to the CBPP for the years ended December 31, 2012 and 2011, respectively. Of the amount contributed by the City, the Water Fund contributed $139,983 and $145,758 for the years ended December 31, 2012 and 2011, respectively.

C. *Annual Pension Cost and Net Pension Obligation*

The City's annual pension cost and net pension obligation (asset) for the CBPP for the years ended December 31, 2012 and 2011 were as follows:

	2012	2011
Annual required contribution	$ 516,512	$ 504,280
Interest on net pension obligation (asset)	(6,357)	(6,520)
Adjustment to annual required contribution	8,476	8,693
Annual pension cost	518,631	506,453
Contributions	516,512	504,280
Change in net pension obligation (asset)	2,119	2,173
Net pension obligation (asset), beginning of year	(84,756)	(86,929)
Net pension obligation (asset), end of year	$ (82,637)	$ (84,756)

The Water Fund does not report a portion of the City's net pension asset.

The January 1, 2012 actuarial valuation used the entry age normal actuarial cost method. The actuarial assumptions included a) 7.50% investment rate of return, b) a projected salary increase of 5%, c) level dollar closed amortization method, and d) 16-year amortization period. The actuarial value of assets from the prior valuation report (reduced for benefits paid and increased for contributions) is projected forward at an artificial investment return of 6.50% (interest rate assumption minus 1%). In no event is the actuarial value of assets allowed to be greater than 130% or less than 70% of market value.

Three-Year Information

CBPP:

Calendar Year	Annual Pension Cost (APC)	Percentage of APC Contributed	Net Pension Obligation (Asset)
2010	$ 501,354	99.6%	$ (86,929)
2011	506,453	99.6%	(84,756)
2012	518,631	99.6%	(82,637)

Funded Status and Schedule of Funding Progress:

The schedule of funding progress, presented as required supplementary information following the notes to financial statements, presents multi-year trend information about whether the actuarial value of plan assets is increasing or decreasing over time relative to the actuarial accrued liability for benefits.

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (a/b)	Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ((b-a)/c)
1/1/2012	$ 9,583,121	$ 11,273,769	$ 1,690,648	85.0%	$ 12,365,380	13.7%

Defined Contribution Plan

The City administers a single-employer defined contribution plan, the Supplemental Savings Plan (SSP), in which all eligible, full-time, nonuniformed employees of the City may elect to participate. As of December 31, 2012 and 2011, there were 187 and 190 plan participants, respectively. Plan participants may elect to contribute up to 10% of their after-tax pay. The City will match 25% of the participant’s contribution, on the first 5% contributed by each participant. Participant contributions in excess of 5% of compensation will not be matched. The plan provisions are established and may be amended by the Nonuniformed Pension Board. During the year ended December 31, 2012, plan participants and the City made contributions of $375,290 and $81,386, respectively. During the year ended December 31, 2011, plan participants and the City made contributions of $376,004 and $83,053, respectively. Of the amount contributed by the City, the Water Fund contributed $27,425 and $29,713 for the years ended December 31, 2012 and 2011, respectively.

The SSP uses the same basis of accounting and methods to value investments as the City's defined benefit plans.

7. Other Post-employment Benefits

Plan Description

In addition to the retirement benefits described in Note 6, the City provides single-employer health care benefits for all retired employees, their spouses, and dependents. These benefit provisions and all other requirements are established under the various union contracts and City policy for non-organized employees. Those employees are required to pay a portion of the cost of the plan, which generally ranges from approximately 20% to 100% of the annual premiums.

Nonuniformed employees are eligible to retire after completion of 10 years of service and attainment of age 55.

Any nonuniformed employee who elects coverage will make monthly contributions. Once any retiree or spouse becomes eligible for Medicare, he/she must apply for Medicare Part A and Part B. For those eligible for Medicare coverage, medical insurance provided by the City will supplement Medicare.

A nonuniformed employee will be eligible for $7,000 of life insurance upon 10 years of service and attainment age of 55.

The union labor contract establishes the post-retirement health care plan provisions for nonuniformed union employees. The union contract does not require City Council approval and may be amended through future negotiations. The post-retirement health care plan provisions for non-union employees are established through the City's human resources policies, which are approved by the Mayor.

Funding Policy and Annual OPEB Costs

The City's contribution is based on projected pay-as-you-go financing requirements through the General Fund. For the years ended December 31, 2012 and 2011, respectively, the City's net cost of providing health benefits and life insurance for retired employees was $4,448,641 and $3,685,450. Of the amount contributed by the City, the Water Fund contributed $1,052,524 and $383,584 for the years ended December 31, 2012 and 2011, respectively. A portion of the contribution made during the year ended December 31, 2012, in the amount of $675,515, was made directly to the City's OPEB trust fund by the City's Water Fund. Plan members receiving benefits contributed $90,157 and $117,907 through their contributions as required by the cost sharing provisions of the plans for the years ended December 31, 2012 and 2011, respectively.

The nonuniformed union labor contract and the City's human resource policies establish and amend the obligations of the plan members and the City to contribute to the plan.

Any nonuniformed employee who elects coverage will make monthly contributions. For eligible nonuniformed individuals under the age of 65, the monthly costs for the retiree, spouse, and eligible dependent children are $65, $110, and $60, respectively. For eligible nonuniformed individuals over the age of 65, the monthly costs for the retiree and spouse are $50 and the monthly costs for eligible dependent children is $65.

The City pays the entire cost of the life insurance benefits.

The City's annual OPEB costs (expense) for the plan is calculated based on the annual required contribution of the employer (ARC), an amount actuarially determined. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal cost each year and to amortize any unfunded actuarial liabilities (or funding excess) over a period not to exceed thirty years.

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

Actuarial Methods and Assumptions

Projections of benefits for financial reporting purposes are based on the substantive plan and include the types of benefits provided at the time of the valuation and on the historical pattern of sharing of benefit costs between the employer and plan members to that point. The actuarial methods and assumptions used include techniques that are designed to reduce the effects of short-term volatility in actuarial accrued liabilities consistent with the long-term perspective of the calculation. The projections of benefits for financial reporting purposes do not explicitly incorporate the potential effects of legal or contractual funding limitations on the pattern of cost sharing between the employer and plan members in the future.

Information as of the latest actuarial valuation follows:

Valuation date	1/1/2012
Actuarial cost method	Entry age normal, level dollar
Actuarial assumptions	
Interest rate	4.5%
Salary increases	5% per year
Medical inflation	7.5% in 2012, decreasing by 0.5% per year to 5.5% in 2016. Rates gradually decrease from 5.3% in 2017 to 4.2% in 2089 and later
Amortization period	30 years, open period

Annual OPEB Cost and Net OPEB Obligation

The Water Fund portion of the City's annual OPEB costs and net OPEB obligations to the plan for the years ended December 31, 2012 and 2011 were as follows:

	2012	2011
Annual required contribution	$ 1,067,625	$ 1,191,735
Interest on net OPEB obligation	152,088	117,649
Adjustment to annual required contribution	(207,486)	(160,504)
Annual OPEB cost	1,012,227	1,148,880
Contribution made	(1,052,524)	(383,584)
Change in Net OPEB obligation	(40,297)	765,296
Net OPEB obligation, beginning	3,379,726	2,614,430
Net OPEB obligation, ending	$ 3,339,429	$ 3,379,726

Three-Year Trend Information

Year	Annual OPEB Cost (AOC)	Percentage of AOC Contributed	Net OPEB Obligation
2010	$ 1,162,377	27.4%	$ 2,614,430
2011	1,148,880	33.4%	3,379,726
2012	1,012,227	104.0%	3,339,429

Funded Status and Schedule of Funding Progress

The schedule of funding progress, presented as required supplementary information following the notes to the financial statements, presents multi-year trend information about whether the actuarial value of plan assets is increasing or decreasing over time relative to the actuarial accrued liability for benefits.

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) - Entry Age (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (a/b)	Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ((b-a)/c)
1/1/2012	$ -	$ 10,700,060	$ 10,700,060	0.00%	$ 3,079,389	347.47%

8. RISK MANAGEMENT

The City maintains both insurance contracts and self-funded arrangements to deal with the risk of loss arising from the following events: torts; theft of, damage to, or destruction of assets; business interruptions; errors and omissions; job-related illnesses or injuries to employees; acts of God; and losses resulting from providing fringe benefits to employees and their dependents.

Insurance contracts cover public officials, law enforcement, automobile, excess workers' compensation, excess health claims, and umbrella liabilities. The contracts also provide employee, tax collector/treasurer, mayor, controller, city engineer, and employee blanket bonds.

Self-Insurance-Workers' Compensation

The City has a self-funded third-party administered workers' compensation arrangement through Murray Risk Management and Insurance. During 2012, the City was limited to

$500,000 per each accident and $500,000 per each employee for disease. Claim expenditures and liabilities are reported when it is probable that a loss has occurred and the amount of that loss can be reasonably estimated.

A summary of workers' compensation claims for the Water Fund for the years ended December 31, 2012 and 2011 is as follows:

Unpaid claims as of January 1, 2011	$ 23,258
Incurred claims during 2011	11,309
Payments during 2011	(7,099)
Unpaid claims as of January 1, 2012	27,468
Incurred claims during 2012	-
Payments during 2012	(5,836)
Unpaid claims as of December 31, 2012	$ 21,632

9. CONTINGENCIES

Litigation

In the normal course of business, there are various claims and lawsuits pending against the City. In the opinion of City management, after consultation with legal counsel, the potential loss, if any, on all claims and lawsuits will not materially affect the City's financial position. With the exception of workers' compensation and health insurance, the City purchases commercial insurance for all risks of loss. Settled claims have not exceeded this commercial coverage in any of the past three fiscal years. There were no significant reductions in insurance coverage in 2012.

10. CONTRACT COMMITMENTS

In 2012, the Water Fund contracted to make necessary capital improvements to the water system. As a result of this, the City entered into contracts with construction contractors totaling $2,275,947. At December 31, 2012, $818,238 was included in accounts payable. The commitment remaining on the contracts at December 31, 2012 was $1,402,943.

11. NEGATIVE UNRESTRICTED NET POSITION

A series of inside City water rate increases, as well as a nearly 75% increase in rates for outside City customers approved by the PA Public Utility Commission (PUC) in July 2011, have greatly improved cash flow. The need for cash borrowing from the General Fund was reduced from $2.46 million during the year ended December 31, 2011 to $153,000 during the year ended December 31, 2012. The City is currently in the process of reviewing proposals for PUC rate case attorneys to begin another rate case for outside City water rates in late 2013

Required Supplementary Information

CITY OF LANCASTER WATER FUND

REQUIRED SUPPLEMENTARY INFORMATION

SCHEDULE OF FUNDING PROGRESS - PENSION PLAN (UNAUDITED)

Cash Balance Pension Plan:

Actuarial Valuation January 1,	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL)- Entry age (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (a/b)	Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ((b-a)/c)
2007	$ 8,428,386	$ 9,052,319	$ 623,933	93.1%	$ 10,644,441	5.9%
2008	8,747,557	9,591,825	844,268	91.2%	10,905,822	7.7%
2009	8,802,470	9,815,584	1,013,114	89.7%	10,853,541	9.3%
2010	9,311,791	10,448,552	1,136,761	89.1%	12,022,604	9.5%
2011	8,974,375	10,432,429	1,458,054	86.0%	11,972,809	12.2%
2012	9,583,121	11,273,769	1,690,648	85.0%	12,365,380	13.7%

The following changes affect the comparability of costs:

Actuarial Valuation Date	Reason	Change in Unfunded Actuarial Accrued Liability
1/1/2009	Assumption change	$ (2,031,339)
1/1/2011	Assumption change	252,898

SCHEDULE OF EMPLOYER CONTRIBUTIONS - PENSION PLAN (UNAUDITED)

Calendar Year	Annual Required Contribution	Contributions From Employer	Percentage Contributed
2007	$ 410,346	$ 410,346	100.0%
2008	459,603	459,603	100.0%
2009	475,248	475,248	100.0%
2010	499,125	499,125	100.0%
2011	504,280	504,280	100.0%
2012	516,512	516,512	100.0%

Note: Contributions include state pension aid.

CITY OF LANCASTER WATER FUND

REQUIRED SUPPLEMENTARY INFORMATION

SCHEDULE OF FUNDING PROGRESS - OPEB (UNAUDITED)

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL)- Entry age (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (a/b)	Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ((b-a)/c)
1/1/2008	$ -	$ 8,834,931	$ 8,834,931	0.0%	$ 2,914,972	303.1%
1/1/2010	-	11,365,848	11,365,848	0.0%	3,814,064	298.0%
1/1/2012	-	10,700,060	10,700,060	0.0%	3,079,389	347.5%

Note: Valuation as of 1/1/08 represent the initial valuation of the plan.

SCHEDULE OF EMPLOYER CONTRIBUTIONS - OPEB (UNAUDITED)

Year	Annual Required Contribution	Percentage Contributed
2008	$ 1,019,581	10.6%
2009	1,019,581	14.3%
2010	1,191,735	26.8%
2011	1,191,735	32.2%
2012	1,067,625	98.6%