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INDEPENDENT AUDITORS' 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, 2003 and 2002 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. The financial statements of KEYS as of September 30, 2002, were audited by Marva Green P.A., Inc., whose report dated December 2, 2002, expressed an unqualified opinion on those statements.

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.

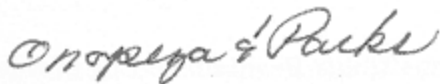
In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Utility Board of the City of Key West, Florida, Keys Energy Services as of September 30, 2003 and 2002, and the results of its operations and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As described in Note 1, KEYS adopted the provisions of Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis For State and Local Governments*, as of October 1, 2001.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental schedules are presented for purposes of additional

analysis and are not a required part of the basic financial statements. The supplemental schedules and Management's Discussion and Analysis have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole. The Management's Discussion and Analysis is also not a required part of the basic financial statements but is supplementary information required by the *Governmental Accounting Standards Board*. The statistical section has not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated January 13, 2004 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 grants. 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.



OROPEZA & PARKS
CERTIFIED PUBLIC ACCOUNTANTS

January 13, 2004

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, 2003. 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 presented in this report 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 through user fees and other charges. 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 increased in 2003 by \$1.5 million, or 2.8%, which consisted of a \$1.4 million decrease in Total Assets offset by a \$2.9 million decrease in Total Liabilities. The principal impact came from a \$3.7 million decrease in Long-Term Debt, Net of Current Portion. Net Property, Plant and Equipment, including Utility Plant, which is discussed more in *Significant Capital Assets*, increased \$2.4 million or 2.0%. Utility Plant increased by \$3.0 million or 1.6% and Accumulated Depreciation increased \$3.3 million or 3.8%, while Construction in Progress was higher by \$2.7 million. More detailed information about changes in utility plant is presented in the Notes to the Financial Statements.

	2001	2002	2003	Increase (Decrease)	
				Amount	Percent
Net Property, Plant and Equipment	\$112,687,740	\$112,961,324	\$115,335,893	\$2,374,569	2.1%
Other Property and Investments	29,329,732	24,567,386	22,339,213	(2,228,173)	-9.1%
Current and Non-Current Assets	18,113,747	17,086,313	15,543,862	(1,542,451)	-9.0%
Total Assets	\$160,131,219	\$154,615,023	\$153,218,968	(\$1,396,055)	-0.9%
Invested in Capital Assets, net of related debt	\$26,426,478	\$34,953,312	\$42,238,508	\$7,285,196	20.8%
Restricted for Debt Service	154,460	9,577	6,905	(2,672)	-27.9%
Unrestricted	24,222,061	17,905,602	12,114,420	(5,791,182)	-32.3%
Net Assets	50,802,999	52,868,491	54,359,833	1,491,342	2.8%
Long-Term Debt, Net of Current Portion	93,308,207	85,079,540	81,338,006	(3,741,534)	-4.4%
Liabilities Payable from Restricted Assets	10,637,211	11,215,528	11,341,165	125,637	1.1%
Current Liabilities and Deferred Revenue	5,382,802	5,451,464	6,179,964	728,500	13.4%
Total Liabilities	109,328,220	101,746,532	98,859,135	(2,887,397)	-2.8%
Total Net Assets and Liabilities	\$160,131,219	\$154,615,023	\$153,218,968	(\$1,396,055)	-0.9%

Statement of Revenues, Expenses, and Changes in Net Assets

Total Revenues of \$74.0 million were \$5.4 million or 7.9% above the 2002 level of \$68.6 million. Operating Revenues, which consist primarily of electricity sales, increased 9.5%, from \$66.7 million in 2002 to \$73.0 million in 2003. Electric Revenues, which is the largest segment, were \$60.6 million in 2003, compared to \$58.8 million in 2002, or 3.0% higher. On an MWh basis, sales of electricity during 2003 were 736,221, 32,588, or 4.6% above the 2002 level of 703,633. Power Cost Adjustment Revenue was \$9.9 million, which increased by \$4.3 million or 76.8% due to the higher cost of energy. Non-Operating Revenue of \$1.0 million was \$0.9 million less than the 2002 level because of lower rates achieved on investable balances (\$0.3 million) and the sales tax credit which occurred in 2002 (\$0.5 million).

Total Expenses of \$72.6 million were above the 2002 level by \$6.0 million or 9.0%. Operating Expenses in 2003 were \$67.1 million compared to the 2002 level of \$60.5 million. The increase of \$6.6 million, or 10.8%, was primarily due to Purchased Power expense, which was \$6.2 million, or 17.6% above the 2002 level due to higher natural gas prices. Purchased Power expenses, expressed in mills per 1,000 kWh sold, were 57.78 in 2003 versus 50.28 in 2002. The payment to the City of Key West was slightly lower because of the Bond Resolution formula calculation.

The Change in Net Assets was \$1.5 million in 2003, which consisted of Income before Capital Contributions of \$1.4 million and Capital Contributions of \$0.1 million.

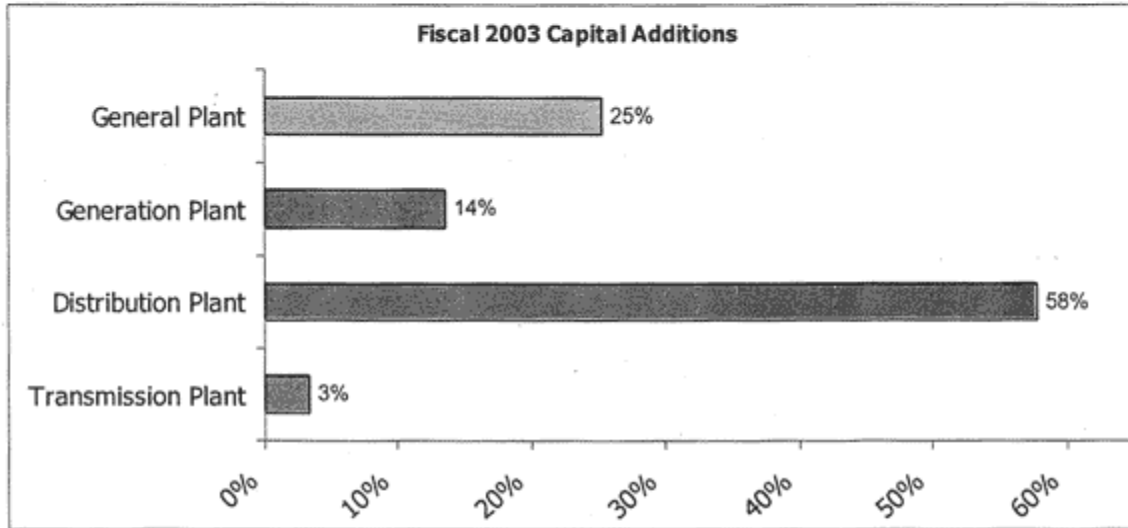
	2001	2002	2003	Increase (Decrease)	
				Amount	Percent
Electric Revenues	\$ 67,800,954	\$ 64,455,430	\$ 70,458,777	\$ 6,003,347	9.3%
Other Electric Revenues	2,187,068	2,202,083	2,535,303	333,220	15.1%
Operating Revenues	69,988,022	66,657,513	72,994,080	6,336,567	9.5%
Non-Operating Revenues	3,134,405	1,929,387	995,705	(933,682)	-48.4%
Total Revenues	73,122,427	68,586,900	73,989,785	5,402,885	7.9%
Operating Expenses	58,585,178	60,511,162	67,074,135	6,562,973	10.8%
Non-Operating Expenses	6,519,892	6,137,569	5,570,895	(566,674)	-9.2%
Total Expenses	65,105,070	66,648,731	72,645,030	5,996,299	9.0%
Income Before Capital Contributions	8,017,357	1,938,169	1,344,755	(593,414)	-30.6%
Capital Contributions	185,059	127,323	146,587	19,264	15.1%
Change in Net Assets	8,202,416	2,065,492	1,491,342	(574,150)	-27.8%
Net Assets, Beginning of Year	42,600,583	50,802,999	52,868,491	2,065,492	4.1%
Net Assets, End of Year	\$ 50,802,999	\$ 52,868,491	\$ 54,359,833	\$ 1,491,342	2.8%

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 that objective during 2003. The same situation held true for the prior fiscal year. Although Income before Capital Contributions decreased \$0.6 million, the Utility increased net assets by \$1.5 million while paying down debt by \$3.7 million.

Significant Capital Assets

Total Property, Plant and Equipment were \$201.6 million at September 30, 2003, compared to \$198.6 million at September 30, 2002, or an increase of \$3.0 million. Significant projects placed in service occurred in Distribution Plant - Daily Work Orders, ER's and Transformers; Generation Plant - Fuel Dock Renovations and resurfacing of the Synchronous Condenser Deck; Transmission Plant - Line #4 Re-insulation of Down Guy-Wires; and General Plant - New Vehicles. Major retirements occurred in Distribution Plant - transformers, meters and poles; and General Plant - Fuel Dock. Construction in Progress was \$5.0 million at fiscal year end 2003 related to Distribution Plant - Daily Work Orders and Meters; and Transmission Plant - Florida Keys Electric Cooperative (FKEC) Tie-line upgrade. Please see Note 1 in Notes to Financial Statements for further information.



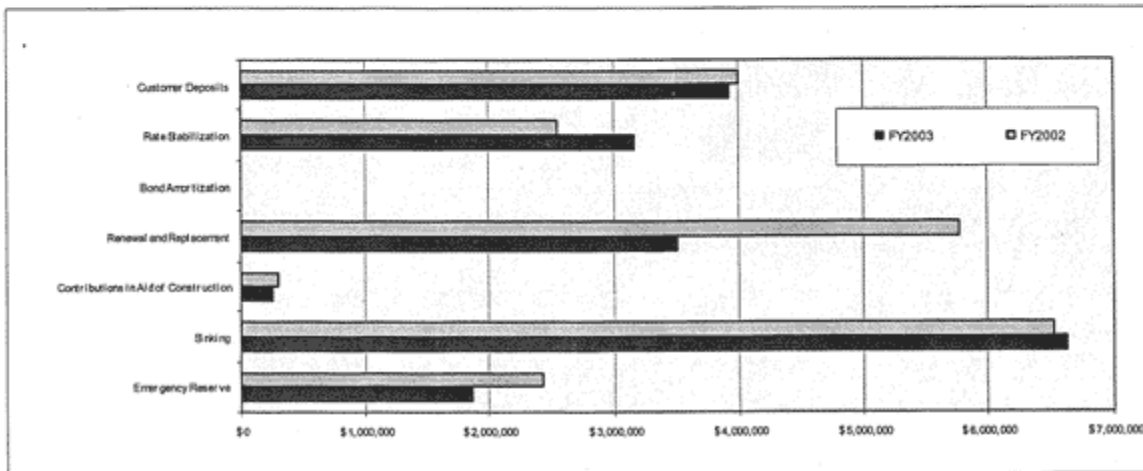
Long Term Debt

The Utility's trustee paid to the bondholders a principal payment of \$4.5 million on October 1, 2003. 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 1 and October 1 of each year. The Utility's debt service payments have been structured to remain fairly constant at approximately \$8.3 million through 2014 and \$9.3 million through 2018. Please see Note 5 in Notes to Financial Statements for further information.

On April 10, 2002, the Utility Board authorized the redemption on May 10, 2002 of Electric System Revenue Bonds, Series 1987, due October 1, 2013, with a maturity value of \$2.5 million. The Board used \$1.6 million received on February 15, 2002 to pay the accreted value of the bonds, the redemption premium, and issuance costs. The excess proceeds were applied to current debt service due October 1, 2002. This action allowed a corresponding amount of revenues to be deposited into the Rate Stabilization Fund.

Restricted Assets

Total Restricted Assets were \$19.3 million at September 30, 2003, compared to \$21.5 million at September 30, 2002. The Utility's Bond Resolution specifies the manner in which moneys 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 moneys 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 of, premium, if any, and interest on or maturity value of, the Bonds as they mature and become due. Restricted Assets decreased \$2.2 million or 10.3% because Renewal and Replacement funds were used for approved capital projects, primarily the new Cudjoe Key Substation.



Overall Analysis of Financial Position and Results of Operations

The Utility's overall financial position in 2003 improved as shown by the Net Assets increase of \$1.5 million, or 2.8%. The Change in Net Assets consisted of a \$1.4 million decrease in Total Assets offset by a \$2.9 million decrease in Total Liabilities. The major component of the decrease in Total Assets resulted from the utilization of Renewal and Replacement funds for approved capital projects, primarily the new Cudjoe Key Substation. The principal impact in Total Liabilities came from a \$3.7 million decrease in Long-Term Debt, Net of Current Portion.

Sales of Electricity in 2003 showed positive gains in the residential, commercial, military segments. On an MWh basis, total sales of electricity were 736,221 or 4.6% above the 2002 level of 703,633 because of higher than normal temperatures. The increase in sales, combined with budgetary control, contributed to the increase in Net Assets of \$1.5 million.

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 Director of Finance, 305-295-1000, 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, 2003 AND 2002

ASSETS

	<u>2003</u>	<u>2002</u>
Property, Plant and Equipment:		
Utility Plant	\$ 182,319,814	\$ 179,362,512
Less Accumulated Depreciation	72,005,483	68,737,664
Net Utility Plant	<u>110,314,331</u>	<u>110,624,848</u>
Construction in Progress	<u>5,021,562</u>	<u>2,336,476</u>
Net Property, Plant and Equipment	<u>115,335,893</u>	<u>112,961,324</u>
Other Property and Investments:		
Non-Utility Plant	19,284,211	19,284,211
Less Accumulated Depreciation	<u>16,274,438</u>	<u>16,274,438</u>
Net Non-Utility Plant	3,009,773	3,009,773
Cash and Cash Equivalents -Restricted	7,865,611	7,752,672
Investments - Restricted	<u>11,463,829</u>	<u>13,804,941</u>
Net Other Property and Investments	<u>22,339,213</u>	<u>24,567,386</u>
Current Assets:		
Cash and Cash Equivalents	301,162	815,390
Investments	2,577,545	2,259,289
Customer Accounts Receivable, net of Allowance for Bad Debts of \$137,304 and \$129,710 for 2003 and 2002, respectively	4,317,862	4,514,931
Other Accounts Receivable	289,821	236,388
Due From Other Governments	5,000	5,000
Plant Material and Operating Supplies Inventory	2,496,248	3,408,455
Prepaid Expenses	<u>864,617</u>	<u>568,529</u>
Total Current Assets	<u>10,852,255</u>	<u>11,807,982</u>
Non-Current Assets:		
Investments	3,573,337	4,055,554
Bond Discount and Issue Costs, Net	<u>1,118,270</u>	<u>1,222,777</u>
Total Non-Current Assets	<u>4,691,607</u>	<u>5,278,331</u>
Total Assets	<u>\$ 153,218,968</u>	<u>\$ 154,615,023</u>

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

(Continued)

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

BALANCE SHEETS (CONTINUED)

FOR THE YEARS ENDED SEPTEMBER 30, 2003 AND 2002

NET ASSETS AND LIABILITIES

	<u>2003</u>	<u>2002</u>
Net Assets:		
Invested in Capital Assets net of related debt	\$ 42,238,508	\$ 34,953,312
Restricted for Debt Service	6,905	9,577
Unrestricted	<u>12,114,420</u>	<u>17,905,602</u>
Total Net Assets	54,359,833	52,868,491
Long-Term Debt, Net of Current Portion:		
Revenue Bonds	70,565,376	75,233,511
Accrued Interest	10,772,630	9,506,029
Loan Payable	<u>-</u>	<u>340,000</u>
Total Long-Term Debt	81,338,006	85,079,540
Liabilities Payable from Restricted Assets:		
Current Portion of Long-Term Debt	5,009,373	4,790,611
Accounts Payable	518,400	424,638
Accrued Interest	1,889,160	1,998,716
Due to Customers	<u>3,924,232</u>	<u>4,001,563</u>
Total Liabilities Payable from Restricted Assets	11,341,165	11,215,528
Current Liabilities		
Accounts Payable	4,657,297	3,864,900
Due to Other Governments	-	224,018
Accrued Expenses	<u>1,457,832</u>	<u>1,250,345</u>
Total Current Liabilities	6,115,129	5,339,263
Non-Current Liabilities:		
Deferred Revenue	<u>64,835</u>	<u>112,201</u>
Total Liabilities	<u>98,859,135</u>	<u>101,746,532</u>
Total Net Assets and Liabilities	<u>\$ 153,218,967</u>	<u>\$ 154,615,023</u>

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

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA
STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS
FOR THE YEARS ENDED SEPTEMBER 30, 2003 AND 2002

	<u>2003</u>	<u>2002</u>
Operating Revenues	\$ 72,994,080	\$ 66,657,513
Operating Expenses:		
Production Expenses - Diesel	916,557	779,761
Purchased Power	41,618,787	35,379,069
Transmission Expenses	3,711,111	3,485,983
Distribution Expenses	2,832,211	3,241,386
Customer Accounts and Collection Expenses	1,015,116	985,698
Administrative and General Expenses	8,757,455	8,460,644
Depreciation	6,367,595	6,500,687
Taxes Other than Income Taxes	1,855,303	1,677,934
Total Operating Expenses	<u>67,074,135</u>	<u>60,511,162</u>
Operating Income	<u>5,919,945</u>	<u>6,146,351</u>
Non-Operating Revenue and Expenses:		
Interest Income	396,649	655,969
Grant Revenue	3,022	6,500
Miscellaneous Non-Operating Revenue	596,034	1,266,918
Payment to City of Key West	(318,394)	(334,485)
Interest on Debt	(5,147,993)	(5,543,381)
Amortization of Bond Discount and Issue Costs	(104,508)	(259,703)
Total Non-Operating Revenue and Expenses	<u>(4,575,190)</u>	<u>(4,208,182)</u>
Income Before Capital Contributions	<u>1,344,755</u>	<u>1,938,169</u>
Capital Contributions	<u>146,587</u>	<u>127,323</u>
Change in Net Assets	1,491,342	2,065,492
Net Assets, Beginning of Year	<u>52,868,491</u>	<u>50,802,999</u>
Net Assets, End of Year	<u>\$ 54,359,833</u>	<u>\$ 52,868,491</u>

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, 2003 AND 2002

	2003	2002
Cash Flows Provided (Used by) Operating Activities:		
Received from Customers	\$ 71,372,862	\$ 66,934,258
Payments to Suppliers for Goods and Services	(49,804,466)	(45,406,189)
Payments to Employees for Services	(7,481,088)	(7,037,602)
Received for Deposits	822,401	790,022
Deposits Refunded	(899,732)	(846,805)
Received for Taxes	1,786,473	1,611,989
Paid for Taxes	(1,828,687)	(1,702,017)
Received from Other Operating Sources	550,752	646,533
Net Cash Provided by Operating Activities	14,518,515	14,990,189
Cash Flows Provided (Used by) Non-Capital Financing Activities:		
Received from Operating Grants	(220,996)	225,518
Paid to City of Key West, Florida	(318,394)	(334,485)
Net Cash Provided (Used by) Non-Capital Financing Activities	(539,390)	(108,967)
Cash Flows Provided (Used by) Capital and Related Financing Activities:		
Principal Paid on Long-Term Debt	(4,850,000)	(8,253,250)
Interest Paid on Revenue Bond Maturities	(3,930,321)	(5,040,886)
Contributions in Aid of Construction	146,587	127,323
Acquisition and Construction of Capital Assets	(8,700,289)	(6,497,392)
Proceeds from Disposal of Assets	51,887	-
Cost of Bond Issuance	-	(24,453)
Net Cash (Used by) Capital and Related Financing Activities	(17,282,136)	(19,688,658)
Cash Flows Provided (Used by) Investing Activities:		
Purchase of Investments	-	(6,703,136)
Redemption of Investments	2,505,073	15,254,580
Interest Received on Investments	396,649	948,466
Net Cash Provided (Used by) Investing Activities	2,901,722	9,499,910
Net Increase (Decrease) in Cash and Cash Equivalents	(401,289)	4,692,474
Cash and Cash Equivalents at Beginning of Year	8,568,062	3,875,588
Cash and Cash Equivalents at End of Year	\$ 8,166,773	\$ 8,568,062

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UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED SEPTEMBER 30, 2003 AND 2002

Reconciliation of Operating Income to
Net Cash Provided by Operating Activities

	<u>2003</u>	<u>2002</u>
Operating Income	<u>\$5,919,945</u>	<u>\$6,146,351</u>
Adjustments to Reconcile Operating Income To Net Cash Provided by Operating Activities:		
Depreciation	6,367,595	6,500,687
Provision for Uncollectible Accounts	117,271	113,273
Amortization of Deferred Revenue	(208,941)	(221,482)
Receipt of Deferred Revenue	161,575	59,382
Other Operating Sources of Revenues	598,120	808,633
Changes in Assets and Liabilities:		
Decrease in Accounts Receivable	24,278	1,491,418
(Increase) Decrease in Plant Material, Inventory and Fuel Stock	912,207	(126,100)
(Increase) in Prepaid Expenses	(296,088)	(212,587)
Increase (Decrease) in Accounts Payable	792,397	(28,215)
Increase in Accrued Expenses	207,487	515,612
(Decrease) in Amounts Due to Customers	(77,331)	(56,783)
Total Adjustments	<u>8,598,570</u>	<u>8,843,838</u>
Net Cash Provided by Operating Activities	<u>\$ 14,518,515</u>	<u>\$ 14,990,189</u>

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

In 2003 and 2002, amortization of bond discount and issue costs was \$104,508 and \$259,703, respectively.

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, 2003 AND 2002

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). 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 Manager 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 recognized in the period incurred, regardless of the timing of the related cash flows.

GASB Statement No. 34 - KEYS adopted the provisions of GASB Statement No. 34, Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments, during the year ended September 30, 2002. Statement 34 establishes standards for external financial reporting for all state and local governmental entities which includes a Management's Discussion and Analysis section, a Balance Sheet; a Statement of Revenues, Expenses, and Changes in Net Assets; and a Statement of Cash Flows. It requires the classification of Net Assets into three components - Invested in Capital Assets, net of related debt; Reserved for Debt Service, and Unreserved.

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2003 AND 2002

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

The adoption of Statement 34 had little effect on the basic financial statements except for the classification of net assets, and the inclusion of a Management's Discussion and Analysis (MD&A) section providing an analysis of the KEYS' overall financial position and results of operations.

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 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. 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.

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2003 AND 2002

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

The following is a summary of property, plant and equipment for the year ended September 30, 2003:

	Balance 2002	Additions	Deletions	Balance 2003
Utility Plant:				
Generation	\$ 47,267,682	\$ 826,049	\$ -	\$ 48,093,731
Transmission	71,151,516	204,794	-	71,356,310
Distribution	48,161,211	3,530,973	2,664,504	49,027,680
General	12,561,839	1,547,148	487,158	13,621,829
Other	220,264	-	-	220,264
Total Utility Plant in Service	<u>179,362,512</u>	<u>6,108,964</u>	<u>3,151,662</u>	<u>182,319,814</u>
Accumulated Depreciation-Utility Plant:				
Generation	(21,075,015)	(1,736,240)	-	(22,811,255)
Transmission	(23,692,344)	(1,862,795)	-	(25,555,139)
Distribution	(18,834,215)	(1,690,904)	(2,643,064)	(17,882,055)
General	(5,136,090)	(1,077,655)	(456,711)	(5,757,034)
Other	-	-	-	-
Total Accumulated Depreciation-Utility Plant in Service:	<u>(68,737,664)</u>	<u>(6,367,594)</u>	<u>(3,099,775)</u>	<u>(72,005,483)</u>
Net Utility Plant in Service	<u>\$ 110,624,848</u>	<u>\$ (258,630)</u>	<u>\$ 51,887</u>	<u>\$ 110,314,331</u>
Construction Work in Progress	<u>\$ 2,336,476</u>	<u>\$ 8,794,051</u>	<u>\$ 6,108,965</u>	<u>\$ 5,021,562</u>

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 years ended 2003 and 2002, 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

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2003 AND 2002

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Statement No. 16. At September 30, 2003, annual vacation leave earned but not taken is \$349,466 and sick leave accumulated but not taken is \$604,719.

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, 2003 and 2002 is summarized as follows:

	<u>2003</u>	<u>2002</u>
Electric Refunding Revenue Bonds, Series 1987	\$ -	\$ 76,236
Electric Refunding Revenue Bonds, Series 1991	1,266,601	1,181,480
Electric Revenue Bonds, Series 1993	-	130,850
Electric Forward Refunding Revenue Bonds, Series 2000	3,330,174	3,525,735
Electric Forward Refunding Revenue Bonds, Series 2001	448,145	471,695
Series 2001 Loss on Refunding	60,627	60,626
Interest on Customer Deposits	31,538	74,701
FMPA Pooled Loan	10,908	22,058
	<u>\$ 5,147,993</u>	<u>\$ 5,543,381</u>

Total Interest Expense

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 Debt Service – Consists of net assets with constraints placed on their use by revenue bond resolution.

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, 2003 and 2002, the board has designated \$625,872 and \$486,589 respectively, for certain future repair and replacement costs.

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2003 AND 2002

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

Non-Utility Plant - The Key West Steam Plant, which has a cost of \$19,284,211 and accumulated depreciation of \$16,274,438 at September 30, 2003, has been idle since 1991. The plant has been decommissioned at a cost of \$2,055,702.

The Utility Board executed a lease agreement in 2003 with a potential developer for a long-term 99-year lease of the decommissioned Key West Steam Plant and adjacent property. The proposed project will consist of a mixture of 19 luxury-housing units and 38 affordable housing units. The developer has obtained permitting approval from the local authorities. The developer is currently procuring financing and is in the final stages of design for the project. The proposed project is scheduled for completion in year 2005.

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, 2003 and 2002 consist of the following:

	<u>Cash and Cash Equivalents</u>	<u>Investments</u>	<u>Cash and Cash Equivalents</u>	<u>Investments</u>
Emergency Reserve Fund	\$ -	\$ 1,852,101	\$ -	\$ 2,426,794
Sinking Fund	6,618,889	7,176	6,508,978	9,315
Contributions in Aid of				
Construction Fund	251,242		297,467	
Renewal and Replacement Fund	792,618	2,720,086	774,309	4,989,505
Rate Stabilization Fund	28,400	3,130,391	28,400	2,513,243
Customer Deposits Fund	174,462	3,754,075	143,518	3,866,084
Total	<u>\$ 7,865,611</u>	<u>\$ 11,463,829</u>	<u>\$ 7,752,672</u>	<u>\$ 13,804,941</u>

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2003 AND 2002

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.

KEYS invests funds throughout the year with the Local Government Surplus Funds Trust Fund (SBA), an investment pool administered by the State Board of Administration, under the regulatory oversight of the State of Florida.

Throughout the year and as of September 30, 2002, the SBA contained certain floating and adjustable rate securities which were indexed based on the prime rate and/or one and three month LIBOR rates. These investments represented approximately 0.72% of the SBA's portfolio at September 30, 2002. The SBA met the criteria to be "2A-7Like" as defined in GASB 31 at September 30, 2003. Therefore, the investment was valued at amortized cost and the fair value at September 30, 2003 was the account balance at that time.

Investments – In the following schedule, KEYS' investments are summarized and categorized to give an indication of the level of risk assumed by KEYS at September 30, 2003 and 2002. Category 1 includes investments that are insured or registered or for which the counterparty's or its agent in KEYS' name holds the securities. Category 2 includes uninsured and unregistered investments for which the counterparty's trust department or agent in KEYS' name holds the securities. Category 3 includes uninsured and unregistered investments for which the securities are held by the counterparty's trust department or agent but not in KEYS' name.

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2003 AND 2002

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

2003	Category			Carrying Amount	Fair Value
	1	2	3		
Guaranteed Income Contract	\$ -	\$ -	\$ -	\$ 554,913	\$ 554,913
Local Government Surplus Trust Fund	-	-	-	15,128,201	15,128,201
Repurchase Agreements	-	-	1,931,597	1,931,597	1,931,597
Total	\$ -	\$ -	\$ 1,931,597	\$ 17,614,711	\$ 17,614,711

2002	Category			Carrying Amount	Fair Value
	1	2	3		
Guaranteed Income Contract	\$ -	\$ -	\$ -	\$ 1,035,667	\$ 1,035,667
Local Government Surplus Trust Fund	-	-	-	17,436,411	17,436,411
Repurchase Agreements	-	-	1,647,706	1,647,706	1,647,706
Total	\$ -	\$ -	\$ 1,647,706	\$ 20,119,784	\$ 20,119,784

Cash and Cash Equivalents – All demand deposits and certificates of deposit are fully collateralized through the Florida Securities for Public Deposits Act, and are considered insured for risk categorization purposes. Deposits at September 30, 2003 and 2002 are \$7,353,935 and \$8,568,062 respectively.

NOTE 4 – LONG-TERM DEBT

Changes in Long-Term Debt during 2003 are as follows:

	2002	Additions	Retired	2003
Series 1991	\$ 8,077,785	\$ -	\$ 0	\$ 8,077,785
Series 2000	60,685,000	-	3,725,000	56,960,000
Series 2001, net	10,921,337	-	724,373	10,196,964
FMPA Loan	680,000	-	340,000	340,000
	\$ 80,364,122	\$ -	\$ 4,789,373	\$ 75,574,749

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2003 AND 2002

NOTE 4 – LONG-TERM DEBT (Continued)

Revenue Bonds:

Electric System Refunding Revenue Bonds, Series 1991, collateralized by Net Revenues and certain Reserve Funds, payable October 1, 2003 to October 1, 2018 in installments of various amounts, bearing interest at rates from 7.05% to 7.1%.

	<u>2003</u>	<u>2002</u>
	\$ 8,077,785	\$ 8,077,785
Electric System Refunding Revenue Bonds, Series 2000, collateralized by Net Revenues and certain Reserve Funds, payable October 1, 2003 to October 1, 2013 in installments of various amounts, bearing interest at rates from 5.50% to 6.0%.	56,960,000	60,685,000
Electric System Refunding Revenue Bonds, Series 2001, collateralized by Net Revenues and certain Reserve Funds, payable from October 1, 2003 to October 1, 2013 in installments of various amounts, interest at rates from 3.25% to 5.0%.	10,790,000	11,575,000
Deferred Loss on Refunding-net, amortized on the straight line basis over the term of the Series 2001 Revenue Bonds	(593,036)	(653,663)
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, due in installments of \$340,000 on November 22 until November 22, 2004, bearing interest at a rate determined by FMPA (currently 0.85%).	<u>340,000</u>	<u>680,000</u>
Total Long-Term Debt	75,574,749	80,364,122
Less Current Portion	<u>5,009,373</u>	<u>4,790,611</u>
Net Long-Term Debt	<u>\$ 70,565,376</u>	<u>\$ 75,573,511</u>

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.

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2003 AND 2002

NOTE 4 – LONG-TERM DEBT (Continued)

Summary of Debt Service Funding Requirements to Maturity

(In Thousands of Dollars)

Years Ended October 1	Interest	Principal	Total
2004	\$ 3,536	\$ 4,970	\$ 8,506
2005	3,280	5,230	8,510
2006	2,997	5,515	8,512
2007	2,696	5,755	8,451
2008	2,382	6,005	8,387
2009 – 2013	6,403	35,545	41,948
2014 – 2018	38,272	8,078	46,350
	<u>\$ 59,566</u>	<u>\$ 71,098</u>	<u>\$ 130,664</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, 2003, as those funding requirements have been fully satisfied.

The long-term portion of accrued interest represents amounts payable on capital appreciation bonds, which will become due October 1, 2003 to October 1, 2018. No interest is payable on these bonds until their scheduled maturity at which time it is paid in full with the principal amount.

Advance Refunding of Series 1991 Bonds - On July 3, 2001, KEYS issued \$11.8 million in Electric System Refunding Revenue bonds, Series 2001, with an average interest rate of 4.3 percent to advance refund \$11.1 million of outstanding 1991 Series bonds with an average interest rate of 6.7 percent. The net proceeds of \$11.6 million (after payment of \$222,000 in costs of issuance, underwriting fees, and insurance costs) were used to purchase U.S. government securities. Those securities were deposited in an irrevocable trust with an escrow agent to provide for all future debt service payments on the 1991 Series bonds. As a result, a portion of the 1991 Series bonds are considered defeased and the liability for the 1991 Series bonds was reduced to \$8.7 million.

KEYS completed the advance refunding to reduce its total debt service payments over the next thirteen years by \$1.5 million and to obtain an economic gain (difference between the present values of the old and new debt service payments) of \$1.1 million.

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2003 AND 2002

NOTE 5 – PRIOR YEAR DEFEASANCE OF DEBT

During 1986, 1987, 1991, 1995, 2000 and 2001, KEYS defeased certain revenue bonds by placing the 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, 2003, \$33,250,906 of bonds outstanding relative to the 1980C, 1983, 1984 and 1980D issues, \$18,536,976 relative to the 1985 issue, \$18,714,714 relative to the 1987 issue, \$14,516,919 relative to the 1988 issue, and \$9,775,000 relative to the 1991 issue are considered defeased.

NOTE 6 – 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 7 – 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 Utility Board, which 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

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2003 AND 2002

NOTE 7 – PENSION PLAN (Continued)

contribute at a rate based on the annual actuarial valuation, which indicated the minimum required contribution. The minimum required contribution rate of covered payroll would be adjusted to include any benefit changes approved by the Utility Board.

Schedule of Funding Progress – KEYS' annual contribution for the calendar year 2003 of \$1,668,657 (24.4%) was determined as part of the January 1, 2003 actuarial valuation using the entry age normal actuarial cost method. 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 3.5%. 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, 2003 was 30 years. KEYS had an unfunded actuarial accrued liability of \$1,974,607 and \$1,216,820 as of January 1, 2003 and 2002 respectively. The net pension obligation was \$(26,551) at December 31, 2002.

(1) Actuarial Valuation Date January 1,	(2) Entry Age Actuarial Value of Assets	Dollar Amounts in Thousands			(6) Covered Payroll	(7) UAAL as a Percentage of Covered Payroll
		(3) Actuarial Accrued Liability (AAL)	(4) Unfunded AAL (UAAL)	(5) Funded Ratio		
1994	\$ 25,161	\$ 25,589	\$ 428	98.3%	\$ 6,264	6.8%
1995	\$ 24,597	\$ 27,329	\$ 2,732	90.0%	\$ 6,256	43.7%
1996	\$ 30,143	\$ 32,190	\$ 2,047	93.6%	\$ 5,783	35.4%
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%

<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			
1997	\$ 673,467	132%	\$ -			
1998	\$ 616,835	214%	\$ -			
1999	\$ 624,849	212%	\$ -			
2000	\$ 384,057	268%	\$ -			
2001	\$ 1,245,998	100%	\$ -			
2002	\$ 1,673,299	102%	\$ (26,551)			
						2002 2003
				Annual Required Contribution (ARC)	\$ 1,673,299	\$ 1,668,657
				Interest on NPO	-	(2,124)
				Adjustment to ARC	-	2,358
				APC	\$ 1,673,299	\$ 1,668,891
				Utility Board Contribution	(1,699,850)	
				Increase (Decrease) in NPO	\$ (26,551)	
				NPO (beginning of year)	-	
				NPO (end of year)	\$ (26,551)	

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2003 AND 2002

NOTE 8 – LEASES

Rent expense under cancelable operating leases was \$104,894 and \$105,584 in 2003 and 2002, respectively, related to copiers, telephone switch, mailing equipment, time clocks.

NOTE 9 - 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' 50.4 MW of existing generating resources and two combustion turbine units that are owned by FMPA, which currently total 36.7 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. 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 busbar.

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2003 AND 2002

NOTE 9 - PURCHASED POWER COMMITMENTS (Continued)

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 a 100 MW undivided ownership and KEYS' power entitlement share is approximately 9.9 MW at the plant busbar.

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.

Southernmost Waste Energy Facility – KEYS has entered into a Parallel Generation Agreement where KEYS will purchase the net electric generation from the Southernmost Waste Energy Facility, which is a municipal solid waste-fueled resource recovery unit located on Stock Island. The unit was placed in service during February 1987 and has a net generating capacity of approximately 2.0 MW. Energy from the unit is purchased by KEYS on a "take-and-pay" basis at KEYS' average energy cost, including purchased power capacity and energy costs. This facility is considered by KEYS to be a non-firm capacity resource.

NOTE 10 – JOINT INVESTMENT

FKEC Transmission Agreement – To provide the long-term transmission needs of both KEYS and the Florida Keys Electric Cooperative (FKEC), the parties entered into an agreement in which both KEYS and FKEC will maintain an appropriate ownership investment in the transmission line between the Monroe/Dade County line and the north end of the Seven Mile Bridge, at the north end of KEYS' service area. The Transmission Agreement is effective for 40 years from its effective date of January 1, 1992, or until all property, comprising the transmission line has been disposed of and all termination costs have been paid, whichever occurs last.

Based on the estimated usage of the transmission system in 1993 and 2020, and other considerations such as allocations of losses, the parties agreed that KEYS would be required to

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2003 AND 2002

NOTE 10 – JOINT INVESTMENT (Continued)

maintain 56.5% of the investment in the transmission system, and FKEC will be required to maintain 43.5% of the investment in the transmission system. Based on the agreement, KEYS is entitled, at all times, to 40% of the approximately 270 MW transfer limit of the 138 KV transmission system, which is currently estimated to approximately 110 MW.

The foregoing allocation percentages are used: (1) to set transmission capacity entitlements, including circumstances where the capacity is fully utilized or limited (provisions have been made for either party to use the unused capacity of the other party by paying a non-firm rate based on the previous year's costs); (2) to allocate a net investment responsibility, for which capital costs are borne by each owning party, and which costs are used to calculate a fixed charge rate that is paid by either party if their net investment is less than the required investment (in addition to the fixed charge for deficit investments, the deficit party has the responsibility to make the next investment or portion thereof to establish its total net investment approximately equal to the required allocation); and (3) to determine the allocation of operation and maintenance, administration and general, renewals and replacements, upgrades, and other appropriate expenses including taxes (FKEC is responsible for the operation and maintenance of the transmission facilities within its service territory, based on recommendations from a joint operating committee, with the associated costs allocated to the parties).

Each party is responsible for losses on the transmission system based upon a loss allocation factor for each line segment, which is determined by dividing the energy flow for each party on the line segment by the total flow on the line segment. FKEC has installed substation-metering necessary to calculate the loss allocation factor, and FKEC is, therefore, responsible for performing the calculation, which is calculated on an hourly basis.

The Transmission Agreement provides for the construction of future capital additions to the transmission system, which would be paid for jointly by FKEC and KEYS based on the allocation percentages. Once parity of investment is achieved under the Transmission Agreement, any subsequent investment deficiency requires the deficient party to pay a monthly penalty to the other party, based upon a formula set out in the Transmission Agreement, which is based in part on the non-deficient party's embedded cost of debt capital.

As the joint investment does not constitute a separate legal entity and as no joint debt was issued to fund this project, therefore KEYS' investment in these facilities is included as part of electric plant on KEYS' balance sheet.

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. KEYS has not experienced an insurance

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2003 AND 2002

NOTE 11 – COMMITMENTS AND CONTINGENCIES (Continued)

settlement in excess of insurance coverage during the past three fiscal years. KEYS bears the risk of loss up to the deductible amounts, which are disclosed in the accompanying statistical tables.

Sales Agreement - KEYS has entered into an 18-year agreement, effective January 1, 1994, (the "FKEC Capacity and Energy Sale Agreement") with the Florida Keys Electric Cooperative, "FKEC", under which KEYS agrees to sell power to FKEC. The contract demand availability under the agreement was originally 10.0 MW adjusted to 12.0 MW on January 1, 1995, which contract demand may be further increased or decreased at any time upon mutual agreement of both parties. The minimum demand charge is \$3.00/kW-month, which is subject to potential future adjustment based upon the increase or decrease in the Base Demand Charge, which FKEC pays FPL (as defined in FKEC's power supply contract with FPL).

The energy charge (mills per net kilowatt-hour) will be KEYS' average fuel cost of its diesel and combustion turbine generating units that are used in the month the energy is provided to FKEC, if such energy is provided from such generating units. If KEYS provides all or a portion of the energy from generating resources other than its diesel and combustion turbine generating units, the energy charge, mills per kilowatt hours, in the month the energy is provided to FKEC will be KEYS' net cost of such energy plus 1.0 mill per kilowatt hour for the portion of energy provided by KEYS to FKEC from such generating resources. KEYS' net cost includes, but is not limited to, fuel cost, transmission cost, and losses incurred by KEYS.

KEYS is required to provide the capacity and energy only to the extent FKEC cannot meet a portion of its load with FPL and FKEC resources. In the event the transmission line is interrupted, KEYS may curtail the amount it sells to FKEC pursuant to a formula in the contract, which prorates FKEC's contract demand based on the relationship between KEYS' available resources and its projected monthly peak requirements (including FKEC's contract demand).

NOTE 12 - NAVY CONTRACT

The United States Navy is the largest customer of KEYS and accounted for approximately 10.4% and 9.4% of operating revenues in 2003 and 2002 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 service contract on December 8, 1999, which modified the existing rate schedule. The term of the contract was also extended to September 1, 2004 subject to certain termination and renegotiation provisions.

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2003 AND 2002

NOTE 12 - NAVY CONTRACT(Continued)

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. The responses are currently being reviewed and evaluated. It is anticipated that the successful bidder will be notified sometime during 2004.

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.

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, 2003, 110 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

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2003 AND 2002

NOTE 14 – POST EMPLOYMENT HEALTH CARE BENEFITS (Continued)

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 \$565,211 and \$453,616 for 2003 and 2002, respectively.

NOTE 15 – PAYMENT TO 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.)

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

SCHEDULES OF REVENUES EARNED

FOR THE YEARS ENDED SEPTEMBER 30, 2003 AND 2002

	<u>2003</u>	<u>2002</u>
Operating Revenues:		
Electric Revenues	\$ 60,566,314	\$ 58,830,688
Power Cost Adjustment	9,892,463	5,624,742
Service Charges	159,050	158,049
Penalty Charges	457,717	387,600
Reserve Capacity	1,883,557	1,598,265
Other	34,979	58,169
Total	<u>72,994,080</u>	<u>66,657,513</u>
Other Income:		
Interest	396,649	655,969
Grant Revenue	3,022	6,500
Miscellaneous Non-Operating Revenue	452,869	1,094,141
Charges for New Service	143,165	172,777
Total Other Income	<u>995,705</u>	<u>1,929,387</u>
Total Revenues	<u>\$ 73,989,785</u>	<u>\$ 68,586,900</u>

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

SCHEDULE OF REVENUES AND EXPENDITURES – BUDGET TO ACTUAL

FOR THE YEAR ENDED SEPTEMBER 30, 2003

	Budget		Actual	Variance- Favorable (Unfavorable)
	Original	Final		
Revenues:				
Operating Revenues	\$ 66,698,393	\$ 66,698,393	\$ 70,458,777	\$ 3,760,384
Other Operating Revenues	2,392,340	2,478,154	2,535,303	57,149
Interest	539,533	539,533	396,649	(142,884)
Grants	5,000	5,000	3,022	(1,978)
Non-Operating Revenues	494,809	494,809	452,869	(41,940)
Charges for New Service			143,165	143,165
Total Revenues	70,130,075	70,215,889	73,989,785	3,773,896
Expenditures:				
Production Expenses - Diesel	773,732	854,348	916,557	(62,209)
Purchased Power and Other Power				
Supply Expenses	37,058,627	37,058,627	41,618,787	(4,560,160)
Transmission Expenses	4,137,788	3,964,748	3,711,111	253,637
Distribution Expenses	2,940,746	2,872,603	2,832,211	40,392
Customer Accounts and				
Collection Expenses	1,057,746	1,048,510	1,046,654	1,856
Administrative and General				
Expenses	12,309,588	12,278,287	12,255,212	23,075
Senior Lien Debt Service	8,508,320	8,508,320	8,508,319	1
Junior Lien Debt Service	353,600	353,600	350,908	2,692
Dividend to City of Key West	320,321	320,321	318,394	1,927
Total Expenditures	67,460,468	67,259,364	71,558,153	(4,298,789)
Excess of Revenues Over Expenditures	<u>\$ 2,669,607</u>	<u>\$ 2,956,525</u>	2,431,632	<u>\$ (524,893)</u>
Adjustments:				
Depreciation			(6,367,595)	
Principal Portion of Budgeted Debt Service			5,070,000	
Capitalized Overhead			1,642,454	
Interest Accrued but Unfunded			(1,266,601)	
Amortization of Issuance Costs			(104,508)	
Capital Contributions			146,587	
Amortization of Loss on Refunding Bonds			(60,627)	
Change in Net Assets, GAAP Basis			<u>\$ 1,491,342</u>	



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

**INDEPENDENT AUDITORS' REPORT ON COMPLIANCE WITH BOND
COVENANTS**

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

We have audited, in accordance with United States generally accepted auditing standards, the Balance Sheets of the Utility Board of the City of Key West, Florida, d/b/a Keys Energy Services, ("KEYS") as of September 30, 2003 and 2002 and the related Statements of Revenues, Expenses and Changes in Net Assets for the years then ended, and have issued our report thereon dated January 13, 2004.

In connection with our audits, nothing came to our attention that caused us to believe that the Utility Board of the City of Key West, Florida failed to comply with the terms, covenants, provisions, or conditions of Section 5.01 of Resolution No. 532 dated November 13, 1985, as amended and supplemented, as far as they relate to accounting matters. However, it should be noted that our audits were not directed primarily toward obtaining knowledge of such noncompliance.

This report is intended solely for the information and use of the Utility Board, management and others within KEYS, and officials of applicable Federal and State agencies and should not be used for any other purpose.

Oropeza & Parks
OROPEZA & PARKS
CERTIFIED PUBLIC ACCOUNTANTS

January 13, 2004

REPORT ON COMPLIANCE AND ON INTERNAL CONTROL OVER FINANCIAL REPORTING BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

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

We have audited the 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 year ended September 30, 2003, and have issued our report thereon dated January 13, 2004. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether KEYS' financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered KEYS' internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

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

This report is intended solely for the information and use of the Utility Board, management, federal awarding agencies and pass-through entities, is not intended to be, and should not be used by anyone other than these specified parties.

Oropeza & Parks

OROPEZA & PARKS
CERTIFIED PUBLIC ACCOUNTANTS

January 13, 2004