

City of Hamilton, Ohio – Gas System

Financial Statements

Years Ended December 31, 2011 and 2010

With Independent Auditors' Report

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INDEPENDENT AUDITORS' REPORT

Honorable City Council
City of Hamilton, Ohio

We have audited the accompanying financial statements of the City of Hamilton, Ohio - Gas System, an enterprise fund of the City of Hamilton, Ohio as of and for the years ended December 31, 2011 and 2010, as listed in the table of contents. These financial statements are the responsibility of the City of Hamilton's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those 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 audits provide a reasonable basis for our opinion.

As discussed in Note 1, the financial statements present only the Gas System and do not purport to, and do not, present fairly the financial position of the City of Hamilton, Ohio as of December 31, 2011 and 2010, and the changes in its financial position and cash flows for the years 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 City of Hamilton, Ohio - Gas System as of December 31, 2011 and 2010 and the changes in financial position and cash flows thereof for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 2-8 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 audit 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.

Clark, Schaefer, Hackett & Co.

Cincinnati, Ohio
June 7, 2012

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City of Hamilton, Ohio

Gas System

Management's Discussion and Analysis
For the Years Ended December 31, 2011 and 2010
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The discussion and analysis of the City of Hamilton, Ohio's Gas System's financial performance provide an overall review of that system's financial activities for the years ended December 31, 2011 and 2010. While the intent of this discussion and analysis is to look at the system's financial performance, readers should also review the Statements of Net Assets, Revenues, Expenses and Changes in Net Assets, and Cash Flows to enhance their understanding of the system's fiscal performance.

Financial Highlights

Key highlights for 2011 and 2010 are as follows:

- ❑ The assets of the Hamilton Gas System exceeded its liabilities at the close of 2011 and 2010, respectively, by \$39,562,973 and \$39,325,881 (net assets). Of these amounts, \$10,332,015 and \$10,506,340 (unrestricted net assets) in those years can be used to meet the system's ongoing obligations to customers and creditors.
- ❑ The system's total net assets increased by \$237,092 between 2011 and 2010, representing a 0.6% increase.
- ❑ In 2011, the Gas System's total long-term debt, net of premiums, discounts, and unamortized loss on debt refunding, decreased by \$1,126,679.

Gas System Summary and Using this Annual Report

The City has owned and operated a natural gas utility system since 1890. It is currently the largest municipal gas distribution operation in Ohio and serves approximately 23,900 customers located in the City and the immediate environs through approximately 275 miles of pipe. The City purchases natural gas from a supplier, then resells the gas to residential and general service (commercial and industrial) customers. The City also provides distribution delivery service to several large non-residential customers who have each contracted with natural gas suppliers. In 2011, the City was the natural gas supplier for Mohawk Paper/Beckett Mill, USALCO, AMP-Ohio OMEGA JV2 (JV2) and the City's Thermal Power Plant. Terry Materials/Barrett Paving purchases natural gas through a supplier other than the City, but uses the City's distribution system to receive its natural gas.

The Gas System provides gas service to customers located in the City and its immediate environs. The Gas System provides full service (acquisition of gas supply, transportation of the gas supply to the City's interconnections, and distribution of gas supply from the City's interconnections to the customer meter) and distribution delivery service (distribution delivery of the gas arranged for by, or on behalf of, the customer from the City's interconnections to the customer's meter.) Currently, the Gas System provides full service to residential and general service customers.

Through 2011, Mohawk Fine Papers was a distribution delivery service customer of the Gas System. In fall 2011, however, Mohawk announced the closure of the Beckett Mill, in Hamilton, at the end of 2011. The impact of this closure on the Gas System is examined later in this document. The City provides Gas Purchasing Services to USALCO pursuant to which the City purchases gas at its City rate specifically for their individual usage. The costs of the gas supply are accounted for individually and paid for directly by the customer.

City of Hamilton, Ohio

Gas System

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Terry Materials/Barrett Paving has an agreement with the City, pursuant to which the City has agreed to provide distribution delivery services. Terry Materials purchases gas from their natural gas supplier and arranges for the transportation of the gas to the City's interconnections. Pursuant to their agreement with the City, the gas supply of the company is periodically balanced. If, at the end of the relevant period (monthly for Terry Materials), a distribution delivery service customer has used more gas than it has purchased from its supplier, it will purchase the difference from the City. Conversely, if the distribution delivery service customer has used less gas than it purchased from its supplier, the City will either buy the excess gas from the customer or will credit the price of the gas to the customer.

The City's Electric System arranges for its own supply of gas used to fuel its Electric Generating Thermal Power Plant. The City's Electric System also purchases gas for the American Municipal Power (AMP) OMEGA JV2 Project ("JV2"). The Thermal Power Plant and the JV2, however, pay the City for distribution delivery service and certain other charges. The JV2 is a joint venture sponsored by AMP. The City is one of 36 joint venture parties and provides for the operation of the JV2. In accordance with an amendment to the City's rate ordinance passed in March 2003, the distribution delivery service rate paid by the City's Thermal Power Plant and the JV2 is less than the distribution delivery service rate paid by other distribution delivery service customers. There are no franchise service territories for natural gas utilities in Ohio and the City is not prohibited from providing gas service in areas outside its corporate limits. Under the Ohio Constitution, however, the City's gas utility sales outside the corporate limits may not exceed 50% of the total service supplied within the City's corporate limits. Currently, less than 1% of the City's total gas sales are to customers located outside the City's corporate limits.

The City currently has a supply and transportation agreement with Atmos Energy Marketing. Pursuant to this agreement, Atmos is obligated to provide all the natural gas required by the City to serve its residential and general service customers and transport such gas to the City's gate. The City currently has an interconnection with two interstate pipelines, Texas Gas and Texas Eastern. Independent of the Atmos agreement, the City has an Interruptible Transportation (IT) Contract and Operational Balancing Agreement (OBA) with Texas Eastern. The Texas Eastern IT Contract receipt points are all the interstate gas pipelines interconnected to Texas Eastern at the Lebanon Lateral in southwest Ohio. The delivery point is the City's Texas Eastern Interconnection. Atmos is currently acting as the City's agent for both of these agreements. All interstate natural gas pipelines, including Texas Gas and Texas Eastern, are subject to rate and service regulations by the Federal Energy Regulatory Commission ("FERC"). FERC, however, does not regulate gas supply rates charged to the City's customers.

This annual report consists only of the Statement of Net Assets, the Statement of Revenues, Expenses and Changes in Net Assets, and the Statement of Cash Flows as well as Notes to the Financial Statements for the City of Hamilton, Ohio's Gas System for the year ended December 31, 2011 and 2010.

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Gas System

Management's Discussion and Analysis
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Reporting Hamilton's Gas System (Whole and Significant Fund)

The financial statements contained within this report include the City of Hamilton, Ohio's Gas System *only*. Readers desiring to view city-wide financial statements, as well as the impact that the Gas System has on the City's overall financial position and operating results, should refer to the City's Basic Financial Statements appearing in the Comprehensive Annual Financial Report for 2011 and 2010. The City of Hamilton's Gas System is reported as a business-type, enterprise fund and is considered a major fund for purposes of individual fund reporting. Payments made from the Gas Fund are restricted to Gas System purposes by municipal ordinance, Ohio Revised Code and indentures issued pursuant to long-term financing.

In the Statement of Net Assets and the Statement of Revenues, Expenses and Changes in Net Assets, the view of the system looks at all financial transactions of the Gas Fund and asks the question, "How did we do financially during 2011 and 2010?" These statements provide answers to that question. The statements include all assets and liabilities of the System using the accrual basis of accounting similar to the accounting used by private sector companies. This basis of accounting considers all of the current year's revenues and expenses regardless of when the cash is received or paid. These two statements report the System's net assets and the changes in those net assets. The change in net assets is important because it tells the reader whether, for the System, the financial position of the City has improved or diminished. However, in evaluating this position, non-financial information including the condition of capital assets will also need to be evaluated. The Notes to the Gas System's Financial Statements provide additional information that is essential to a full understanding of the data provided.

The System provides services that have a charge based upon the amount of usage. The City's Gas System charges fees to recoup the cost of the entire operation of the Gas System as well as all capital expenses associated with these facilities.

Financial Analysis

As noted earlier, net assets may serve over time as a useful indicator of financial position. In the case of the Gas Fund, assets exceeded liabilities by \$39,562,973 as of December 31, 2011. By far the largest portion of the net assets of the Gas System reflect its investment in capital assets (e.g. land, buildings, improvements, construction in progress, machinery and equipment) less any related debt used to acquire those assets that is still outstanding. The ratios of net assets invested in capital assets, net of related debt to total net assets are as follows: 65.40% for 2011, 64.74% for 2010 and 66.18% for 2009. The System employs these assets in the delivery of natural gas to customers; consequently, these assets are not readily available for future spending. The System's investment in its capital assets is reported net of related debt and the resources needed to repay these debts must be provided from other sources, primarily the revenues of the System, since the capital assets themselves cannot be used to liquidate the liabilities.

City of Hamilton, Ohio

Gas System

Management's Discussion and Analysis
For the Years Ended December 31, 2011 and 2010
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Table 1 provides a summary of the Gas System's Statement of Net Assets for the Years Ended December 31, 2011, 2010 and 2009:

	2011	2010	2009
Current and other assets	\$17,574,121	\$19,490,216	\$19,073,903
Capital assets	34,833,209	34,891,866	35,048,966
Total assets	52,407,330	54,382,082	54,122,869
Long-term liabilities	8,632,234	9,795,576	10,916,556
Other liabilities	4,212,123	5,260,625	5,199,326
Total liabilities	12,844,357	15,056,201	16,115,882
Invested in capital assets, net of related debt	25,873,780	25,461,377	25,154,191
Restricted	3,357,178	3,358,164	3,362,637
Unrestricted	10,332,015	10,506,340	9,490,159
Total net assets	\$39,562,973	\$39,325,881	\$38,006,987

As of December 31, 2011, 2010 and 2009, the City reported positive balances in the overall changes in net assets of \$237,092, \$1,318,894 and \$1,980,295, respectively. For the years ended December 31, 2011, 2010 and 2009, there was operating income of \$812,909, \$1,853,446 and \$2,658,171, respectively. Net operating income of \$812,909, which is a decrease of \$1,040,537 from 2010 to 2011, is due to lower sales (approximately a 3% reduction) to the non-transportation customers, resulting in decreased operating revenues in 2011. Net non-operating expenses of \$616,317 increased by \$31,765, primarily because investment earnings decreased due to low interest rates and the disposal of capital assets, offset by a decrease in interest and fiscal charges as the City continues to make its scheduled debt service payments.

City of Hamilton, Ohio

Gas System

Management's Discussion and Analysis
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Statements of Revenues, Expenses and Changes in Net Assets

	2011	2010	2009
Operating revenues	\$21,930,366	\$26,793,820	\$31,662,109
Operating expenses:			
Purchased gas	13,744,349	17,429,023	21,199,188
Depreciation	1,887,279	1,847,513	1,908,856
Other operating expenses	5,485,829	5,663,838	5,895,894
Total operating expenses	21,117,457	24,940,374	29,003,938
Operating income	812,909	1,853,446	2,658,171
Non-Operating revenues (expenses)			
Interest and fiscal charges	(572,569)	(657,860)	(579,889)
Loss on disposal of capital assets	(87,844)	-	(48,837)
Other non-operating revenues	44,096	73,308	133,350
Total non-operating revenues (expenses)	(616,317)	(584,552)	(495,376)
Capital Contributions	40,500	50,000	-
Transfers	-	-	(182,500)
Change in net assets	237,092	1,318,894	1,980,295
Beginning net assets	39,325,881	38,006,987	36,026,692
Ending net assets	\$39,562,973	\$39,325,881	\$38,006,987

Capital Assets and Debt Administration

Capital Assets: The City's investment in capital assets of the Gas System as of December 31, 2011, 2010 and 2009 amounted to \$25.9 million, \$25.5 million and \$25.2 million, respectively, (net of accumulated depreciation and related debt). This investment in capital assets includes land, buildings, improvements, construction in progress, and machinery and equipment.

Note 5 (Capital Assets) provide Gas System capital asset activity during 2011 and 2010.

Debt Administration: At the end of 2011, the City had two outstanding long-term revenue bond issues, the 2003 Gas System Revenue Refunding Bonds totaling \$5,295,000 and the 2009 Gas System Revenue Bonds totaling \$4,500,000.

See Note 6 for a discussion of outstanding Gas System bonds and related activity.

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Economic Factors and Future Trends

The City's Gas System is continually monitoring the cost of natural gas and employs a structured hedging plan to mitigate price fluctuations to its customers. The cost of natural gas is highly volatile and the City is required by both ordinance and indentures to pass through these gas costs to its customers via the GCR. During 2011, the GCR changed from \$4.80/MCF to \$4.50/MCF. The overall number of customers has remained relatively steady while, like most gas systems, the usage per residential customer has continued to slowly decline as a result of improved efficiency of appliances.

In September 2011, City Council adopted an ordinance, creating the RSLM Program and Rider C for the Gas System. The RSLM and Rider C charges apply only to the City's residential gas accounts. The RSLM and funds collected through Rider C are earmarked for two separate and distinct activities: the replacement of Design A (field-assembled risers), in compliance with a PUCO statewide order, and the assumption of the maintenance responsibility of gas service lines to residential customers by the City. The riser replacement portion of the RSLM is scheduled to be a five-year program, with a corresponding five-year collection period through Rider C.

In 2011, both Mohawk Fine Papers and Smart Papers both closed their facilities located in the City. For calendar year 2011, Mohawk Fine Papers/Beckett Mill was the largest customer, albeit a distribution delivery service (transportation) customer, by Ccf usage and amount billed, for the Gas System. Mohawk used almost 5.8 million Ccf and was billed almost \$3.1 million for gas service at the Beckett Mill. Mohawk accounted for approximately 16.6% of the total gas usage and almost 13.5% of the revenues of the Gas System. However, Mohawk's average cost per Ccf, in 2011, was \$0.571 per Ccf, or approximately 19.1% less than the \$0.705 per Ccf for all customers of the Gas System. Smart Papers accounted for less than 0.1% of the total usage and revenues of the Gas System in 2011; therefore, the direct impact of the Smart Papers closure, sale and/or downsizing on the Gas System is minimal. In total, the loss of Mohawk and Smart Papers is estimated to result in a direct Total Net Revenue Loss to the City's Gas System of approximately \$366,000, based upon 2011 operations. Almost the entirety of this Total Net Revenue Loss is accounted for by Mohawk. Indirect losses, from vendors, suppliers, and other associated entities, will increase this estimate further.

The annual budget of the City Gas System is adopted in accordance with ten-year projections developed by a rate consultant, and these projections are reviewed and updated in the spring and fall of each year, or more often as deemed necessary by City Management.

Natural gas prices have stabilized recently due to extraction of shale gas and reduced demand from recessionary pressures. The City continues to monitor potential threats to supply and maintains its disciplined hedging program. The City's Gas System has continued its strong financial performance into 2011. The City maintains an A1 bond rating with a stable outlook for its Gas System and for both its 2003 Gas System Revenue Refunding Bonds and its 2009 Gas System Revenue Bonds.

City of Hamilton, Ohio

Gas System

Management's Discussion and Analysis
For the Years Ended December 31, 2011 and 2010
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Requests for Information

This financial report is designed to provide our citizens, customers, taxpayers, creditors, investors and elected officials with an overview of the City of Hamilton, Ohio's Gas System's finances and to show accountability for the money the system receives. If you have any questions about this report or need additional information, contact Peg Bradner Hancock, City of Hamilton Finance Director, 345 High Street, Hamilton, Ohio 45011, (513) 785-7174, (email at hancockp@ci.hamilton.oh.us) or visit the City website at www.hamilton-city.org.

CITY OF HAMILTON, OHIO – GAS SYSTEM
STATEMENTS OF NET ASSETS
DECEMBER 31, 2011 AND 2010

	<u>2011</u>	<u>2010</u>
ASSETS		
Current assets:		
Cash and investments	\$ 11,008,546	11,369,277
Accounts receivable (less allowance for uncollectible accounts of \$3,179,277 and \$3,404,038, respectively)	2,752,063	4,252,896
Interest receivable	3,575	4,896
Inventory of supplies at cost	152,109	148,825
Prepaid expenses	<u>148,680</u>	<u>166,862</u>
Total current assets	<u>14,064,973</u>	<u>15,942,756</u>
Restricted assets:		
Cash and investments	<u>3,357,178</u>	<u>3,358,164</u>
Bond issuance costs	<u>151,970</u>	<u>189,296</u>
Capital assets:		
Property, plant and equipment	66,483,313	64,592,347
Construction in progress	3,400,043	3,666,816
Accumulated depreciation	<u>(35,050,147)</u>	<u>(33,367,297)</u>
Total capital assets	<u>34,833,209</u>	<u>34,891,866</u>
Total assets	\$ <u>52,407,330</u>	<u>54,382,082</u>
LIABILITIES		
Current liabilities:		
Accounts payable	\$ 2,076,039	3,106,647
Accrued wages and benefits	62,365	50,671
Intergovernmental payable	46,511	118,180
Accrued interest payable	94,269	106,835
Customer deposits payable	568,649	566,013
Compensated absences payable-current	134,290	137,279
Revenue bonds payable-current	<u>1,230,000</u>	<u>1,175,000</u>
Total current liabilities	<u>4,212,123</u>	<u>5,260,625</u>
Noncurrent liabilities:		
Compensated absences payable	206,485	188,148
Revenue bonds payable	<u>8,425,749</u>	<u>9,607,428</u>
Total noncurrent liabilities	<u>8,632,234</u>	<u>9,795,576</u>
Total liabilities	<u>12,844,357</u>	<u>15,056,201</u>
NET ASSETS		
Invested in capital assets, net of related debt	25,873,780	25,461,377
Restricted for debt service	857,178	858,164
Restricted for rate stabilization	2,500,000	2,500,000
Unrestricted	<u>10,332,015</u>	<u>10,506,340</u>
Total net assets	\$ <u>39,562,973</u>	<u>39,325,881</u>

See notes to financial statements.

CITY OF HAMILTON, OHIO - GAS SYSTEM
STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS
YEARS ENDED DECEMBER 31, 2011 AND 2010

	<u>2011</u>	<u>2010</u>
Operating revenues:		
Charges for services	\$ 21,898,395	26,762,930
Other operating revenues	<u>31,971</u>	<u>30,890</u>
Total operating revenues	<u>21,930,366</u>	<u>26,793,820</u>
Operating expenses:		
Personal services	1,809,149	1,534,490
Materials and supplies	244,220	620,683
Contractual services	1,522,263	1,475,348
Purchased gas	13,744,349	17,429,023
Depreciation	1,887,279	1,847,513
Other operating expenses	<u>1,910,197</u>	<u>2,033,317</u>
Total operating expenses	<u>21,117,457</u>	<u>24,940,374</u>
Operating income	812,909	1,853,446
Non-operating revenues (expenses):		
Investment earnings	44,096	73,308
Loss on disposal of capital assets	(87,844)	-
Interest and fiscal charges	<u>(572,569)</u>	<u>(657,860)</u>
Total non-operating revenues (expenses)	<u>(616,317)</u>	<u>(584,552)</u>
Income before contributions	196,592	1,268,894
Capital contributions	<u>40,500</u>	<u>50,000</u>
Change in net assets	237,092	1,318,894
Net assets - beginning of year	<u>39,325,881</u>	<u>38,006,987</u>
Net assets - end of year	\$ <u>39,562,973</u>	<u>39,325,881</u>

See notes to financial statements.

CITY OF HAMILTON, OHIO - GAS SYSTEM
STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 31, 2011 AND 2010

	<u>2011</u>	<u>2010</u>
Cash flows from operating activities:		
Cash received from customers	\$ 23,433,835	27,846,334
Cash paid for employee services and benefits	(1,759,882)	(1,523,528)
Cash paid to suppliers for goods and services	<u>(18,419,857)</u>	<u>(21,586,790)</u>
Net cash provided by operating activities	<u>3,254,096</u>	<u>4,736,016</u>
Cash flows from capital and related financing activities:		
Capital grants	40,500	50,000
Payments for capital acquisition	(2,027,242)	(1,473,236)
Debt principal payments	(1,175,000)	(1,120,000)
Debt interest payments	<u>(499,488)</u>	<u>(573,780)</u>
Net cash used by capital and related financing activities	<u>(3,661,230)</u>	<u>(3,117,016)</u>
Cash flows from investing activities:		
Interest from investments	<u>45,417</u>	<u>96,169</u>
Net change in cash and investments	(361,717)	1,715,169
Cash and investments at beginning of year	<u>14,727,441</u>	<u>13,012,272</u>
Cash and investments at end of year	\$ <u>14,365,724</u>	<u>14,727,441</u>
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	\$ 812,909	1,853,446
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	1,887,279	1,847,513
Changes in Assets and Liabilities:		
(Increase) decrease in receivables	1,500,833	1,297,156
(Increase) decrease in inventory	(3,284)	(1,241)
(Increase) decrease in prepaid items	18,182	(63,307)
Increase (decrease) in customer deposits payable	2,636	15,840
Increase (decrease) in payables	(919,832)	(317,997)
Increase (decrease) in accrued liabilities	27,042	22,161
Increase (decrease) in intergovernmental payables	<u>(71,669)</u>	<u>82,445</u>
Net cash provided by operating activities	\$ <u>3,254,096</u>	<u>4,736,016</u>
Schedule of noncash activities:		
Outstanding liabilities for purchase of certain capital assets	\$ 184,221	294,997
Change in fair value of investments	3,635	5,759

See notes to financial statements.

CITY OF HAMILTON, OHIO – GAS SYSTEM

Notes to Financial Statements Years Ended December 31, 2011 and 2010

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Financial Reporting Entity – The City of Hamilton, Ohio – Gas System (Gas System) is a utility operating as a separate enterprise fund of the City of Hamilton, Ohio (City). The Gas System is controlled by and is dependent on the City’s executive and legislative branches. Control by or dependence on the City is determined on the basis of outstanding debt secured by revenues or general obligations of the City, obligation of the City to finance any deficits that may occur, or receipt of subsidies from the City.

Measurement Focus, Basis of Accounting and Basis of Presentation – The financial statements are prepared in accordance with accounting principles generally accepted in the United States of America as applied to government units. The Governmental Accounting Standards Board (GASB) is the accepted standard-setting body for establishing governmental accounting and financial reporting principles. The financial statements are reported using the economic resources measurement focus and the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of cash flows. The Gas System has elected only to apply Financial Accounting Standards Board (FASB) guidance issued on or before November 30, 1989 that do not conflict with or contradict GASB pronouncements.

Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with the Gas System’s principal ongoing operations. The principal operating revenues are charges to customers for sales and services. Operating expenses include the cost of sales and services, administrative expenses, and depreciation on capital assets. All revenues and expenses not meeting these definitions are reported as non-operating revenues and expenses.

Income Taxes – The Gas System, which is owned and operated by the City, is exempt from income taxes since it is a division of a municipality.

Cash and Investments – Certain Gas System cash and investments are held in the City Treasury and pooled for investment management purposes. The portion of these pooled funds owned by the Gas System is reported as cash and investments. The Gas System’s investments are stated at fair value. Interest earned on funds invested is distributed on the basis of the relationship of the average monthly balance of all funds, including the Gas System.

Inventories – Inventories are stated at the lower of cost or market based on a moving-average cost method.

Capital Assets – Expenditures that increase values or extend the useful life of the respective assets are capitalized while the costs of maintenance and repairs are charged to operating expenses. Interest costs related to the construction of property, plant and equipment are capitalized. Depreciation is calculated on a straight-line basis over the estimated useful life of the various classes of assets. The range of useful lives for computing depreciation is 3 to 75 years.

Bond Premiums, Discounts and Issuance Costs – Unamortized bond premiums and discounts as well as issuance costs are amortized on the interest method over the term of the related bonds. Amortization of bond premiums was \$64,612 and \$76,041 in 2011 and 2010, respectively. Amortization of bond discounts was \$14,930 and \$17,285 in 2011 and 2010, respectively. Amortization of issuance costs in 2011 and 2010 amounted to \$37,236 and \$43,387, respectively.

Compensated Absences - The Gas System follows the provisions of GASB Statement No. 16, “Accounting for Compensated Absences”. Vacation and compensatory time benefits are accrued as a liability as the benefits are earned if the employees' rights to receive compensation are attributable to services already rendered and it is probable that the Gas System will compensate the employees for the benefits through paid time off or some other means. Sick leave termination benefits are accrued using the vesting method. The liability includes the employees who are currently eligible to receive termination benefits and those employees for whom it is probable that they will become eligible to receive payment in the future. The amount is based on accumulated sick leave and employees' wage rates at year-end.

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

2. CASH AND INVESTMENTS

The Gas System follows the practice of pooling cash and investments with the City Treasurer except for the cash and investments of certain accounts maintained by trustees. Pooled cash and investments of the Gas System totaled \$13,508,546 and \$13,869,277 at December 31, 2011 and 2010, respectively and consisted of demand deposits, money market funds, U.S. government securities and STAR Ohio. Cash and investments held by trustees were \$857,178 and \$858,164 at December 31, 2011 and 2010, respectively.

Star Ohio is an investment pool managed by the State Treasurer’s Office, which allows governments within the State to pool their funds for investment purposes. STAR Ohio is not registered with the SEC as an investment company, but does operate in a manner consistent with Rule 2a7 of the Investment Company Act of 1940. Investments in STAR Ohio are valued at STAR Ohio’s share price, which is the price the investment could be sold for on December 31, 2011.

Deposits – Custodial credit risk is the risk that in the event of a bank failure, the City’s deposits may not be returned to it. The City does not have a custodial risk policy. As of December 31, 2011, nearly 98% of the City’s deposits with financial institutions, including the amount of pooled deposits related to the Gas System, were exposed to custodial credit risk because they are considered uninsured and uncollateralized. However, the State of Ohio has established by statute a collateral pooling system for financial institutions acting as public depositories. Public depositories must pledge qualified securities with fair values greater than the total amount of all public deposits to be secured by the collateral pool. This pooled collateral covers the Gas System’s uninsured and uncollateralized deposits.

Investments – The State of Ohio statutes, Gas Revenue Bond indentures, and the City Charter authorize the City to invest in obligations of the U.S. Treasury, agencies, instrumentalities, and repurchase agreements. Custodial credit risk in regards to investments is the risk that, in the event of a failure of a counter party, the City will not be able to recover the value of its investments or collateral securities that are in possession of an outside party. The City employs the use of “safekeeping” accounts to hold and maintain custody of its investments as identified within this policy and as means of mitigating this risk.

Interest rate risk is the risk that the City will incur fair value losses arising from rising interest rates. Such risk is mitigated by the investment policy by limiting investments to certain maximum maturities. As a rule, unless specified otherwise within the policy, investments are to have a maximum maturity of five years unless the investment is matched to a specific expenditure. The context of a specific investment purchase must be weighed in proportion to the remainder of the existing investment portfolio and the “prudent investor” rule to attempt to limit such risk.

The City’s pooled investments, as well as the investments held by trustees specifically for the Gas System, are invested primarily in U.S. governmental agency securities with an AA+ credit rating and an average maximum maturity of 4.69 years and STAR Ohio which has a credit rating of AAAm.

3. ACCOUNTS RECEIVABLE

Receivables at December 31, 2011 and 2010 consist of the following:

	<u>2011</u>	<u>2010</u>
Earned and unbilled consumer accounts	\$ 2,043,051	3,127,748
Earned and billed consumer accounts	3,888,289	4,529,186
Less allowance for uncollectible accounts	<u>(3,179,277)</u>	<u>(3,404,038)</u>
Total	\$ <u>2,752,063</u>	<u>4,252,896</u>

4. RESTRICTED ASSETS

Restricted assets consist of assets whose use has been restricted by bond indenture for debt service and rate stabilization. Restricted assets were \$3,357,178 and \$3,358,164 December 31, 2011 and 2010, respectively.

5. CAPITAL ASSETS

Capital asset activity for the years ended December 31, 2011 and 2010 was as follows:

	Balance 1/1/11	Increases	Decreases	Balance 12/31/11
<i>Capital assets not being depreciated:</i>				
Land	\$ 92,101	-	-	92,101
Construction in progress	<u>3,666,816</u>	<u>1,012,172</u>	<u>(1,278,945)</u>	<u>3,400,043</u>
Subtotal	<u>3,758,917</u>	<u>1,012,172</u>	<u>(1,278,945)</u>	<u>3,492,144</u>
<i>Capital assets being depreciated:</i>				
Buildings and improvements	516,419	-	-	516,419
Machinery and equipment	<u>63,983,827</u>	<u>2,183,239</u>	<u>(292,273)</u>	<u>65,874,793</u>
Subtotal	<u>64,500,246</u>	<u>2,183,239</u>	<u>(292,273)</u>	<u>66,391,212</u>
Totals at historical cost	<u>68,259,163</u>	<u>3,195,411</u>	<u>(1,571,218)</u>	<u>69,883,356</u>
Less accumulated depreciation:				
Buildings and improvements	478,595	19,448	-	498,043
Machinery and equipment	<u>32,888,702</u>	<u>1,867,831</u>	<u>(204,429)</u>	<u>34,552,104</u>
Total accumulated depreciation	<u>33,367,297</u>	<u>1,887,279</u>	<u>(204,429)</u>	<u>35,050,147</u>
Capital assets, net	\$ <u>34,891,866</u>	<u>1,308,132</u>	<u>(1,366,789)</u>	<u>34,833,209</u>
	Balance 1/1/10	Increases	Decreases	Balance 12/31/10
<i>Capital assets not being depreciated:</i>				
Land	\$ 92,101	-	-	92,101
Construction in progress	<u>2,394,544</u>	<u>1,337,897</u>	<u>(65,625)</u>	<u>3,666,816</u>
Subtotal	<u>2,486,645</u>	<u>1,337,897</u>	<u>(65,625)</u>	<u>3,758,917</u>
<i>Capital assets being depreciated:</i>				
Buildings and improvements	516,419	-	-	516,419
Machinery and equipment	<u>63,568,508</u>	<u>418,141</u>	<u>(2,822)</u>	<u>63,983,827</u>
Subtotal	<u>64,084,927</u>	<u>418,141</u>	<u>(2,822)</u>	<u>64,500,246</u>
Totals at historical cost	<u>66,571,572</u>	<u>1,756,038</u>	<u>(68,447)</u>	<u>68,259,163</u>
Less accumulated depreciation:				
Buildings and improvements	459,147	19,448	-	478,595
Machinery and equipment	<u>31,063,459</u>	<u>1,828,065</u>	<u>(2,822)</u>	<u>32,888,702</u>
Total accumulated depreciation	<u>31,522,606</u>	<u>1,847,513</u>	<u>(2,822)</u>	<u>33,367,297</u>
Capital assets, net	\$ <u>35,048,966</u>	<u>(91,475)</u>	<u>(65,625)</u>	<u>34,891,866</u>

6. LONG TERM DEBT

Dated May 1, 2003, the City issued \$14,540,000 in Gas System Revenue Refunding Bonds to refund the 1993 Gas System Revenue Bonds. The Gas System Revenue Refunding Bonds are due serially through 2015 with interest from 4.75% to 5.0% per annum.

On September 9, 2009, the City issued \$4,500,000 in Gas System Revenue Bonds to currently refund bond anticipation notes and provide funding for various Gas System distribution improvements. These bonds are due serially through 2029 with interest from 2.75% to 5.0% per annum, with the first payment due in 2016.

Activity for the year ended December 31, 2011 was as follows:

	Balance			Balance	Due
	1/1/11	Additions	Reductions	12/31/11	Within One Year
2003 Refunding Bonds	\$ 6,470,000	-	(1,175,000)	5,295,000	1,230,000
2009 Revenue Bonds	4,500,000	-	-	4,500,000	-
Less deferred amount on refunding	(300,282)	-	98,003	(202,279)	-
for issuance premium	197,971	-	(64,612)	133,359	-
for issuance discounts	(85,261)	-	14,930	(70,331)	-
	<u>\$ 10,782,428</u>	<u>-</u>	<u>(1,126,679)</u>	<u>9,655,749</u>	<u>1,230,000</u>

Activity for the year ended December 31, 2010 was as follows:

	Balance			Balance	Due
	1/1/10	Additions	Reductions	12/31/10	Within One Year
2003 Refunding Bonds	\$ 7,590,000	-	(1,120,000)	6,470,000	1,175,000
2009 Revenue Bonds	4,500,000	-	-	4,500,000	-
Less deferred amount on refunding	(415,621)	-	115,339	(300,282)	-
for issuance premium	274,012	-	(76,041)	197,971	-
for issuance discounts	(102,546)	-	17,285	(85,261)	-
	<u>\$ 11,845,845</u>	<u>-</u>	<u>(1,063,417)</u>	<u>10,782,428</u>	<u>1,175,000</u>

Under the terms of the revenue bond indenture, the City has agreed to certain covenants including, among other things, maintaining revenue levels and providing for operating expenses and debt service. The revenue bonds are insured under municipal bond insurance policies. Under the terms of the policies, the payments of principal and interest are guaranteed by the insurer.

Annual debt service requirements to maturity for the refunding bonds are as follows:

		<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2012	\$	1,230,000	440,737	1,670,737
2013		1,290,000	379,237	1,669,237
2014		1,355,000	314,737	1,669,737
2015		1,420,000	250,375	1,670,375
2016		250,000	182,925	432,925
2017-2021		1,385,000	792,075	2,177,075
2022-2026		1,670,000	505,050	2,175,050
2027-2029		<u>1,195,000</u>	<u>112,825</u>	<u>1,307,825</u>
Total	\$	<u>9,795,000</u>	<u>2,977,961</u>	<u>12,772,961</u>

7. **DEFINED BENEFIT PENSION PLANS AND OTHER POSTEMPLOYMENT BENEFITS**

The Gas System contributes to the Ohio Public Employees Retirement System, the City of Hamilton Metropolitan Pension Plan, and post-employment life insurance.

Ohio Public Employees Retirement System (OPERS)

The OPERS administers three separate pension plans:

- The Traditional Pension Plan – a cost-sharing multiple-employer defined benefit pension plan.
- The Member-Directed Plan – a defined contribution plan in which the member invests both member and employer contributions (employer contributions vest over five years at 20% per year). Under the Member-Directed Plan, members accumulate retirement assets equal to the value of member and vested employer contributions plus any investment earnings thereon.
- The Combined Plan – a cost sharing multiple-employer defined benefit pension plan. Under the Combined Plan, employer contributions are invested by the retirement system to provide a formula retirement benefit similar in nature to the Traditional Plan benefit. Member contributions, the investment of which is self-directed by the members, accumulate retirement assets in a manner similar to the Member-Directed Plan.

OPERS provides retirement, disability, survivor and death benefits, and annual cost of living adjustments to members and of the Traditional Plan and Combined Plan. Members of the Member-Directed Plan do not qualify for ancillary benefits. The authority to establish and amend benefits is provided by state statute per Chapter 145 of the Ohio Revised Code. OPERS issues a stand-alone financial report that may be obtained by writing to the OPERS, 277 East Town Street, Columbus, Ohio 43215-4642.

Plan members are required to contribute 10.0% of their annual covered salary. The City was required to contribute 14.0% of covered payroll for employees. The Gas System's required contributions to OPERS for the years ended December 31, 2011, 2010, and 2009 were approximately \$179,000, \$150,000, and \$146,000 respectively, equal to the required contributions for each year.

OPERS maintains a cost-sharing multiple employer defined benefit post-employment healthcare plan, which includes a medical plan, prescription drug program and Medicare Part B premium reimbursement, to qualifying members of both the Traditional Pension and the Combined Plans. Members of the Member-Directed Plan do not qualify for ancillary benefits, including post-employment health care coverage.

In order to qualify for post-employment health care coverage, age-and-service retirees under the Traditional Pension and Combined Plans must have 10 or more years of qualifying Ohio service credit. Health care coverage for disability benefit recipients and qualified survivor benefit recipients is available. The health care coverage provided by OPERS meets the definition of an Other Post Employment Benefit (OPEB) as described in GASB Statement 45.

The Ohio Revised Code permits, but does not mandate, OPERS to provide OPEB benefits to its eligible members and beneficiaries. Authority to establish and amend benefits is provided in Chapter 145 of the Ohio Revised Code.

The Ohio Revised Code provides the statutory authority requiring public employers to fund post retirement health care coverage through their contributions to OPERS. A portion of each employer's contribution to OPERS is set aside for the funding of post retirement health care benefits. Employer contribution rates are expressed as a percentage of the covered payroll of active members. In 2011, the City contributed 14.0% of covered payroll. The Ohio Revised Code currently limits the employer contribution to a rate not to exceed 14.0% of covered payroll. Active members do not make contributions to the OPEB Plan.

The OPERS' Post Employment Health Care plan was established under, and is administrated in accordance with, Internal Revenue Code 401(h). Each year, the OPERS Board of Trustees determines the portion of the employer contribution rate that will be set aside for funding of postemployment health care benefits. The portion of employer contributions allocated to health care for members in the Traditional Plan was 4.0% during calendar year 2011. The portion of employer contributions allocated to health care for members in the Combined Plan was 6.05% during calendar year 2011. The portion of employer contributions allocated to health care for the calendar year beginning January 1, 2012 remained the same, but they are subject to change based on Board action. Employers will be notified if the portion allocated to health care changes during calendar year 2012. The OPERS Board of Trustees is also authorized to establish rules for the retiree, or their surviving beneficiaries, to pay a portion of the health care benefits provided. Payments amounts vary depending on the number of covered dependents and the coverage selected. The portion of the Gas System's contributions that were used to fund post employment benefits was approximately \$51,000, \$54,000, and \$61,000 for 2011, 2010, and 2009, respectively.

The Health Care Preservation Plan adopted by the OPERS Board of Trustees on September 9, 2004, was effective January 1, 2007. Members and employer contribution rates increased on January 1 of each year from 2006 to 2008. These increases allowed additional funds to be allocated to the health care plan.

Metropolitan Pension Plan

Employees of the City who were not included under the Ohio Public Employees Retirement System (OPERS) prior to May 15, 1962 and who were included under a Group Annuity Contract of the Metropolitan Life Insurance Company participate in the City of Hamilton Metropolitan Pension Plan, a single-employer defined benefit pension plan.

Upon retirement, plan participants are entitled to a supplemental retirement benefit paid by the City, equal to the difference between OPERS benefits that would have been payable to such employee had the employee been covered by OPERS during the full period of employment and actual OPERS benefits received. Benefit provisions of the plan are established and may be amended by the City Council through ordinance. All current participants in the Metropolitan Pension Plan are retired from service with the City.

For fiscal year 2011, the portion of the Gas System's annual pension cost was \$55,782. The Gas System contributed 89.8%, or \$50,117, resulting in a net pension obligation of \$5,665. For the preceding two years, the City determined the net pension obligation to be immaterial, as annual pension cost approximated City contributions. The Gas System's portion of the total unfunded accrued liability at year end was \$383,001.

The actuarial valuation date was December 31, 2011 and the accrued liability was calculated using the entry age normal cost method. The Metropolitan Pension Plan currently has no assets. The amortization method used was level dollar and the amortization period was 8 years.

Retiree Life Insurance

The City provides post-employment life insurance coverage through the Hartford Insurance Company. The insurance coverage provided is considered an other post-employment benefit (OPEB) as described in GASB Statement No. 45.

Eligible employees are grouped into two classes. Employees who retired prior to March 1, 1977 are eligible to receive \$2,000 in life insurance benefits. Employees who retired after March 1, 1977 are eligible to receive \$4,000 in life insurance benefits. Benefit provisions of the plan are established and may be amended by City Council through ordinance.

For fiscal year 2011, the portion of the Gas System's annual OPEB cost was \$11,346. The Gas System contributed 85.8%, or \$9,729, resulting in a net OPEB obligation of \$1,617. For the preceding two years, the City determined the net OPEB obligation to be immaterial, as the annual OPEB cost approximated City contributions. The Gas System's portion of the total unfunded accrued liability at year end was \$163,186.

The actuarial valuation date was December 31, 2011 and the accrued liability was calculated using the entry age normal cost method. The City's post-employment life-insurance plan currently has no assets.

8. CONTINGENT LIABILITIES

Various claims and lawsuits are pending against the City involving the Gas System. The City believes that the ultimate disposition of such claims and lawsuits will not have a material adverse effect on the financial position of the Gas System.

9. RELATED PARTY TRANSACTIONS

The Gas System sells gas to the City's Electric System for use in the generation of electricity. Revenues of approximately \$676,000 and \$262,000 from the Electric System to the Gas System are included in operating revenues in 2011 and 2010, respectively.

The City allocates the cost of certain administrative services. In addition, the City established internal service funds that provide services to various City departments. Charges to the Gas System for these services were approximately \$2,352,000 and \$2,432,000 in 2011 and 2010, respectively, and are included in other operating expenses.

10. RISK MANAGEMENT

The City is exposed to various risks of loss related to torts and liability, damage to and theft of or destruction of assets; errors and omissions; injuries to employees; and natural disasters. The City maintains comprehensive insurance coverage, for all City departments including the Gas System, with private carriers for real property, building contents, vehicle, property and general liability insurance, police professional liability, and public officials errors and omissions insurance. Vehicle policies include liability coverage for bodily injury and property damage. Claim payments have not exceeded coverage in the past three years. There was no decline in the level of coverage from the prior year.

11. CONTRACTUAL COMMITMENTS

At December 31, 2011, the Gas System had a contractual commitments related to property, plant and equipment improvements and additions, as well as various other contract and agreements to provide or receive services related to the operations of approximately \$636,000.