



815 Peacock Plaza
Key West, Florida 33040
305.294.1049 / 305.294.1040
Fax: 305.294.3951

Scott G. Oropeza, C.P.A., P.A.
John G. Parks, Jr., C.P.A., P.A.

INDEPENDENT AUDITOR'S REPORT

Utility Board of the City
of Key West, Florida
"Keys Energy Services"
Key West, Florida

We have audited the accompanying financial statements of the Utility Board of the City of Key West, Florida, d/b/a Keys Energy Services, ("KEYS") as of and for the years ended September 30, 2006 and 2005 as listed in the table of contents. These financial statements are the responsibility of KEYS' 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 and *Government Auditing Standards*, and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of 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.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Utility Board of the City of Key West, Florida, Keys Energy Services as of September 30, 2006 and 2005, and the changes in financial position, and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated January 11, 2007, on our consideration of KEYS' internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

The management's discussion and analysis and budgetary comparison information as listed in the table of contents are not a required part of the basic financial statements but are supplementary information required by the *Governmental Accounting Standards Board*.

We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise KEYS' basic financial statements. The introductory section and statistical section are presented for purposes of additional analysis and are not a required part of the basic financial statements. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is also not a required part of the basic financial statements of KEYS'. The schedule of expenditures of federal awards has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statement taken as a whole. The introductory and statistical sections have not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on them.


OROPEZA & PARKS
CERTIFIED PUBLIC ACCOUNTANTS

January 11, 2007

Management's Discussion and Analysis

As management of the Utility Board of the City of Key West, Florida, we offer readers of the Utility Board's financial statements this narrative overview and analysis of the financial activities of the Utility Board of the City of Key West for the fiscal year ended September 30, 2006. We encourage readers to consider the information presented here in conjunction with additional information we have furnished in our Letter of Transmittal.

Required Financial Statements

The financial statements consist of the Balance Sheet, Statement of Revenues, Expenses and Changes in Net Assets, and Statement of Cash Flows. The *Balance Sheet* provides information about the nature and amounts of investments in resources (assets) and the obligations to creditors (liabilities). It also provides the basis for assessing the liquidity and financial flexibility of the Utility. All of the current year's revenues and expenses are accounted for in the *Statement of Revenues, Expenses and Changes in Net Assets*. This statement reports all the revenues and expenses during the time periods indicated, and can be used to determine whether the Utility has successfully recovered all its costs. The primary purpose of the *Statement of Cash Flows* is to provide information about the Utility's cash receipts and cash payments. This statement reports cash receipts, cash payments, and net changes in cash resulting from activities related to operations, non-capital financing, and capital and related financing. The statement also provides answers to such questions as "where did cash come from?" "what was cash used for?" and "what was the change in cash balance during the reporting period?"

Balance Sheet

The Utility's Net Assets, which do not include the negative net pension obligation, increased in Fiscal 2006 by \$6.0 million, or 9%.

	2004	2005	2006	2005 to 2006 Increase (Decrease)	
				Amount	Percent
Net Property, Plant and Equipment	\$115,031,750	\$114,111,920	\$114,832,809	\$720,889	0.6%
Other Property and Investments	25,791,610	14,709,156	16,076,733	1,367,577	9.3%
Current and Non-Current Assets	<u>16,404,585</u>	<u>33,723,321</u>	<u>33,923,421</u>	<u>200,100</u>	<u>0.6%</u>
Total Assets	<u>\$157,227,945</u>	<u>\$162,544,397</u>	<u>\$164,832,963</u>	<u>\$2,288,566</u>	<u>1.4%</u>
Invested in Capital Assets, net of related debt	\$47,004,365	\$48,044,762	\$53,995,651	\$5,950,889	12.4%
Restricted for Working Capital	3,243,009	3,243,009	3,243,009	-	0.0%
Unrestricted	<u>11,263,359</u>	<u>15,830,949</u>	<u>15,934,969</u>	<u>104,020</u>	<u>0.7%</u>
Net Assets	<u>61,510,733</u>	<u>67,118,720</u>	<u>73,173,629</u>	<u>6,054,909</u>	<u>9.0%</u>
Long-Term Debt, Net of Current Portion	77,786,466	75,257,723	71,126,824	(4,130,899)	-5.5%
Liabilities Payable from Restricted Assets	10,989,426	11,200,080	11,998,052	797,972	7.1%
Current Liabilities and Deferred Revenue	<u>6,941,320</u>	<u>8,967,874</u>	<u>8,534,458</u>	<u>(433,416)</u>	<u>-4.8%</u>
Total Liabilities	<u>95,717,212</u>	<u>95,425,677</u>	<u>91,659,334</u>	<u>(3,766,343)</u>	<u>-3.9%</u>
Total Net Assets and Liabilities	<u>\$157,227,945</u>	<u>\$162,544,397</u>	<u>\$164,832,963</u>	<u>\$2,288,566</u>	<u>1.4%</u>

The changes to Assets are listed as follows:

- Increase in Net Property, Plant and Equipment - \$720.9 thousand
 - Net Additions to Utility Plant - \$1.9 million, primarily repairs to CT#1 and the purchase of vehicles, replacement of the Kennedy Drive Substation Switchgear, the Transmission Pole Foundation Repairs less various retirements.
 - Net Decrease to Construction Work in Progress - \$1.2 million, primarily the Key West Diesel Transformer, purchase of the telephone system and improvement to facilities which were charged during the year and subsequently placed into service and transferred to Utility Plant.
- Increase in Other Property and Investments - \$1.4 million
 - Increase in the Rate Stabilization Fund - \$1.0 million due to the repayment from the Revenue Fund of prior year's borrowing to smooth the effect of the billed PCA charge.
 - Increase to the Restricted Cash Funds - \$400.0 thousand due to the reimbursement from FEMA hurricane proceeds.
- Increase in Current and Non-Current Assets - \$200.0 thousand
 - Increase in Cash and Accounts Receivable - \$829.0 thousand
 - Increase in Other Receivable - \$173.0 thousand (Steam Plant lease)
 - Increase in Prepaid Expense and Inventory - \$270.0 thousand
 - Decrease in Due from Other Governments - \$1.1 million (FEMA receivables)

The changes to Liabilities are listed as follows:

- Decrease in Long Term Debt - \$4.1 million as a result of the annual fiscal year debt service payment.
- Increase in Liabilities from Restricted Assets - \$797.9 thousand as a result of unpaid capital expenditures.
- Decrease in Current Liabilities and Deferred Revenue - \$433.4 thousand

Statement of Revenues, Expenses and Changes in Net Assets

Electric sales of 704.1 Gigawatt hours (GWh's) in fiscal 2006 were lower than Fiscal 2005 sales of 724.0 GWh's, or -2.8%. During the fall 2005 a major hurricane hit Florida. Although the Utility's service area was not severely directly affected by the hurricane, tourism, which makes up a large portion of the Florida Keys economy, was adversely affected.

The Change in Net Assets was \$6.0 million in 2006. This was primarily due to:

- Increase in Total Revenues - \$17.1 million
 - Increase in Power Cost Adjustment (PCA) - \$14.8 million as a result of a higher billed PCA in FY 2006 [FY 2005 billed PCA ranged from \$24.40 to \$38.20/MWh as compared to FY 2006 billed PCA from \$44.50 to \$55.50/MWh]
 - Increase in Grant Revenue - \$1.6 million, resulting from FEMA reimbursements for hurricane claims
- Increase in Operating Expenses - \$11.3 million
 - Increase of Purchased Power Costs - \$10.6 million primarily due to the increase in the actual power costs from FMPA [FY 2005 power costs ranged from \$61.90 to \$80.70/MWh as compared to FY 2006 actual power costs from \$64.20 to \$104.60/MWh]
 - Increase in Diesel production expenses - \$408.0 thousand primarily due to the reimbursement to FMPA of 50% of the CT#3 insurance deductible
 - Increase in Distribution Expenses - \$348.0 thousand largely due to increases in payroll and tree trimming expense

	2004	2005	2006	2005 to 2006 Increase (Decrease)	
				Amount	Percent
Electric Revenues	\$78,284,627	\$80,406,201	\$93,968,368	\$13,562,167	16.9%
Other Electric Revenues	3,054,809	3,072,535	3,231,697	159,162	5.2%
Operating Revenues	81,339,437	83,478,736	97,200,065	13,721,329	16.9%
Interest Income	301,862	613,525	1,047,716	434,191	143.8%
Grant Revenues	110,937	2,020,069	3,281,600	1,261,531	1137.2%
Non-Operating Revenues	627,346	753,622	2,528,474	1,774,852	282.9%
Total Revenues	82,379,582	86,865,952	104,057,855	15,496,181	18.8%
Production Expense - Diesel	887,371	1,074,167	1,482,077	407,910	46.0%
Purchased Power	44,523,179	49,287,046	59,946,424	10,659,378	23.9%
Transmission Expenses	3,298,491	3,646,679	3,539,845	(106,834)	-3.2%
Distribution Expenses	3,250,018	3,017,736	3,366,439	348,703	10.7%
Customer Accounts and Collection Expenses	1,085,522	1,280,590	1,243,322	(37,268)	-3.4%
Administrative and General Expenses	10,004,675	11,540,112	11,452,519	(87,593)	-0.9%
Depreciation	6,441,587	6,391,999	6,182,488	(209,511)	-3.3%
Taxes Other Income Taxes	2,021,223	2,127,074	2,467,955	340,881	16.9%
Payment to City of Key West	325,998	340,548	343,341	2,793	0.9%
Interest on Debt	4,959,686	4,811,456	4,670,672	(140,784)	-2.8%
Interest on Customer Deposit	29,345	109,429	194,367	84,938	289.4%
Amortization of Bond Discount and Issue Costs	104,508	104,508	104,508	-	0.0%
Total Expenses	76,931,603	83,731,344	94,993,957	11,262,613	14.6%
Income Before Special Items	5,447,979	3,134,608	9,063,898	5,929,290	189.2%
Special Items	-	2,354,033	(3,094,972)	(5,449,005)	-231.5%
Income Before Capital Contributions	5,447,979	5,488,641	5,968,926	480,285	8.8%
Capital Contributions	81,417	119,347	85,983	(33,364)	-41.0%
Change in Net Assets	5,529,396	5,607,988	6,054,909	446,921	8.1%
Net Assets, Beginning of Year	55,981,336	61,510,732	67,118,720	5,607,988	10.0%
Net Assets, End of Year	\$ 61,510,732	\$ 67,118,720	\$ 73,173,629	\$ 6,054,909	9.8%

Statement of Cash Flows

The Utility's rate structure is designed to collect sufficient revenues to pay debt service and recover operating and maintenance expenses, and the Utility successfully accomplished this objective during Fiscal 2006. The same situation held true for the prior fiscal year. Income before Capital Contributions increased \$480 thousand. The Utility increased net assets by \$6.0 million while paying down debt of \$5.5 million in principal and \$3.4 million in interest.

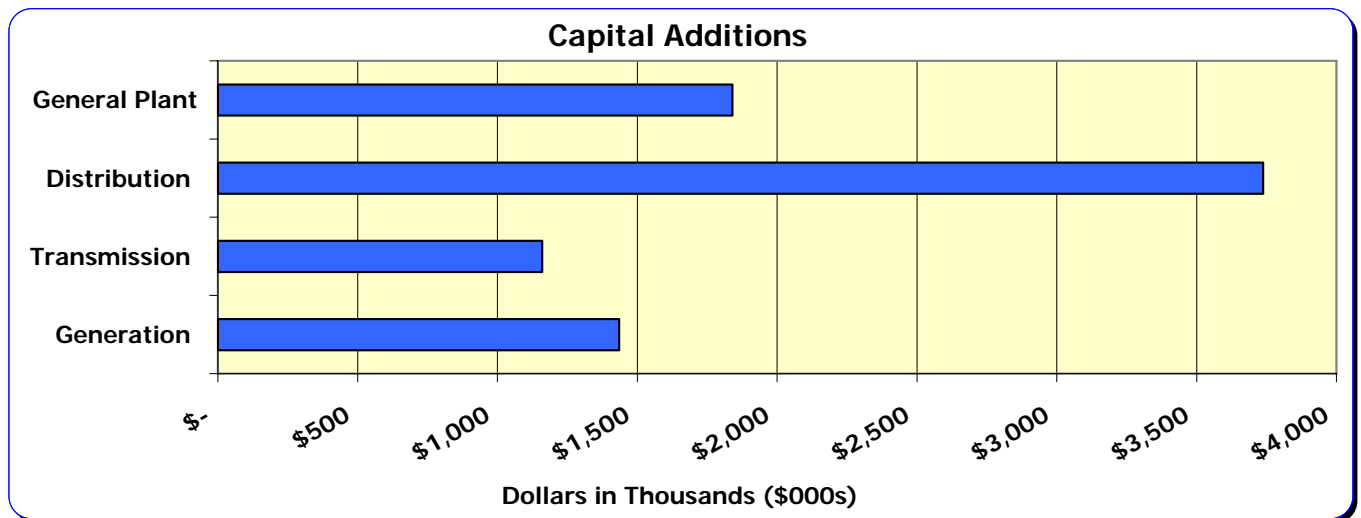
Restricted Assets

Total restricted assets were \$16.0 million at September 30, 2006, compared to \$14.7 million at September 30, 2005. The Utility's bond resolution specifies the manner in which monies on deposit in the various funds must be used. The Contribution in Aid of Construction Capital Fund is used for initial non-residential, commercial or large power service deposits related to transmission or distribution projects. The Customer Deposit Fund is used for residential and commercial deposits for basic electric service. The Emergency Reserve Fund is used to pay emergency repairs or replacements of capital assets, which have been destroyed or damaged. The Rate Stabilization Fund is used to maintain flexibility with respect to future rate adjustments and to provide additional monies for anticipated capital improvements. The Renewal and Replacement Fund is used only for paying the cost of extensions, enlargements, replacements or additions to the capital assets of the Utility. The Sinking Fund is used only to pay principal and interest on Bonds as they mature and become due.

Significant Capital Assets

Net Property, Plant and Equipment totaled \$114.8 million at the end of Fiscal 2006 compared to \$114.1 million the prior year, an increase of \$720.9 thousand.

Significant projects placed in service occurred in Distribution Plant – Kennedy Drive Substation Switchgear Replacement, Distribution Improvements, Key West Diesel Substation Upgrade, Purchase of Residential and Commercial Meters, Daily Work Orders, ER's and Transformers; Generation Plant – Repair CT#1; Transmission Plant – Transmission Pole Foundation Repair; and General Plant – Replace Telephone System, Upgrade Field Communications and Emergency Purchase of Company Vehicles. Major retirements occurred in Distribution Plant - transformers, switches, meters and poles; General Plant – Vehicles, radios and telephones. Please see Note 1 in Notes to Financial Statements for further information.



Long Term Debt

The Utility's trustee paid to the bondholders a principal payment of \$5.4 million on October 1, 2006. In accordance with the Bond covenants, monthly transfers are made from the Revenue Fund to the Sinking Fund, which are reflected on the balance sheet as Other Property and Investments - "restricted assets." The bondholders are paid annual principal payments on October 1 and semiannual interest payments on April 1st and October 1st of each year. On October 31, 2006, KEYS issued \$42.0 million of Electric System Refunding and Capital Improvement Revenue Bonds, Series 2006. The bonds refunded the FMPA loan of \$948,000 and will fund several capital projects, including a pole hardening program, transmission and distribution improvements, a new substation located in Stock Island, installation of new feeders at the Big Pine substation, replace certain substation transformers and install fin fan coolers at the Stock Island Generating Facilities. The issue is rated AAA by Standard & Poor's (S&P) and Fitch and Aaa by Moody's and is insured by the MBIA Insurance Company. In addition, KEYS obtained an underlying bond rating of A2 from Moody's and A- from S&P. The Utility's debt service payments have been structured to remain fairly constant at approximately \$8.5 million through 2014, \$9.3 million through 2018 and \$4.4 million from 2019 through 2031. Please see Note 4 in Notes to Financial Statements for further information.

Summary

This report is intended to provide our customers, bondholders, and other interested parties with a general overview of the financial position of the Utility Board of the City of Key West and to indicate accountability for the revenues received. Questions about this report or requests for additional information should be directed to the Assistant General Manager & Chief Financial Officer, 305-295-1013, or to our offices located at 1001 James Street, Key West Florida 33040.

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

BALANCE SHEETS

SEPTEMBER 30, 2006 AND 2005

ASSETS

	<u>2006</u>	<u>2005</u>
Current Assets		
Cash and Cash Equivalents	\$ 7,064,406	\$ 6,657,203
Customer Accounts Receivable, net of Allowance for Bad Debts of \$263,331 and \$322,571 for 2006 and 2005 respectively	6,152,177	5,729,570
Other Accounts Receivable	495,129	492,778
Due From Other Governments	823,921	1,900,702
Plant Material and Operating Supplies Inventory	2,722,320	2,454,805
Prepaid Expenses	<u>7,918,510</u>	<u>7,810,145</u>
 Total Unrestricted Current Assets	 25,176,463	 25,045,203
 Cash and Cash Equivalents-Restricted	 <u>12,833,724</u>	 <u>11,466,147</u>
 Total Restricted Currents Assets	 <u>12,833,724</u>	 <u>11,466,147</u>
 Total Current Assets	 <u>38,010,187</u>	 <u>36,511,350</u>
 Non-Current Assets		
Capital Assets		
Utility Plant	196,142,287	191,713,948
Less Accumulated Depreciation	<u>82,465,916</u>	<u>79,909,835</u>
Net Utility Plant	113,676,371	111,804,113
Construction in Progress	<u>1,156,438</u>	<u>2,307,807</u>
 Total Capital Assets	 114,832,809	 114,111,920
 Restricted Non-Current Assets		
Deposits-Restricted	<u>3,243,009</u>	<u>3,243,009</u>
 Total Restricted Non-Current Assets	 3,243,009	 3,243,009
 Unrestricted Non-Current Assets		
Other Accounts Receivable	7,942,212	7,768,864
Bond Discount and Issue Costs, Net	<u>804,746</u>	<u>909,254</u>
 Total Unrestricted Non-Current Assets	 <u>8,746,958</u>	 <u>8,678,118</u>
 Total Non-Current Assets	 <u>126,822,776</u>	 <u>126,033,047</u>
 Total Assets	 <u>\$ 164,832,963</u>	 <u>\$ 162,544,397</u>

(Continued)

(Continued)

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

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

BALANCE SHEETS (CONTINUED)

SEPTEMBER 30, 2006 AND 2005

NET ASSETS AND LIABILITIES

	<u>2006</u>	<u>2005</u>
Current Liabilities		
Unrestricted Current Liabilities		
Accounts Payable	5,709,921	6,751,776
Accrued Expenses	2,508,409	2,133,812
Deferred Revenues	316,128	82,286
	<hr/>	<hr/>
Total Unrestricted Current Liabilities	8,534,458	8,967,874
Restricted Current Liabilities		
Current Portion of Long-Term Debt	5,454,373	5,169,373
Accounts Payable	914,510	196,656
Accrued Interest	1,498,275	1,639,823
Security Deposits Payable	110,000	110,000
Due to Customers	4,020,894	4,084,228
	<hr/>	<hr/>
Total Restricted Current Liabilities	11,998,052	11,200,080
	<hr/>	<hr/>
Total Current Liabilities	20,532,510	20,167,954
Long-Term Debt, Net of Current Portion		
Revenue Bonds	55,032,256	60,486,629
Accrued Interest	15,146,568	13,586,094
Loan Payable	948,000	1,185,000
	<hr/>	<hr/>
Total Long-Term Debt	71,126,824	75,257,723
Net Assets		
Invested in Capital Assets		
net of related debt	\$ 53,995,651	\$ 48,044,762
Restricted for Working Capital	3,243,009	3,243,009
Unrestricted	15,934,969	15,830,949
	<hr/>	<hr/>
Total Net Assets	73,173,629	67,118,720
	<hr/>	<hr/>
Total Net Assets and Liabilities	\$ 164,832,963	\$ 162,544,397
	<hr/>	<hr/>

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

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA
STATEMENTS OF REVENUE, EXPENSES, AND CHANGES IN NET ASSETS
FOR THE YEARS ENDED SEPTEMBER 30, 2006 AND 2005

	2006	2005
Operating Revenues		
Salaes & Charges for Service	\$ 94,831,374	\$ 80,675,032
Other Operating Revenues	2,368,691	2,803,704
Total Operating Revenues	97,200,065	83,478,736
Operating Expenses		
Production Expenses - Diesel	1,482,077	1,074,167
Purchased Power	59,946,424	49,287,046
Transmission Expenses	3,539,845	3,646,679
Distribution Expenses	3,366,439	3,017,736
Customer Accounts and Collection Expenses	1,243,322	1,280,590
Administrative and General Expenses	11,452,519	11,540,112
Depreciation	6,182,488	6,391,999
Taxes Other than Income Taxes	2,467,955	2,127,074
Total Operating Expenses	89,681,069	78,365,403
Operating Income	7,518,996	5,113,333
Non-Operating Revenue and (Expenses)		
Interest Income	1,047,716	613,525
Grant Revenue	-	119,367
Miscellaneous Non-Operating Revenue	2,255,168	753,622
Payment to City of Key West	(343,341)	(340,548)
Interest on Debt	(4,670,672)	(4,811,456)
Interest on Customer Deposit	(194,367)	(109,429)
Amortization of Bond Discount and Issue Costs	(104,508)	(104,508)
Total Non-Operating Revenue and (Expenses)	(2,010,004)	(3,879,427)
Income Before Special Items	5,508,992	1,233,906
Special Items		
Hurricane-Grant Revenue	3,281,600	1,900,702
Hurricane-Expenses	(3,094,972)	(2,214,686)
Hurricane - Insurance Proceeds	273,306	-
Sale of Steam Plant	-	4,568,719
Total Special Items	459,934	4,254,735
Income Before Capital Contributions	5,968,926	5,488,641
Capital Contributions	85,983	119,347
Change in Net Assets	6,054,909	5,607,988
Net Assets, Beginning of Year	67,118,720	61,510,732
Net Assets, End of Year	\$ 73,173,629	\$ 67,118,720

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

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED SEPTEMBER 30, 2006 AND 2005

	<u>2006</u>	<u>2005</u>
Cash Flows Provided by Operating Activities		
Cash Received from Customers	\$ 96,550,156	\$ 83,029,877
Cash Payments to Suppliers for Goods and services	(76,347,419)	(68,095,776)
Cash Payments for Restricted Working Capital Deposits	-	-
Cash Payments to Employees for Services	(8,142,697)	(8,357,425)
Cash Received for Deposits	871,306	935,250
Cash Deposits Refunded	(934,640)	(863,988)
Cash Received from Other Operating revenue	2,489,010	727,511
Cash Paid for Hurricane Expenses	<u>1,263,409</u>	<u>(2,214,686)</u>
Net Cash Provided by Operating Sources	\$ 15,749,125	\$ 5,160,763
Cash Flows Provided (Used) by Non-Capital Financing Activities		
Cash Received from Insurance Proceeds	273,306	119,367
Cash Paid to City of Key West, Florida	<u>(343,341)</u>	<u>(340,548)</u>
Net Cash (Used) by Non-Capital Financing Activities	<u>(70,035)</u>	<u>(221,181)</u>
Cash Flows Provided (Used) by Capital and Related Financing Activities		
Principal Paid on Long-Term Debt	(5,467,000)	(3,785,000)
Interest Paid on Revenue Bond Maturities	(3,385,486)	(3,533,002)
Contributions in Aid of Construction	85,983	119,347
Acquisitions and Construction of Capital Assets	(6,303,685)	(5,015,976)
Proceeds (costs) from Disposal of Assets	<u>118,162</u>	<u>(748,797)</u>
Net Cash (Used) by Capital and Related Financing Activities	<u>(14,952,026)</u>	<u>(12,963,428)</u>
Cash Flows Provided (Used) by Investing Activities		
Redemption of Investments	-	44,075
Interest Received on Investments	<u>1,047,716</u>	<u>613,525</u>
Net Cash Provided by Investing Activities	<u>1,047,716</u>	<u>657,600</u>
Net Increase (Decrease) in Cash and Cash Equivalents	1,774,780	(7,366,246)
Cash and Cash Equivalents at Beginning of year	<u>18,123,350</u>	<u>25,489,596</u>
Cash and Cash Equivalents at End of Year	<u>\$ 19,898,130</u>	<u>\$ 18,123,350</u>
	(Continued)	(Continued)

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

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED SEPTEMBER 30, 2006 AND 2005

Reconciliation of Operating Income to
Net Cash Provided by Operating Activities

	<u>2006</u>	<u>2005</u>
Operating Income	\$ 7,518,996	\$ 5,113,333
 Adjustments to Reconcile Operating Income to Net Cash Provided by Operating Activities		
Depreciation	6,182,488	6,391,999
Provision for Uncollectible Accounts	238,648	346,350
Amortization of Deferred Revenue	(82,286)	(108,397)
Receipt of Deferred Revenue	316,128	82,286
Other Non-Operating Sources of Revenue	2,255,168	753,622
Hurricane Loss	186,628	(313,984)
 Changes in Assets and Liabilities:		
(Increase) Decrease in Restricted Working Capital Deposit	-	-
(Increase) Decrease in Accounts Receivable	(836,954)	(755,862)
(Increase) Decrease in Plant Material & Inventory	(267,515)	205,008
(Increase) Decrease in Prepaid Expenses	(108,365)	(6,886,821)
(Increase) Decrease in Due from Other Governments	1,076,781	(1,900,702)
Increase (Decrease) in Accounts Payable	(1,041,855)	1,616,759
Increase (Decrease) in Accrued Expenses	374,597	435,911
Increase (Decrease) in Customer Deposits	(63,334)	71,261
Increase (Decrease) in Security Deposits	-	110,000
 Total Adjustments	 <u>8,230,129</u>	 <u>47,430</u>
 Net Cash Provided by Operating Activities	 <u>\$ 15,749,125</u>	 <u>\$ 5,160,763</u>

Supplemental Schedule of Non-Cash Financing, Capital and Investing Activities

In Fiscal Years 2006 and 2005, amortization of bond discount and issue costs were \$104,508 in both fiscal years.

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

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2006 AND 2005

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accounting policies and the presentation of the financial report of the Utility Board of the City of Key West, Florida "Keys Energy Services" (KEYS) have been designed to conform to generally accepted accounting principles as applicable to governmental units, in accordance with the Governmental Accounting Standards Board (GASB). The GASB embodies the official pronouncements previously issued by the National Council on Governmental Accounting (NCGA). KEYS applies Financial Accounting Standards Board (FASB) pronouncements and Accounting Principles Board (APB) opinions issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements, in which case, GASB prevails. The following is a summary of the significant accounting policies.

Entity Definition - KEYS was created by an Act of the Florida Legislature to manage, operate and maintain the electric utility servicing the citizens of the City of Key West, Florida (the City) and the lower Florida Keys. KEYS is the successor of the electric public utility once owned by the City and was given all powers and rights necessary to manage, operate, maintain, control, and extend the electric utility property owned by the City of Key West at the time of its creation. The Board is composed of a Chairman who is elected every two years and four members who are elected every four years by the voters of the City. The General Manager & CEO of KEYS serves as Secretary to the Board and is responsible for the day-to-day operations of KEYS. KEYS is not a component unit of the City.

Measurement Focus - The accounting and financial reporting treatment applied to a fund is determined by its measurement focus. KEYS' operations are accounted for on a flow of economic resources measurement focus. With this measurement focus, all assets and all liabilities associated with the operation of the enterprise fund are included on the balance sheet. Operating statements present increases (e.g. revenue) and decreases (e.g. expenses) in net assets.

Basis of Accounting - KEYS' financial statements are accounted for based on accounting required by the Federal Energy Regulatory Commission (FERC), which is an application of generally accepted accounting principles that is peculiar to utilities. Revenues are recognized in the period earned and expenses are recognized in the period incurred, regardless of the timing of the related cash flows.

Budget - In accordance with KEYS' enabling Legislation, the Utility Board holds public hearings and subsequently adopts an annual budget for operating expenses and capital outlay. Actual revenues and expenses are compared to the budget on a line item basis (which is the legal level of control) within cost centers and an analysis of variances report is prepared and submitted to the Utility Board each month as required by bond indentures. During the year, staff can make amendments within the operating budget or the capital budget that do not change the total budget for those categories. The Utility Board approves all other budget changes. Supplemental appropriations were necessary during FY 06 and the Utility Board, in accordance with KEYS' policies, amended the budgetary data presented herein. Budget appropriations lapse at each fiscal year-end except for the Capital Budget. The budget is adopted on a basis consistent with KEYS' basis of accounting except for depreciation and amortization, debt service on revenue bonds and allocation of administrative costs to capital projects.

Cash and Investments - Cash and investments in U.S. Government Securities are recorded at cost or amortized cost. Amortized cost does not significantly vary from market value.

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2006 AND 2005

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Any other investments are stated at fair value in accordance with GASB 31. Florida Statutes govern KEYS' investment policies. These policies are described in more detail in Note 3.

Revenue - Revenue is recognized based on monthly route billings to customers. Revenue is not accrued for services supplied but unbilled at the end of the fiscal period. Charges for new service are reported as revenue only to the extent of connection costs, while amounts exceeding this cost are recorded as contributed capital revenue.

Bond Discount and Issue Costs - Bond discount and issue costs consist of debt issue costs, original issue discounts, and underwriter discounts, which are capitalized and amortized over the term of the related indebtedness.

Property, Plant and Equipment - Property, Plant and Equipment is stated at cost. Transmission, Distribution and Generation Plant are defined by KEYS as assets with an initial, individual cost of \$5,000 or more and an estimated useful life of more than one year. General Plant assets are defined as assets with an initial, individual cost of \$1,000 or more and an estimated useful life of more than one year. Under FERC accounting practices and procedures, the cost of electric plant retired, together with removal costs less salvage, is charged to accumulated depreciation when property is removed from service.

The following is a summary of property, plant and equipment for the year ended September 30, 2006:

	Balance 2005	Additions	Deletions	Balance 2006
Utility Plant in Service:				
Generation Plant	\$ 49,248,023	\$ 1,435,368	\$ -	\$ 50,683,391
Transmission Plant	71,321,581	1,159,574	-	72,481,155
Distribution Plant	56,439,514	3,738,199	2,015,356	58,162,357
General Plant	14,484,566	1,839,767	1,729,213	14,595,120
Other	220,264	-	-	220,264
Total Utility Plant in Service	<u>191,713,948</u>	<u>8,172,908</u>	<u>3,744,569</u>	<u>196,142,287</u>
Accumulated Depreciation:				
Generation Plant	(26,044,882)	(1,682,392)	-	(27,727,274)
Transmission Plant	(26,373,582)	(1,773,954)	-	(28,147,536)
Distribution Plant	(20,400,310)	(1,771,439)	(2,088,646)	(20,083,103)
General Plant	(7,091,061)	(954,702)	(1,537,760)	(6,508,003)
Other	-	-	-	-
Total Accumulated Depreciation	<u>(79,909,835)</u>	<u>(6,182,487)</u>	<u>(3,626,406)</u>	<u>(82,465,916)</u>
Net Utility Plant in Service	<u>\$ 111,804,113</u>	<u>\$ 1,990,421</u>	<u>\$ 118,163</u>	<u>\$ 113,676,371</u>
Construction Work in Progress	<u>\$ 2,307,807</u>	<u>\$ 7,021,539</u>	<u>\$ 8,172,908</u>	<u>\$ 1,156,438</u>

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2006 AND 2005

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

KEYS' policy concerning capitalized interest costs is in accordance with Statement of Financial Accounting Standards No. 62, which requires the capitalization of interest costs of restricted tax-exempt borrowings less any interest earned on investment funds during the construction period. For the fiscal years ended 2006 and 2005, there was no capitalized interest cost.

Property, Plant and Equipment is depreciated using the straight-line method at rates which will amortize costs over the estimated useful lives of the assets. The estimated useful lives of the electric plant assets are as follows:

Generation Plant	25 Years
Transmission Plant	31 - 45 Years
Distribution Plant	20 - 45 Years
General Plant	5 - 40 Years

Inventory - Inventories are stated at the lower of cost (determined on an average cost basis) or market.

Compensated Absences - KEYS records compensation for unused vacation and sick leave as an expense in the year in which the vacation and sick leave is earned in accordance with GASB Statement No. 16. At September 30, 2006, annual vacation leave earned but not taken is \$413,346 and sick leave accumulated but not taken is \$769,156.

Operating Revenues and Expenses – Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with the KEYS principal ongoing operations. The principal operating revenues of KEYS 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 this definition are reported as nonoperating revenues and expenses.

Interest - Interest for the years ended September 30, 2006 and 2005 is summarized as follows:

	<u>2006</u>	<u>2005</u>
Electric Refunding Revenue Bonds, Series 1991	\$ 1,560,475	\$ 1,455,631
Electric Forward Refunding Revenue Bonds, Series 2000	2,635,599	2,886,875
Electric Forward Refunding Revenue Bonds, Series 2001	360,950	392,771
Series 2001 Loss on Refunding	60,627	60,626
Interest on Customer Deposits	194,367	109,429
FMPA Pooled Loan	53,021	15,553
Total Interest Expense	<u>\$ 4,865,039</u>	<u>\$ 4,920,885</u>

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2006 AND 2005

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

Net Assets – Equity is classified as net assets and displayed in three components:

Invested in Capital Assets, net of related debt – Consists of capital assets, net of accumulated depreciation and reduced by the outstanding balances of any bonds that are attributable to the acquisition, construction, or improvement of those assets.

Restricted for Working Capital – Consists of a restricted working capital deposit required by FMPA for participation in the All Requirements Project.

Unrestricted – All other net assets that do not meet the definition of “restricted for debt service” or “invested in capital assets, net of related debt.” For the years ended September 30, 2006 and 2005, the board has designated \$1.2 million and \$954.2 thousand respectively, for certain future repair and replacement costs.

Income Taxes - No provision for income taxes is reflected in the financial statements as KEYS is considered a unit of local government.

NOTE 2 – OTHER PROPERTY AND INVESTMENTS

Restricted Assets - Certain assets consisting of cash, cash equivalents and investments are restricted by bond resolutions; additionally, some assets have been classified as restricted in accordance with FERC. KEYS is required by revenue bond covenants to maintain a debt service reserve account in the amount of its highest debt service, which requirement is satisfied by a debt surety bond.

KEYS' Restricted Assets as of September 30, 2006 and 2005, respectively consist of the following:

	<u>2006</u>	<u>2005</u>
Emergency Reserve Fund	\$ 2,000,000	\$ 1,002,473
Sinking Fund	-	50,972
Contributions in Aid of Construction Fund	215,922	203,648
Renewal and Replacement Fund	2,606,517	3,162,071
Rate Stabilization Fund	3,925,074	2,924,539
Customer Deposits Fund	4,086,211	4,122,444
Total	<u>\$ 12,833,724</u>	<u>\$ 11,466,147</u>

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2006 AND 2005

NOTE 2 – OTHER PROPERTY AND INVESTMENTS (Continued)

Restricted Deposits- Florida Municipal Power Agency (FMPA) has required a working capital contribution. As of September 30, 2006 and 2005, the deposit balance remained at \$3,243,009.

NOTE 3 – CASH, CASH EQUIVALENTS, AND INVESTMENTS

State Statutes govern KEYS' investment policies. In addition, KEYS has its own investment practices. Monies must be deposited in banks designated as qualified public depositories by the State of Florida, Department of Insurance and Treasurer. Permissible investments include the obligations of the U.S. Treasury and U.S. agencies, certificates of deposit, commercial paper, repurchase agreements, and other securities meeting KEYS' criteria for risk and return.

Collateral is provided for demand deposits and certificates of deposit through the Florida Security for Public Deposits Act. This Act established guidelines for qualification and participation by banks and savings associations, procedures for the administration of the collateral requirements and characteristics of eligible collateral. Under the Act, the qualified public depository must pledge at least 50% of the average daily balance for each month of all public deposits in excess of any applicable deposit insurance.

Additional collateral, up to a maximum of 125%, may be required if deemed necessary under the conditions set forth in the Act. Eligible collateral consists of obligations of the United States and its agencies and obligations of states and their political subdivisions, and unaffiliated corporations.

Obligations pledged to secure deposits must be delivered to the State Treasurer or, with the approval of the State Treasurer, to a bank, savings association, or trust company provided a power of attorney is delivered to the Treasurer.

On a monthly basis, the State Treasurer determines that the collateral has a market value adequate to cover the deposits under the provisions of the Act. For purposes of the statement of cash flows, KEYS considers all liquid investments (including restricted assets) with a maturity of three months or less when purchased to be cash equivalents.

Interest Rate Risk – As a means of limiting its exposure to fair value losses arising from rising interest rates KEYS investment policy limits its portfolio to maturities of no more than five years unless matched to a specific cash flow.

Credit Risk – KEYS general investment policy is to apply the prudent person rule: investments are made as a prudent person would be expected to act, with discretion and intelligence, to seek reasonable income, preserve capital and, in general avoid speculative investments. KEYS investment policy allows investments in U. S. Treasury, U. S. Agencies, and any U. S. state, certificates of deposits, repurchase agreements, and units of participation in the State of Florida Local Government Surplus Trust Fund.

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2006 AND 2005

NOTE 3 – CASH, CASH EQUIVALENTS, AND INVESTMENTS (Continued)

In addition to these, KEYS also allows investment in commercial paper which is rated at the time of purchase in the single highest classification by Moody's and S&P and does not mature more than 270 calendar days after the date of purchase and agreements with a bank or insurance company which has an unsecured, uninsured and unguaranteed obligation (or claims-paying ability) rated "A3" or better by Moody's and a rating of "A-" or better by Standard & Poor's.

Deposits

Custodial Credit Risk – Custodial credit risk is the risk that in the event of a bank failure, KEYS deposits may be returned. KEYS' does not have a deposit policy for custodial risk. The carrying amount of KEYS' deposits with financial institutions, as of September 30, 2006 and 2005, were \$19,879,955 and \$4,122,521 respectively, and the bank balances were \$20,076,767 and \$4,686,955, respectively. The bank balances were covered by federal depository insurance and for the amount in excess of such federal depository insurance, by the State of Florida's Security of Public Deposits Act. The Act requires each qualified public depository to deposit with the State Treasurer eligible collateral equal to or in excess of the required collateral as determined by the provisions of the Act. In the event of a failure by a qualified public depository, losses in excess of federal depository insurance and proceeds from the sale of securities pledged by the depository are assessed against the other qualified public depositories of the same type as the depository in default.

In addition, KEYS' deposits with the Florida State Board of Administration Pooled Investment Fund, as of September 30, 2006 and 2005, were \$0 and \$13,491,800 respectively. During 2006, KEYS' transferred all deposits held with the Florida State Board of Administration Pooled Investment Fund to local financial institutions in order to take advantage of more attractive interest rates.

NOTE 4 – NON-CURRENT ASSETS

Other Receivable – The Key West Steam Plant was decommissioned in 1991. In Fiscal Year 2005 the developer received all the permitting and financing to begin construction, to redevelop the Steam Plant site. The Utility Board executed two 99 year lease agreements in 2005 one with Steam Plant Condominiums, LLC for 19 luxury condominiums and one with Old Town Key West Development, LLC for 38 affordable housing units. Due to the four hurricanes in 2005, the completion date for both housing projects has been extended to late 2007. The sale of the Steam Plant resulted in an extraordinary gain of \$4,568,719 in Fiscal Year 2006. The sale also resulted in four long term lease receivables totaling \$7,942,212. The leases are as follows: 1) base rent of the luxury units for \$6,264,920 due at the end of construction, 2) initial rent of \$500,000 due 42 months after execution of lease, 3) percentage rent of luxury units of \$1,177,205 with a percentage due after sale and/or occupancy of unit, and 4) affordable rent of \$87 due at the end of construction.

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2006 AND 2005

NOTE 4 – NON-CURRENT ASSETS (Continued)

Other Receivable – Summary of Lease Receivable is as follows:

Summary of Lease Receivable			
<u>Year</u>	<u>Receivable</u>		
2007	\$ 1,871,487		
2008	95,650		
2009	94,670		
2010	93,700	Lease Receivable - Current	-
2011	92,740		
2012 - 2104	5,693,965	Lease Receivable - Long Term	7,942,212
Total Lease Receivable	<u>\$ 7,942,212</u>	Total Lease Receivable	<u>\$ 7,942,212</u>

NOTE 5 – LONG-TERM DEBT

Net Revenues, as defined for purposes of bond security, is all income or earnings derived from the operation of KEYS, except Capital Improvement Charges, investment earnings on Construction and Bond Amortization Funds, and transfers to the Rate Stabilization Fund, less costs of operation and maintenance which do not include capital expenditures, extraordinary repairs, amortization of the costs of issuance of debt obligations, payments under Unconditional Output Contracts, or depreciation. See Note 6 for the rate covenant pertaining to revenues.

Summary of Debt Service Funding Requirements to Maturity

<u>Payment 12 mos ending October 1,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2007	\$ 5,755,000	\$ 2,697,000	\$ 8,452,000
2008	6,005,000	2,382,000	8,387,000
2009	6,340,000	2,052,000	8,392,000
2010	6,695,000	1,689,000	8,384,000
2011	7,090,000	1,305,000	8,395,000
2012 - 2016	20,615,000	23,972,000	44,587,000
2017 - 2018	2,883,000	15,657,000	18,540,000
Total	<u>\$ 55,383,000</u>	<u>\$ 49,754,000</u>	<u>\$ 105,137,000</u>

Prior to the due date of each series of revenue bonds, KEYS is required to set aside sufficient funds to retire the matured principal amounts in equal, monthly amounts. Accordingly, the above schedule does not include principal amounts maturing October 1, 2006, as those funding requirements have been fully satisfied.

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2006 AND 2005

NOTE 5 – LONG-TERM DEBT (Continued)

Changes in Long-Term Debt during Fiscal 2006 are as follows:

	<u>2005</u>	<u>Additions</u>	<u>Retired</u>	<u>2006</u>
Series 1991	\$ 8,077,785	\$ -	\$ -	\$ 8,077,785
Series 2000	48,900,000	-	4,370,000	44,530,000
Series 2001, net	8,678,217	-	799,373	7,878,844
FMPA	1,185,000	-	237,000	948,000
Total	<u>\$ 66,841,002</u>	<u>\$ -</u>	<u>\$ 5,406,373</u>	<u>\$ 61,434,629</u>

Revenue Bonds:

Electric System Refunding Revenue Bonds, Series 1991, collateralized by Net Revenues and certain Reserve Funds, payable October 1, 2006 to October 1, 2018 in installments of various amounts, bearing interest at rates from 7.05% to 7.10%.

	<u>2006</u>	<u>2005</u>
	\$ 8,077,785	\$ 8,077,785
	44,530,000	48,900,000
	8,290,000	9,150,000
	(411,156)	(471,783)
	<u>948,000</u>	<u>1,185,000</u>
	61,434,629	66,841,002
	<u>5,454,373</u>	<u>5,169,373</u>
	<u>\$ 55,980,256</u>	<u>\$ 61,671,629</u>

Electric System Refunding Revenue Bonds, Series 2000, collateralized by Net Revenues and certain Reserve Funds, payable October 1, 2006 to October 1, 2013 in installments of various amounts, bearing interest at rates from 5.75% to 6.00%.

Electric System Refunding Revenue Bonds, Series 2001, collateralized by Net Revenues and certain Reserve Funds, payable from October 1, 2006 to October 1, 2013 in installments of various amounts, interest at rates from 3.70% to 4.62%.

Deferred Loss on Refunding-net, amortized on the straight line basis over the term of the Series 2001 Revenue Bonds

Loan Payable:

Loan from the Florida Municipal Power Agency, collateralized by a lien upon and pledge of the Net Revenues of KEYS subordinate to the claims of KEYS' bonds on the Net Revenues. The payment date of March 15, 2006 was extended and refunded in Series 2006 bond issuance.

Total Long-Term Debt

Less Current Portion

Net Long-Term Debt

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2006 AND 2005

NOTE 6 – PRIOR YEAR DEFEASANCE OF DEBT

During 1986, 1987, 1991, 1995, 2000 and 2001, KEYS defeased certain revenue bonds by placing proceeds of new bonds in an irrevocable trust to provide for all future debt service payments of the old bonds. Accordingly, the trust account assets and the liability for the defeased bonds are not included in KEYS' financial statements. At September 30, 2006, \$26,444,468 of bonds outstanding relative to the 1980C, 1983, 1984 and 1980D issues, \$15,786,016 relative to the 1985 issue, \$11,863,443 relative to the 1987 issue, \$14,516,919 relative to the 1988 issue, and \$7,480,000 relative to the 1991 issue are considered defeased.

NOTE 7 – RATE COVENANT

KEYS has agreed to establish and revise rates such that revenues will be sufficient to pay 100% of its costs of operations and maintenance, all required reserve payments, and 125% of the principal and interest becoming due on all outstanding bonds.

NOTE 8 – PENSION PLAN

Plan Description - The Retirement System for General Employees (the Plan) is a single-employer defined benefit pension plan administered by the Board of Trustees of the Plan. The Plan provides retirement, disability and death benefits to plan members and beneficiaries. Cost of living adjustments are automatically provided to members and beneficiaries. Commencing January 1, 2001, and every year thereafter, the rate will be increased from 2% to 3%. The Plan was created by resolution of the Utility Board, which the Plan by resolution assigns the authority to establish and amend its provisions to the Utility Board. The Plan issues a publicly available financial report that includes financial statements and required supplementary information for the Plan. That report may be obtained by writing to the Retirement System for General Employees, P.O. Drawer 6100, Key West, FL 33041-6100.

Basis of Accounting - The financial statements of the Plan are prepared using the accrual basis of accounting. KEYS' contributions are recognized when due and a formal commitment to provide the contributions has been made. Benefits are recognized when due and payable in accordance with the terms of the Plan.

Plan investments are reported at fair value. Short-term investments are reported at cost, which approximates fair value. Securities traded on a national or international exchange are valued at the last reported sales price at current exchange rates. Plan investments do not include any of KEYS' debt securities. All investments represent less than 5% of Plan net assets.

Funding Policy – The contribution requirements of plan members and KEYS are established and may be amended by the Utility Board. Plan members have not been required to contribute to the Plan since October 1, 1985. A former member who takes a refund of accumulated contributions and who is later re-employed by KEYS within three years of his termination of service shall have the right to repay the Plan for amounts received. Upon such re-payment, the member shall receive credit for his years of credited service as of his last termination date. KEYS is required to contribute at a rate based on the annual actuarial valuation, which indicates the minimum required contribution.

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2006 AND 2005

NOTE 8 – PENSION PLAN (Continued)

The minimum required contribution rate of covered payroll would be adjusted to include any benefit changes approved by the Utility Board.

Pension overpayment- During Fiscal 2004, KEYS identified benefit calculation errors resulting in overpayment of benefits over several years for a group of retirees. KEYS is currently examining the effects of these miscalculations and determining a plan of action to remedy the overpayments. Effective October 1, 2004, KEYS corrected the benefit calculations to preclude subsequent overpayments.

Schedule of Funding Progress – KEYS' annual contribution for the calendar year 2006 of \$2,343,090 (30.7%) was determined as part of the January 1, 2006 actuarial valuation using the entry age normal actuarial cost method. The actuarial also stated another cost method that the Board opted to use with an annual contribution rate of 28.7%. The actuarial assumptions included (a) 8.0% investment rate of return and (b) projected salary increases of 5.5% per year. Both (a) and (b) included an inflation component of 3.0%. The actuarial value of the Plan assets is the fair value of assets as reported in the Plan financial statements. The unfunded actuarial accrued liability is being amortized as a level payment on a closed basis. The remaining amortization period at January 1, 2006 was 30 years. KEYS had an unfunded actuarial accrued liability of \$6,737,730 and \$4,475,017 as of January 1, 2006 and 2005 respectively. The net pension obligation was \$(77,580) at December 31, 2005. KEYS has accepted the negative pension obligation and this will be adjusted through the Annual Required Contribution calculation in the next fiscal year.

(1) Actuarial Valuation Date <u>January 1,</u>	(2) Entry Age Actuarial Value of <u>Assets</u>	(3) Actuarial Accrued Liability <u>(AAL)</u>	(4) Unfunded AAL <u>(UAAL)</u>	(5) Funded Ratio	(6) Covered <u>Payroll</u>	(7) UAAL as a Percentage of Covered <u>Payroll</u>
1997	\$ 34,436	\$ 33,475	\$ (961)	102.9%	\$ 5,866	-16.4%
1998	\$ 40,933	\$ 34,826	\$ (6,107)	117.5%	\$ 6,038	-101.1%
1999	\$ 48,032	\$ 40,295	\$ (7,737)	119.2%	\$ 6,127	-126.3%
2000	\$ 53,398	\$ 41,776	\$ (11,622)	127.8%	\$ 6,168	-188.4%
2001	\$ 52,329	\$ 48,646	\$ (3,683)	107.6%	\$ 6,398	-57.6%
2002	\$ 49,513	\$ 50,730	\$ 1,217	97.6%	\$ 6,764	18.0%
2003	\$ 50,459	\$ 52,434	\$ 1,975	96.2%	\$ 6,845	28.9%
2004	\$ 51,439	\$ 55,408	\$ 3,969	92.8%	\$ 6,898	57.5%
2005	\$ 53,036	\$ 57,511	\$ 4,475	92.2%	\$ 6,934	64.5%
2006	\$ 54,266	\$ 61,004	\$ 6,738	89.0%	\$ 7,644	88.1%

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2006 AND 2005

NOTE 8 – PENSION PLAN (Continued)

<u>Historical Trend Information</u>				<u>Annual Pension Cost and Net Pension Obligation (NPO)</u>		
Calendar Year	Annual Pension Cost (APC)	Percentage APC Contributed	Net Pension Obligation		<u>2005</u>	<u>2006</u>
1997	\$ 673,467	132%	\$ -	Annual Required Contribution (ARC)	\$ 1,979,201	\$ 2,343,090
1998	\$ 616,835	214%	\$ -	Interest on NPO	(3,406)	(6,206)
1999	\$ 624,849	212%	\$ -	Adjustment to ARC	3,816	6,891
2000	\$ 384,057	268%	\$ -	APC	<u>\$ 1,979,611</u>	<u>\$ 2,343,775</u>
2001	\$ 1,245,998	100%	\$ -	Utility Board Contribution	<u>(2,014,613)</u>	
2002	\$ 1,673,299	102%	\$ (26,551)	Increase (Decrease) in NPO	<u>(35,002)</u>	
2003	\$ 1,644,221	101%	\$ (42,957)	NPO (beginning of year)	<u>(42,578)</u>	
2004	\$ 1,911,019	100%	\$ (42,578)	NPO (end of year)	<u>(77,580)</u>	
2005	\$ 1,979,611	102%	\$ (77,580)			

NOTE 9 – LEASES

Rent expense under cancelable operating leases related to copiers, mailing equipment and time clocks was \$179,882 and \$109,443 in 2006 and 2005.

NOTE 10 - PURCHASED POWER COMMITMENTS

All Requirements Power Supply Project – In July 1997, KEYS agreed to become a member of the Florida Municipal Power Agency (FMPA) All-Requirements Power Supply Project (the “All-Requirements Project”) and began operations as a project participant effective April 1, 1998. Under the contractual arrangement with FMPA, KEYS has assigned all of its generating and firm purchased power resources to FMPA, and FMPA will serve all of KEYS’ requirements (net of up to 2 MW of non-firm capacity when available from the local resource recovery facility). Further, in the event that power cannot be delivered to the KEYS’ service area over the tie line to the mainland, KEYS established a policy to have island generation capability equal to at least 60% of KEYS’ peak load. KEYS and FMPA have agreed to meet these criteria through a combination of KEYS’ 43.4 MW of existing generating resources and three combustion turbine units that are owned by FMPA, which currently total 79.7 MW. As part of the All-Requirements Project contract, the Florida Municipal Power Agency is required to maintain generation assets within KEYS’ Service Area equal to or above 60 percent of the KEYS’ load. Florida Municipal Power Agency purchased a General Electric LM 6000 (CT #4) capable of producing 43 MW that went on line in 2006, allowing KEYS to retire the Big Pine and Cudjoe High Speed Diesels (7 MW). The FMPA All-Requirements Project, the related assignment of resources by KEYS to FMPA, and other matters pertaining to KEYS’ power supply are discussed in the paragraphs following.

KEYS has previously entered into several purchased power agreements with other parties including (i) the FMPA Tri-City Project, (ii) the FMPA Stanton 2 Project; and (iii) a long-term purchase agreement with FPL. As a member of the All-Requirements Project, KEYS’ resources and costs under these three contracts have been assigned to FMPA.

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2006 AND 2005

NOTE 10 - PURCHASED POWER COMMITMENTS (Continued)

Other power purchase and sale arrangements include KEYS' purchases from a small resource recovery unit located on Stock Island, sale of power to FKEC, and interchange service agreements with other Florida utilities and with power marketers.

KEYS appoints one representative to FMPA's Board of Directors, which governs the Agency's activities. The governance of rates charged to members includes the All-Requirements Project Committee (KEYS has one vote) and the FMPA Board of Directors (KEYS' vote is weighted based on KEYS' net energy for load).

FMPA Tri-City Project (Stanton 1) – KEYS is a member of the FMPA Tri-City Project (Stanton 1). KEYS and FMPA have entered into a Tri-City Project Power Sales Contract and a Tri-City Project Support Contract wherein KEYS has agreed to purchase 54.546% of FMPA's Tri-City Project. FMPA's Tri-City Project consists of a 5.3012% undivided ownership interest in Curtis H. Stanton Energy Center ("Stanton") unit No. 1, a 425 MW coal-fired generating unit jointly owned by the Orlando Utilities Commission ("OUC"), the Kissimmee Utility Authority, and FMPA, and operated by the OUC. Stanton Unit No. 1 began commercial operation in July 1987. Based upon the unit's high dispatch rating of 425 MW, the Tri-City Project consists of a 22 MW undivided ownership and KEYS' power entitlement share is approximately 12 MW at the plant bus bar.

FMPA Stanton 2 Project – KEYS is a member of the FMPA Stanton 2 Project. KEYS and FMPA have entered into a Stanton 2 Project Power Sales Contract and a Project Support Contract wherein KEYS has agreed to purchase 9.8932% of FMPA's Stanton 2 Project. FMPA's Stanton 2 Project consists of a 23.2367% undivided ownership interest in Stanton Unit No. 2, a 429 MW coal-fired generating unit jointly owned by OUC and FMPA, and operated by OUC. Stanton Unit No. 2 began commercial operation in June 1996. Based on the unit's 429 MW high dispatch rating, the Stanton 2 Project consists of 100 MW undivided ownership and KEYS' power entitlement share is approximately 9.9 MW at the plant bus bar.

Florida Power & Light (FPL) Long-Term Purchase – KEYS entered into an agreement with FPL on August 15, 1991, entitled the Long-Term Agreement to Provide Capacity and Energy by Florida Power & Light Company to Keys Energy Services, the Utility Board of the City of Key West, Florida (the "FPL Long-Term Agreement") which became effective on June 1, 1993 after the termination of a short-term purchase agreement with FPL. The FPL Long-Term Agreement will continue in effect for 20 years. The initial purchase amount (the "Initial Contract Demand") is 45 MW. The contract demand for each year is to be designated by September 1 of each prior year, but the contract demand cannot be less than the initial contract demand during the term of the agreement. In the event KEYS' peak load during a year is lower than the KEYS peak load in the immediately preceding year, KEYS may decrease the portion of its contract demand in excess of the Initial Contract Demand, subject to certain limitations.

NOTE 11 – COMMITMENTS AND CONTINGENCIES

Risk Management - KEYS is exposed to various risks of loss related to torts, damage, theft or destruction of assets, errors or omissions, injuries to employees, and natural disasters. KEYS purchases commercial insurance policies from a commercial insurance carrier and other insurance carriers to minimize its risk of loss in these areas.

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2006 AND 2005

NOTE 11 – COMMITMENTS AND CONTINGENCIES (Continued)

KEYS' has not experienced an insurance settlement in excess of insurance coverage during the past four fiscal years. KEYS' bears the risk of loss up to the deductible amounts, which are disclosed in the accompanying statistical tables.

NOTE 12 - NAVY CONTRACT

The United States Navy is the largest customer of KEYS and accounted for approximately 9.2% and 10.4% of kilowatt hours sold in Fiscal 2006 and 2005 respectively. KEYS' contract with the Navy is for a term of five years with a provision which requires the parties to commence negotiations for a new contract at least two years prior to the end of the current contract. The contract also contains provisions for minimum billing, service reduction and exclusive service provisions. Pursuant to this contract, KEYS has agreed to provide a maximum of 15 megawatts of power at multiple locations.

KEYS executed an amendment to the Navy's service contract on December 8, 1999, which modified the existing rate schedule. The term of the contract was extended to September 1, 2004 subject to certain termination and renegotiation provisions. On February 17, 2004, both parties agreed that this contract shall continue in effect through September 1, 2007. All terms and conditions remain unchanged and in full force and effect.

KEYS submitted a proposal on June 18, 2003 in response to the Department of the Navy's Solicitation No. N62467-00-R-1801 to privatize electric systems at NAS Key West.

In January 2005, the Navy notified KEYS that it had been selected as a best value respondent to the Navy's solicitation. However, after several months of negotiations, the parties were not able to reach agreement on the terms and conditions of the privatization contract between the Navy and KEYS.

NOTE 13 – REGULATION

According to existing laws of the State of Florida, the five members of the Utility Board act as the regulatory authority for the establishment of electric rates.

The Florida Public Service Commission (FPSC) has authority to regulate the electric "rate structures" of municipal utilities in Florida. It is believed that "rate structures" are clearly distinguishable from the total amount of revenues which a particular utility may receive from rates, and that distinction has thus far been carefully made by the FPSC. Prior to implementation of any rate change, KEYS files the proposed tariff with the Florida Public Service Commission and has established the prerequisite of a Public Notice and the holding of a Public Hearing.

The Florida Electric Power Plant Siting Act has given the FPSC exclusive authority to approve the construction of new power plants. The FPSC also exercises jurisdiction under the National Energy and the Florida Energy Efficiency and Conservation Acts as related to electric use conservation programs and prescribes conformance to the Federal Energy Regulatory Commission's Uniform System of Accounts.

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2006 AND 2005

NOTE 13 – REGULATION (Continued)

Operations of KEYS are subject to environmental regulation by Federal, State and local authorities and to zoning regulations by local authorities. Federal and State standards and procedures that govern control of the environment can change. These changes can arise from continuing legislative, regulatory, and judicial action respecting the standards and procedures.

Therefore, there is no assurance that the electric plant in operation, under construction or contemplated will always remain subject to the regulations currently in effect, or will always comply with future regulations. An inability to comply with environmental standards or deadlines could result in reduced operating levels or complete shutdown of individual electric generating units not in compliance. Furthermore, compliance with environmental standards or deadlines may substantially increase capital and operating costs.

NOTE 14 – POST EMPLOYMENT HEALTH CARE BENEFITS

In addition to providing pension benefits, KEYS provides life insurance and health care benefits for retired employees. These benefits are provided pursuant to KEYS' personnel policies as adopted by the Utility Board. KEYS is not required to provide contributions to this benefit by any statutory, contractual or other authority. KEYS employees hired before June 9, 1999 are eligible for these benefits if they qualify for retirement status while working for KEYS. At September 30, 2006, 120 retirees were eligible for and were receiving these benefits. These and similar benefits for active employees are provided through an insurance company whose premiums are based on the benefits paid during the year. KEYS recognizes the cost of providing these benefits on a pay-as-you-go basis by expensing the insurance premiums for retirees, which were \$953,344 and \$876,797 for 2006 and 2005, respectively.

NOTE 15 – PAYMENT TO THE CITY OF KEY WEST

KEYS is the successor of the electric public utility once owned by the City. All electric utility property owned by the City of Key West was transferred to KEYS at the time of KEYS' creation. KEYS pays the City an annual amount as a return on the City's contribution to KEYS.

Paragraph (11) of Section 3.03 (B) of the Original Resolution 532 was amended on September 8, 1999 by Resolution 678 to be effective for the amount paid in 2001. The Board will pay to the City a sum equal to the greater of (a) \$200,000 (adjusted annually for changes in the Consumer Price index or (b) one percent (1%) of the Gross Revenues derived from sales of electricity at retail (exclusive of Power Cost Revenues which are defined as (i) revenues determined by reference to the power cost component of base rates, plus or minus (ii) power cost adjustment charges or credits.) The annual payments were \$343,341 and \$340,548 for 2006 and 2005, respectively.

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2006 AND 2005

NOTE 16 – SPECIAL ITEMS

On October 24, 2005, Hurricane Wilma struck the Florida Keys causing an estimated \$3.1 million in damages, most of which was to the transmission and distribution system. Grants were received from the Florida Department of Community Affairs (DCA) and the Federal Emergency Management Agency (FEMA) which will reimburse 87.5% of eligible costs.

NOTE 17 – SUBSEQUENT EVENT

On October 31, 2006, KEYS issued \$42.0 million of Electric System Refunding and Capital Improvement Revenue Bonds, Series 2006. The bonds refunded the FMPA loan of \$948,000 and will fund several capital projects, including a pole hardening program, transmission and distribution improvements, a new substation located in Stock Island, installation of new feeders at the Big Pine substation, replace certain substation transformers and install fin fan coolers at the Stock Island Generating Facilities. The issue is rated AAA by Standard & Poor's (S&P) and Fitch and Aaa by Moody's and is insured by the MBIA Insurance Company. In addition, KEYS obtained an underlying bond rating of A2 from Moody's and A- from S&P.

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA
SCHEDULE OF REVENUES EARNED
FOR THE YEARS ENDED SEPTEMBER 30, 2006 AND 2005

	<u>2006</u>	<u>2005</u>
Operating Revenues:		
Electric Revenues	\$ 59,750,375	\$ 60,954,878
Power Cost Adjustment	34,217,993	19,451,323
Service Charges	134,068	141,677
Penalty Charges	470,133	482,655
Reserve Capacity	1,804,033	2,029,173
Other	94,525	291,876
Charges for New Service	<u>728,938</u>	<u>127,154</u>
Total	<u>97,200,065</u>	<u>83,478,736</u>
Other Income:		
Interest	1,047,716	613,525
Grant Revenue	-	119,367
Hurricane-Grant Revenue	3,281,600	1,900,702
Hurricane-Insurance Proceeds	273,306	-
CT#1 Insurance Proceeds	781,813	-
Pole Attachment	368,669	188,516
FKEC Audit Revenue	231,637	-
DOE Crude Oil Refund	145,416	-
Generating Unit Expense Reimbursement	189,742	22,545
Tree Trimming	92,565	81,573
KW Steam Plant Rental Income	173,348	-
Miscellaneous Non-Operating Revenue	<u>271,978</u>	<u>460,988</u>
Total Other Income	<u>6,857,790</u>	<u>3,387,216</u>
Total Revenues	<u>\$ 104,057,855</u>	<u>\$ 86,865,952</u>

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

UTILITY BOARD OF THE CITY OF KEY WEST
SCHEDULE OF REVENUES AND EXPENDITURES – BUDGET TO ACTUAL
FOR THE YEAR ENDED SEPTEMBER 30, 2006

	Annual Budget		Year to Date Actual	Variance- Favorable (Unfavorable)
	Original	Current		
Revenues				
Operating Revenues	\$ 83,151,423	\$ 95,890,056	\$ 93,968,368	\$ (1,921,688)
Other Operating Revenues	4,722,805	4,997,805	3,231,697	(1,766,108)
Interest Income	559,085	632,841	1,047,716	414,875
Grant Revenue	-	-	-	-
Hurricane - Grant Revenue	-	-	3,281,600	3,281,600
Hurricane - Insurance Proceeds	-	-	273,306	273,306
Non-Operating Revenues	<u>600,988</u>	<u>958,806</u>	<u>2,255,168</u>	<u>1,296,362</u>
Total Budget Revenue	<u>89,034,301</u>	<u>102,479,508</u>	<u>104,057,855</u>	<u>1,578,347</u>
Expenditures				
Production Expenses - Diesel	1,159,817	1,531,783	1,482,077	49,706
Purchased Power	51,121,682	63,541,863	59,946,424	3,595,439
Transmission Expenses	3,778,672	3,914,606	3,539,845	374,761
Distribution Expenses	4,056,412	3,755,708	3,366,439	389,269
Customer Accounts and Collection Expenses	1,085,996	1,089,361	1,243,322	(153,961)
Customer Deposit Interest	118,852	118,852	194,367	(75,515)
Administrative and General Expenses	13,708,055	13,467,890	15,153,075	(1,685,185)
Hurricane-Expenses	-	379,298	3,094,972	(2,715,674)
Senior Lien Debt Service	8,451,538	8,451,538	8,511,550	(60,012)
Junior Lien Debt Service	836,933	836,933	290,020	546,913
Dividend to City of Key West	<u>320,297</u>	<u>320,297</u>	<u>343,341</u>	<u>(23,044)</u>
Total Expenditures	<u>84,638,254</u>	<u>97,408,129</u>	<u>97,165,432</u>	<u>242,697</u>
Excess of Revenues Over Expenditures	<u>\$ 4,396,047</u>	<u>\$ 5,071,379</u>	6,892,423	<u>\$ (1,821,044)</u>
Adjustments				
Depreciation			(6,182,488)	
Principal Portion of Budgeted Debt Service			5,752,000	
Capitalized Overhead			1,232,601	
Interest Accrued but Unfunded			(1,560,475)	
Amortization of Issuance Costs			(104,508)	
Capital Contributions			85,983	
Amortization of Loss on Refunding			<u>(60,627)</u>	
Change in Net Assets, GAAP Basis			<u>\$ 6,054,909</u>	

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