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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 ("KEYS") as of and for the years ended September 30, 2002 and 2001 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 United States generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. 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, as of September 30, 2002 and 2001, and the results of its operations and cash flows for the years then ended in conformity with United States generally accepted accounting principles.

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 made 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 December 2, 2002 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.



Marva Green P.A., Inc.  
Certified Public Accountants

December 2, 2002

## 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, 2002. 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 2002 by \$2.1 million, or 4.1%, which consisted of a \$5.5 million decrease in Total Assets offset by a \$7.6 million decrease in Total Liabilities. The principal impact came from a \$8.2 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 \$273,584 or 0.2%. Utility Plant increased by \$2.6 million or 1.5% while Accumulated Depreciation increased \$2.5 million or 3.0%. More detailed information about changes in utility plant is presented in the Notes to the Financial Statements.

	2002	2001	Increase (Decrease)	
			Amount	Percent
Net Property, Plant and Equipment	\$ 115,971,097	\$ 115,697,513	\$ 273,584	0.2%
Restricted Assets	21,557,613	26,319,959	(4,762,346)	-18.1%
Current and Other Assets	<u>17,086,313</u>	<u>18,113,747</u>	<u>(1,027,434)</u>	<u>-5.7%</u>
Total Assets	<u>\$ 154,615,023</u>	<u>\$ 160,131,219</u>	<u>\$ (5,516,196)</u>	<u>-3.4%</u>
Invested in Capital Assets, net of related debt	\$ 34,953,312	\$ 26,426,478	\$ 8,526,834	32.3%
Restricted for Debt Service	9,577	154,460	(144,883)	-93.8%
Unrestricted	<u>17,905,602</u>	<u>24,222,061</u>	<u>(6,316,459)</u>	<u>-26.1%</u>
Net Assets	<u>52,868,491</u>	<u>50,802,999</u>	<u>2,065,492</u>	<u>4.1%</u>
Long-Term Debt, Net of Current Portion	85,079,540	93,308,207	(8,228,667)	-8.8%
Liabilities Payable from Restricted Assets	11,215,528	10,637,211	578,317	5.4%
Current Liabilities and Deferred Revenue	<u>5,451,464</u>	<u>5,382,802</u>	<u>68,662</u>	<u>1.3%</u>
Total Liabilities	<u>101,746,532</u>	<u>109,328,220</u>	<u>(7,581,688)</u>	<u>-6.9%</u>
Total Net Assets and Liabilities	<u>\$ 154,615,023</u>	<u>\$ 160,131,219</u>	<u>\$ (5,516,196)</u>	<u>-3.4%</u>

### Statement of Revenues, Expenses, and Changes in Net Assets

Total Revenues of \$68.6 million were \$4.5 million or 6.2% below the 2001 level of \$73.1 million. Operating Revenues, which consist primarily of electricity sales, decreased from \$70.0 million in 2001 to \$66.7 million in 2002, or by 4.8%. Electric Revenues, which is the largest segment, were \$58.8 million compared to \$58.0 million or 1.3% higher. On a MWh basis, sales of electricity during 2002 were 703,633, 32,770, or 4.9% above the 2001 level of 670,863. Power Cost Adjustment Revenue was \$5.6 million, which decreased by \$4.1 million or 42.3% due to the lower cost of energy. Non-Operating Revenue of \$1.9 million was \$1.2 million less than the 2001 level because of lower rates achieved on investable balances.

Total Expenses of \$66.6 million were above the 2001 level by \$1.5 million or 2.4%. Operating Expenses in 2002 were \$60.5 million compared to the 2001 level of \$58.6 million. The increase of \$1.9 million, or 3.3%, was primarily due to Administrative & General Expense, which was \$2.5 million or 41.5% higher primarily because of an increase in the required pension contribution, less G&A transferred to capital projects, and higher insurance costs. Purchased Power expense was \$35.4 million, which was 3.3% below the 2001 level. Purchased Power expenses, expressed in mills per 1,000 kWh sold, were 50.28 in 2002 versus 54.53 in 2001. The payment to the City of Key West was slightly higher as a result of the Bond Resolution formula calculation.

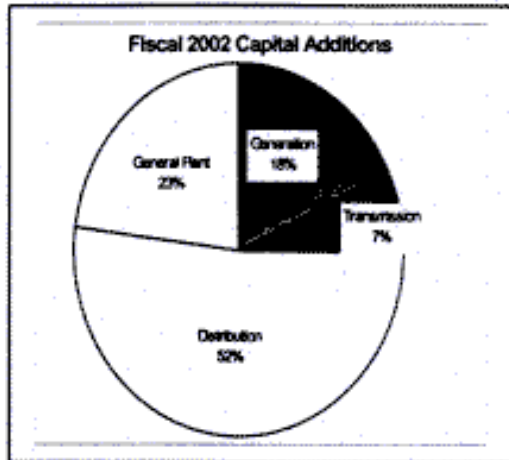
The Change in Net Assets was \$2.1 million in 2002, which consisted of Income before Capital Contributions of \$2.0 million and Capital Contributions of \$0.1 million.

	2002	2001	Increase (Decrease)	
			Amount	Percent
Electric Revenues	\$64,455,430	\$67,800,954	(\$3,345,524)	-4.9%
Other Electric Revenues	<u>2,202,083</u>	<u>2,187,068</u>	<u>15,015</u>	<u>0.7%</u>
Operating Revenues	66,657,513	69,988,022	(3,330,509)	-4.8%
Non-Operating Revenues	<u>1,929,387</u>	<u>3,134,405</u>	<u>(1,205,018)</u>	<u>-38.4%</u>
Total Revenues	<u>68,586,900</u>	<u>73,122,427</u>	<u>(4,535,527)</u>	<u>-6.2%</u>
Operating Expenses	60,511,162	58,585,178	1,925,984	3.3%
Non-Operating Expenses	334,485	323,851	10,634	3.3%
Debt Expenses	<u>5,803,084</u>	<u>6,196,041</u>	<u>(392,957)</u>	<u>-6.3%</u>
Total Expenses	<u>66,648,731</u>	<u>65,105,070</u>	<u>1,543,661</u>	<u>2.4%</u>
Income Before Capital Contributions	1,938,169	8,017,357	(6,079,188)	-75.8%
Capital Contributions	<u>127,323</u>	<u>185,059</u>	<u>(57,736)</u>	<u>-31.2%</u>
Change in Net Assets	2,065,492	8,202,416	(6,136,924)	-74.8%
Net Assets, Beginning of Year	<u>50,802,999</u>	<u>42,600,583</u>	<u>8,202,416</u>	<u>19.3%</u>
Net Assets, End of Year	<u>\$ 52,868,491</u>	<u>\$ 50,802,999</u>	<u>\$ 2,065,492</u>	<u>4.1%</u>

### 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 2002. The same situation held true for the prior fiscal year. Although Income Before Capital Contributions decreased \$6.1 million, the Utility increased net assets by \$2.1 million while paying down debt by \$8.3 million.

## Significant Capital Assets



Total Property, Plant and Equipment was \$198.6 million at September 30, 2002, compared to \$196.0 million at September 30, 2001, or an increase of \$2.6 million. Significant projects placed in service occurred in Distribution Plant-pole replacements and upgrades, Generation Plant-Combustion Turbine No. 1 Mark V Controls and Medium Speed Diesel Upgrade, Transmission Plant-Area Pole Foundations, and General Plant-New Warehouse and Key West Diesel Plant Roof. Major retirements occurred in General Plant. The Construction in Progress account was \$2.3 million at fiscal year end 2002 related to projects involving Distribution Plant-Substation Upgrades, General Plant-Replace Company Vehicles, and Transmission Plant-Relay Upgrade. Please see Note 1 in Notes to Financial Statements for further information.

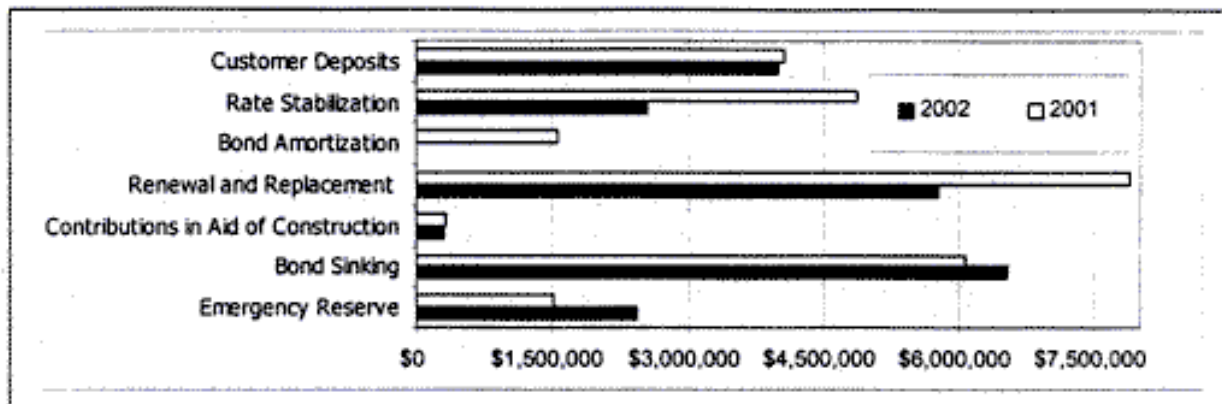
## Long Term Debt

The Utility's trustee paid to the bondholders a principal payment of \$4.0 million on October 1, 2001. 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 "restricted assets." The bondholders are then 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 November 14, 2001, the Utility Board authorized the early redemption of the remaining \$3.6 million of Electric System Refunding Bonds, Series 1993. Additionally, 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 \$21.5 million at September 30, 2002, compared to \$26.3 million at September 30, 2001. 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 \$4.8 million or 18.1% primarily because Rate Stabilization funds were used to redeem outstanding Revenue Bonds Series 1993 and the Bond Amortization fund, which consisted of U.S. Treasury Bonds, were called and used to redeem Refunding Revenue Bonds Series 1987.



### Overall Analysis of Financial Position and Results of Operations

The Utility's overall financial position in 2002 improved as shown by the Net Assets increase of \$2.1 million, or 4.1%. The net change consisted of a \$5.5 million decrease in Total Assets offset by a \$7.6 million decrease in Total Liabilities. The major component of the decrease in Total Assets resulted from using the Bond Amortization Fund and a portion of the Rate Stabilization Fund to redeem high interest debt, thus lowering the debt service requirement in future years. The principal impact in Total Liabilities came from a \$8.2 million decrease in Long-Term Debt, Net of Current Portion.

Sales of Electricity in 2002 showed positive gains in the residential, commercial, military segments. On a MWh basis, total sales of electricity were 703,633 or 4.9% above the 2001 level of 670,863 as a result of higher than normal temperatures. The increase in sales, combined with budgetary control, sales tax credit, and early redemption of outstanding bonds contributed to the Income Before Capital Contribution increase of \$2.0 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, 2002 AND 2001

ASSETS

	<u>2002</u>	<u>2001</u> <u>(As Restated)</u>
Property, Plant and Equipment:		
Utility Plant	\$ 179,362,512	\$ 176,785,300
Non-Utility Plant	<u>19,284,211</u>	<u>19,284,211</u>
Total Property, Plant and Equipment	198,646,723	196,069,511
Less Accumulated Depreciation	<u>85,012,102</u>	<u>82,530,022</u>
	113,634,621	113,539,489
Construction in Progress	<u>2,336,476</u>	<u>2,158,024</u>
Net Property, Plant and Equipment	<u>115,971,097</u>	<u>115,697,513</u>
Restricted Assets:		
Cash and Cash Equivalents	7,752,672	3,233,161
Investments	13,804,941	23,043,478
Interest Receivable	<u>-</u>	<u>43,320</u>
Total Restricted Assets	<u>21,557,613</u>	<u>26,319,959</u>
Current Assets:		
Cash and Cash Equivalents	815,390	642,427
Investments	2,259,289	1,121,656
Customer Accounts Receivable, net of Allowance for Bad Debts of \$129,710 and \$147,216 for 2002 and 2001 respectively	4,514,931	6,149,240
Other Accounts Receivable	236,388	574,487
Due From Other Governments	5,000	-
Plant Material and Operating Supplies Inventory	3,408,455	3,282,355
Prepaid Expenses	<u>568,529</u>	<u>355,942</u>
Total Current Assets	<u>11,807,982</u>	<u>12,126,107</u>
Other Assets:		
Investments	4,055,554	4,506,094
Bond Discount and Issue Costs, Net	<u>1,222,777</u>	<u>1,481,546</u>
Total Other Assets	<u>5,278,331</u>	<u>5,987,640</u>
Total Assets	<u>\$ 154,615,023</u>	<u>\$ 160,131,219</u>

(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, 2002 AND 2001

NET ASSETS AND LIABILITIES

	<u>2002</u>	<u>2001</u> <u>(As Restated)</u>
Net Assets:		
Invested in Capital Assets, net of related debt	\$ 34,953,312	\$ 26,426,478
Restricted for Debt Service	9,577	154,460
Unrestricted	<u>17,905,602</u>	<u>24,222,061</u>
Total Net Assets	<u>52,868,491</u>	<u>50,802,999</u>
Long-Term Debt, Net of Current Portion:		
Revenue Bonds	75,233,511	83,636,135
Accrued Interest	9,506,029	8,992,072
Loan Payable	<u>340,000</u>	<u>680,000</u>
Total Long-Term Debt	<u>85,079,540</u>	<u>93,308,207</u>
Liabilities Payable from Restricted Assets:		
Current Portion of Long-Term Debt	4,790,611	4,240,611
Accounts Payable	424,638	268,384
Accrued Interest	1,998,716	2,069,870
Due to Customers	<u>4,001,563</u>	<u>4,058,346</u>
Total Liabilities Payable from Restricted Assets	<u>11,215,528</u>	<u>10,637,211</u>
Current Liabilities:		
Accounts Payable	3,864,900	3,917,568
Due to Other Governments	224,018	-
Accrued Expenses	<u>1,250,345</u>	<u>1,190,933</u>
Total Current Liabilities	<u>5,339,263</u>	<u>5,108,501</u>
Deferred Revenue	<u>112,201</u>	<u>274,301</u>
Total Liabilities	<u>101,746,532</u>	<u>109,328,220</u>
Total Net Assets and Liabilities	<u>\$ 154,615,023</u>	<u>\$ 160,131,219</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, 2002 AND 2001

	<u>2002</u>	<u>2001</u> <u>(As Restated)</u>
Operating Revenues	\$ 66,657,513	\$ 69,988,022
Operating Expenses:		
Production Expenses - Diesel	779,761	816,946
Purchased Power	35,379,069	36,585,038
Transmission Expenses	3,485,983	3,589,637
Distribution Expenses	3,241,386	3,143,081
Customer Accounts and Collection Expenses	985,698	1,033,617
Administrative and General Expenses	8,460,644	5,977,699
Depreciation	6,500,687	5,680,618
Taxes Other than Income Taxes	1,677,934	1,758,542
Total Operating Expenses	<u>60,511,162</u>	<u>58,585,178</u>
Operating Income	<u>6,146,351</u>	<u>11,402,844</u>
Non-Operating Revenue and Expenses:		
Interest Income	655,969	1,815,338
Grant Revenue	6,500	193,019
Miscellaneous Non-Operating Revenue	1,266,918	1,126,048
Payment to City of Key West	(334,485)	(323,851)
Total Non-Operating Revenue and Expenses	<u>1,594,902</u>	<u>2,810,554</u>
Income Before Debt Expenses	<u>7,741,253</u>	<u>14,213,398</u>
Debt Expenses:		
Interest	5,543,381	6,068,327
Amortization of Bond Discount and Issue Costs	259,703	127,714
Total Debt Expenses	<u>5,803,084</u>	<u>6,196,041</u>
Income Before Capital Contributions	1,938,169	8,017,357
Capital Contributions	<u>127,323</u>	<u>185,059</u>
Change in Net Assets	2,065,492	8,202,416
Net Assets, Beginning of Year	<u>50,802,999</u>	<u>42,600,583</u>
Net Assets, End of Year	<u>\$ 52,868,491</u>	<u>\$ 50,802,999</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, 2002 AND 2001

Increase (Decrease) in Cash and Cash Equivalents

	<u>2002</u>	<u>2001</u> <u>(As Restated)</u>
Cash Flows Provided (Used by) Operating Activities:		
Cash Received from Customers	\$ 66,934,258	\$ 66,882,304
Cash Payments to Suppliers for Goods and Services	(45,406,189)	(43,733,167)
Cash Payments to Employees for Services	(7,037,602)	(6,783,060)
Cash Received for Deposits	790,022	788,628
Cash Deposits Refunded	(846,805)	(1,121,071)
Cash Received for Taxes	1,611,989	1,707,508
Cash Paid for Taxes	(1,702,017)	(1,730,321)
Cash Received from Other Operating Sources	<u>646,533</u>	<u>1,431,601</u>
Net Cash Provided by Operating Activities	<u>14,990,189</u>	<u>17,442,422</u>
Cash Flows Provided (Used by) Non-Capital Financing Activities:		
Cash Received from Operating Grants	225,518	536,333
Cash Paid to City of Key West, Florida	<u>(334,485)</u>	<u>(323,851)</u>
Net Cash Provided (Used by) Non-Capital Financing Activities	<u>(108,967)</u>	<u>212,482</u>
Cash Flows Provided (Used by) Capital and Related Financing Activities:		
Proceeds from Issuance of Long-Term Debt	-	921,056
Principal Paid on Long-Term Debt	(8,253,250)	(8,845,000)
Interest Paid on Revenue Bond Maturities	(5,040,886)	(4,202,722)
Contributions in Aid of Construction	127,323	185,059
Acquisition and Construction of Capital Assets	(6,497,392)	(12,933,015)
Cost of Bond Issuance	<u>(24,453)</u>	<u>(85,188)</u>
Net Cash (Used by) Capital and Related Financing Activities	<u>(19,688,658)</u>	<u>(24,959,810)</u>
Cash Flows Provided (Used by) Investing Activities:		
Purchase of Investments	(6,703,136)	(18,405,402)
Redemption of Investments	15,254,580	1,019,741
Interest Received on Investments	<u>948,466</u>	<u>1,999,812</u>
Net Cash Provided (Used by) Investing Activities	<u>9,499,910</u>	<u>(15,385,849)</u>
Net Increase (Decrease) in Cash and Cash Equivalents	4,692,474	(22,690,755)
Cash and Cash Equivalents at Beginning of Year	<u>3,875,588</u>	<u>26,566,343</u>
Cash and Cash Equivalents at End of Year	<u>\$ 8,568,062</u>	<u>\$ 3,875,588</u>

(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 (Continued)

FOR THE YEARS ENDED SEPTEMBER 30, 2002 AND 2001

Reconciliation of Operating Income to  
Net Cash Provided by Operating Activities

	<u>2002</u>	<u>2001</u> <u>(As Restated)</u>
Operating Income	\$ 6,146,351	\$ 11,402,844
Adjustments to Reconcile Operating Income To Net Cash Provided by Operating Activities:		
Depreciation	6,500,687	5,680,618
Provision for Uncollectible Accounts	113,273	106,224
Amortization of Deferred Revenue	(221,482)	(13,957)
Receipt of Deferred Revenue	59,382	205,738
Other Operating Sources of Revenues	808,633	1,367,015
Changes in Assets and Liabilities:		
(Increase) Decrease in Accounts Receivable	1,491,418	(1,385,507)
(Increase) in Plant Material, Inventory and Fuel Stock	(126,100)	(344,067)
(Increase) Decrease in Prepaid Expenses	(212,587)	189,229
Increase (Decrease) in Accounts Payable	(28,215)	442,165
Increase in Accrued Expenses	515,612	124,563
(Decrease) in Amounts Due to Customers	(56,783)	(332,443)
Total Adjustments	<u>8,843,838</u>	<u>6,039,578</u>
Net Cash Provided by Operating Activities	<u>\$ 14,990,189</u>	<u>\$ 17,442,422</u>

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

In 2002 and 2001, amortization of bond discount and issue costs was \$259,703 and \$127,714, respectively.

In 2001, the change in fair value of investments was \$147,583.

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

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

SEPTEMBER 30, 2002 AND 2001

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 also 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 on the basis of 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

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

SEPTEMBER 30, 2002 AND 2001

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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.

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. All other budget changes are approved by the Utility Board. Supplemental appropriations were necessary and the budgetary data presented herein was amended by the Utility Board in accordance with KEYS' policies. 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. KEYS' investment policies are governed by Florida

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

SEPTEMBER 30, 2002 AND 2001

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Statutes. These policies are described in more detail in Note 3.

Revenue - Revenue is recognized on the basis of 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 at such time as property is removed from service.

The following is a summary of property, plant and equipment for the year ended September 30, 2002:

	Balance 2001 (As Restated)	Additions	Deletions	Balance 2002
Utility Plant in Service:				
Generation Plant	\$ 46,125,174	\$ 1,185,129	\$ 42,621	\$ 47,267,682
Transmission Plant	70,660,538	490,978	-	71,151,516
Distribution Plant	46,098,068	3,392,264	1,329,121	48,161,211
General Plant	13,681,256	1,527,448	2,646,865	12,561,839
Other	220,264	-	-	220,264
	<u>176,785,300</u>	<u>6,595,819</u>	<u>4,018,607</u>	<u>179,362,512</u>
Accumulated Depreciation - Utility Plant	(66,255,584)	(6,500,687)	(4,018,607)	(68,737,664)
Net Utility Plant In Service	<u>110,529,716</u>	<u>95,132</u>	<u>-</u>	<u>110,624,848</u>
Non-Utility Plant	19,284,211	-	-	19,284,211
Accumulated Depreciation - Non Utility Plant	(16,274,438)	-	-	(16,274,438)
Net Non-Utility Plant	<u>3,009,773</u>	<u>-</u>	<u>-</u>	<u>3,009,773</u>
Construction Work In Progress	2,158,024	6,774,271	6,595,819	2,336,476
Total Net Property, Plant and Equipment	<u>\$115,697,513</u>	<u>\$ 6,869,403</u>	<u>\$ 6,595,819</u>	<u>\$115,971,097</u>

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

SEPTEMBER 30, 2002 AND 2001

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

In order to meet the requirements of the Federal Energy Regulatory Commission ("FERC") Order 2000, KEYS conducted a review of the classification of its generating, transmission and distribution equipment as compared to the classifications mandated by FERC. It was determined that the synchronous condenser should be classified as transmission equipment as its primary function is to provide stability to the transmission line. It was previously classified as distribution equipment.

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 2002 and 2001, 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
Non-Utility Plant	Not in Service

Inventory - Inventories are stated at the lower of cost (determined on a 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, 2002, annual vacation leave earned but not taken is \$355,163 and sick leave accumulated but not taken is \$529,650.

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 is charges to customers for sales and services.

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

SEPTEMBER 30, 2002 AND 2001

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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, 2002 and 2001 is summarized as follows:

	<u>2002</u>	<u>2001</u>
Electric Refunding Revenue Bonds, Series 1987	\$ 76,236	\$ 72,108
Electric Refunding Revenue Bonds, Series 1991	1,181,480	1,697,692
Electric Revenue Bonds, Series 1993	130,850	194,600
Electric Forward Refunding Revenue Bonds, Series 2000	3,525,735	3,634,570
Electric Forward Refunding Revenue Bonds, Series 2001	471,695	119,555
Series 2000 Net Loss on Refunding/Premium	-	2,032
Series 2001 Loss on Refunding	60,626	17,204
Interest on Customer Deposits	74,701	279,568
FMPA Pooled Loan	<u>22,058</u>	<u>50,998</u>
Total Interest Expense	<u>\$ 5,543,381</u>	<u>\$ 6,068,327</u>

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.

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

SEPTEMBER 30, 2002 AND 2001

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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, 2002 and 2001, the board has designated \$486,589 and \$389,812 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 to be a unit of local government.

Prior-Period Information - Certain prior-year amounts have been reclassified to conform to the current year's financial statement presentation.

NOTE 2 - RESTRICTED ASSETS

Certain assets consisting of cash, cash equivalents, investments and interest receivable are restricted by bond resolutions; additionally, some assets have been classified as restricted in accordance with government accounting standards for enterprise funds and utility industry accounting practices.

KEYS' restricted assets as of September 30, 2002 and 2001 consist of the following:

	<u>2002</u>		<u>2001</u>	
	<u>Restricted Assets</u>	<u>Interest Earned</u>	<u>Restricted Assets</u>	<u>Interest Earned</u>
Emergency Reserve Fund	\$ 2,426,794	\$ 46,181	\$ 1,510,791	\$ 96,656
Sinking Fund	6,518,293	70,043	6,063,347	135,719
Contributions in Aid of Construction Fund	297,467	5,534	328,211	14,662
Renewal and Replacement Fund	5,763,814	147,675	7,878,696	516,157
Bond Amortization Fund	-	52,932	1,587,306	121,946
Rate Stabilization Fund	2,541,643	49,284	4,872,242	215,795
Customer Deposits Fund	4,009,602	83,927	4,079,366	277,250
Total	<u>\$ 21,557,613</u>	<u>\$ 455,576</u>	<u>\$ 26,319,959</u>	<u>\$ 1,378,185</u>

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

SEPTEMBER 30, 2002 AND 2001

NOTE 2 - RESTRICTED ASSETS (Continued)

KEYS is required by revenue bond covenants to maintain a debt service reserve account in the amount of its highest annual debt service, which requirement is satisfied by a debt surety bond.

NOTE 3 - CASH, CASH EQUIVALENTS, AND INVESTMENTS

KEYS' investment policies are governed by State Statutes. 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.

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

SEPTEMBER 30, 2002 AND 2001

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

For purposes of the statement of cash flows, KEYS considers all highly 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, 2002. Therefore, the investment was valued at amortized cost and the fair value at September 30, 2002 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, 2002 and 2001. Category 1 includes investments that are insured or registered or for which the securities are held by the counterparty's or its agent in KEYS' name. Category 2 includes uninsured and unregistered investments for which the securities are held by the counterparty's trust department or agent in KEYS' name. 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.

<u>2002</u>	<u>Category</u>			<u>Carrying Amount</u>	<u>Fair Value</u>
	<u>1</u>	<u>2</u>	<u>3</u>		
Guaranteed Income Contract	\$ N/A	\$ N/A	\$ N/A	\$ 1,035,667	\$ 1,035,667
Local Government Surplus Trust Fund	N/A	N/A	N/A	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

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

SEPTEMBER 30, 2002 AND 2001

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

<u>2001</u>	<u>Category</u>			<u>Carrying Amount</u>	<u>Fair Value</u>
	<u>1</u>	<u>2</u>	<u>3</u>		
Guaranteed Income Contract	\$ N/A	\$ N/A	\$ N/A	\$ 1,488,046	\$ 1,488,046
U.S. Government Securities	-	3,587,460	-	3,587,460	3,836,637
Local Government Surplus Trust Fund	-	-	N/A	21,046,879	21,046,879
Repurchase Agreements	-	-	2,548,843	2,548,843	2,548,843
Total	\$ -	\$ 3,587,460	\$ 2,548,843	\$ 28,671,228	\$ 28,920,405

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, 2002 and 2001 are \$8,568,062 and \$3,875,588 respectively.

NOTE 4 - NON-UTILITY PLANT

The Key West Steam Plant, which has a cost of \$19,284,211 and accumulated depreciation at \$16,274,438 at September 30, 2002, has been idle since 1991. The plant has been decommissioned at a cost of \$2,055,702.

The Utility Board executed a Memorandum of Understanding in August, 2002 with a potential developer for a long-term 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 is currently procuring financing and permitting for the project. The proposed project is scheduled for completion in year 2005.

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

SEPTEMBER 30, 2002 AND 2001

NOTE 5 - LONG-TERM DEBT

Revenue Bonds:	<u>2002</u>	<u>2001</u>
Electric System Refunding Revenue Bonds, Series 1987, collateralized by Net Revenues and certain Reserve Funds. The Utility Board authorized early redemption during fiscal year 2002.	\$ -	\$ 348,250
Electric System Refunding Revenue Bonds, Series 1991, collateralized by Net Revenues and certain Reserve Funds, payable October 1, 2002 to October 1, 2018 in installments of various amounts, bearing interest at rates from 6.4% to 7.1%.	8,077,785	8,672,785
Electric System Refunding Revenue Bonds, Series 1993, collateralized by Net Revenues and certain Reserve Funds. The Utility Board authorized early redemption during fiscal year 2002.	-	4,025,000
Electric System Refunding Revenue Bonds, Series 2000, collateralized by Net Revenues and certain Reserve Funds, payable October 1, 2002 to October 1, 2013 in installments of various amounts, bearing interest at rates from 5.25% to 6.0%.	60,685,000	63,405,000
Electric System Refunding Revenue Bonds, Series 2001, collateralized by Net Revenues and certain Reserve Funds, payable from October 1, 2002 to October 1, 2013 in installments of various amounts, interest at rates from 3.0% to 5.0%.	11,575,000	11,800,000
Deferred Loss on Refunding-net, amortized on the straight line basis over the term of the Series 2001 Revenue Bonds	(653,663)	(714,289)
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 1.10%).	680,000	1,020,000
Total Long-Term Debt	80,364,122	88,556,746
Less Current Portion	4,790,611	4,240,611
Net Long-Term Debt	<u>\$ 75,573,511</u>	<u>\$ 84,316,135</u>

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

SEPTEMBER 30, 2002 AND 2001

NOTE 5 - LONG-TERM DEBT (Continued)

Changes in Long-Term Debt during 2002 are as follows:

	<u>2001</u>	<u>Additions</u>	<u>Retired</u>	<u>2002</u>
Series 1987	\$ 348,250	\$ -	\$ 348,250	\$ -
Series 1991	8,672,785	-	595,000	8,077,785
Series 1993	4,025,000	-	4,025,000	-
Series 2000, net	63,405,000	-	2,720,000	60,685,000
Series 2001, net	11,085,711	-	164,374	10,921,337
FMPA Loan	<u>1,020,000</u>	<u>-</u>	<u>340,000</u>	<u>680,000</u>
	<u>\$ 88,556,746</u>	<u>\$ -</u>	<u>\$ 8,192,624</u>	<u>\$ 80,364,122</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 7 for the rate covenant pertaining to revenues.

Summary of Debt Service Funding Requirements to Maturity  
(In Thousands of Dollars)

<u>Years Ended</u> <u>October 1</u>	<u>Interest</u>	<u>Principal</u>	<u>Total</u>
2003	\$ 3,778	\$ 4,730	\$ 8,508
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 - 2012	7,597	34,354	41,951
2013 - 2017	31,581	13,883	45,464
2018	<u>7,879</u>	<u>1,391</u>	<u>9,270</u>
	<u>\$ 63,344</u>	<u>\$ 75,828</u>	<u>\$ 139,172</u>

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

SEPTEMBER 30, 2002 AND 2001

NOTE 5 - LONG-TERM DEBT (Continued)

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, 2002 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, 2002 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 to be 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.

NOTE 6 - 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, 2002, \$33,826,530 of bonds outstanding relative to the 1980C, 1983, 1984 and 1980D issues.

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

SEPTEMBER 30, 2002 AND 2001

NOTE 6 - PRIOR YEAR DEFEASANCE OF DEBT (Continued)

\$19,674,913 relative to the 1985 issue, \$24,415,377 relative to the 1987 issue, \$15,141,919 relative to the 1988 issue, and \$10,450,000 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 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'

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

SEPTEMBER 30, 2002 AND 2001

NOTE 8 - PENSION PLAN (Continued)

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 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.

Annual Pension Cost and Net Pension Obligation - KEYS' annual contribution for the calendar year 2002 of \$1,670,857 was determined as part of the January 1, 2002 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 6.0% 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, 2002 was 30 years.

(1) Valuation Date	(2) Actuarial Value of Assets (AVA)	(3) Entry Age Normal Actuarial Accrued Liability	(4) (Overfunded) Unfunded Actuarial Accrued Liability (UVAL) (3)-(2)	(5) Funded Ratio (2)/(3)	(6) Annual Covered Payroll	(7) (Overfunded) Unfunded UVAL as % of Payroll (4)/(6)
January 1, 1993	\$ 22,760	\$ 23,715	\$ 955	96.0%	\$ 5,964	16.0%
January 1, 1994	\$ 25,161	\$ 25,589	\$ 428	98.3%	\$ 6,264	6.8%
January 1, 1995	\$ 24,597	\$ 27,329	\$ 2,732	90.0%	\$ 6,256	43.7%
January 1, 1996	\$ 30,143	\$ 32,190	\$ 2,047	93.6%	\$ 5,783	35.4%
January 1, 1997	\$ 34,436	\$ 33,475	\$ (961)	102.9%	\$ 5,866	-(16.4%)
January 1, 1998	\$ 40,933	\$ 34,826	\$ (6,107)	117.5%	\$ 6,038	-(101.1%)
January 1, 1999	\$ 48,032	\$ 40,295	\$ (7,737)	119.2%	\$ 6,127	-(126.3%)
January 1, 2000	\$ 53,398	\$ 41,776	\$ (11,622)	127.8%	\$ 6,168	-(188.4%)
January 1, 2001	\$ 52,329	\$ 48,646	\$ (3,683)	107.6%	\$ 6,398	-(57.6%)
January 1, 2002	\$ 49,513	\$ 50,720	\$ 1,207	97.60%	\$ 6,764	17.80%

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

SEPTEMBER 30, 2002 AND 2001

NOTE 8 - PENSION PLAN (Continued)

Schedule of Contributions

<u>Plan Year</u>	<u>Annual Required Contribution</u>	<u>Percentage Contributed</u>
1999	\$ 624,849	212%
2000	\$ 384,057	268%
2001	\$ 1,245,998	100%

KEYS had no net pension obligation for the years ended December 31, 2001, 2000, and 1999.

NOTE 9 - LEASES

Rent expense under cancelable operating leases was \$105,584 and \$79,853 in 2002 and 2001, respectively.

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 this criteria through a combination of KEYS' 50.4 MW of existing generating resources and two 17.5 MW combustion turbine units that are owned by FMPA. 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

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

SEPTEMBER 30, 2002 AND 2001

NOTE 10 - PURCHASED POWER COMMITMENTS (Continued)

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.

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

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

SEPTEMBER 30, 2002 AND 2001

NOTE 10 - PURCHASED POWER COMMITMENTS (Continued)

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 Southernmost unit is purchased by KEYS on a "take-and-pay" basis at KEYS' average energy cost, including fuel and purchased power capacity and energy costs. This facility is considered by KEYS to be a non-firm capacity resource.

NOTE 11 - 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.

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

SEPTEMBER 30, 2002 AND 2001

NOTE 11 - JOINT INVESTMENT (Continued)

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 will be required to 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 on the basis of the allocation percentages. Once parity of

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

SEPTEMBER 30, 2002 AND 2001

NOTE 11 - JOINT INVESTMENT (Continued)

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 12 - 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 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

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

SEPTEMBER 30, 2002 AND 2001

NOTE 12 - COMMITMENTS AND CONTINGENCIES (Continued)

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 13 - NAVY CONTRACT

The United States Navy is the largest customer of KEYS and accounted for approximately 9.4% and 9.9% of operating revenues in 2002 and 2001 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 2004 subject to certain termination and renegotiation provisions.

NOTE 14 - 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.

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

SEPTEMBER 30, 2002 AND 2001

NOTE 14 - REGULATION (Continued)

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 be in compliance 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 15 - POST RETIREMENT 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. Substantially all of KEYS' employees hired

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

NOTES TO FINANCIAL STATEMENTS

SEPTEMBER 30, 2002 AND 2001

NOTE 15 - POST RETIREMENT HEALTH CARE BENEFITS (Continued)

before June 9, 1999 are eligible for these benefits if they qualify for retirement status while working for KEYS. At September 30, 2002, 107 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 \$453,616 and \$352,681 for 2002 and 2001, respectively.

NOTE 16 - 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

SEPTEMBER 30, 2002 AND 2001

	<u>2002</u>	<u>2001</u>
Operating Revenues:		
Electric Revenues	\$ 58,830,688	\$ 58,049,636
Power Cost Adjustment	5,624,742	9,751,318
Service Charges	158,049	153,693
Penalty Charges	387,600	515,682
Reserve Capacity Charges	1,598,265	1,471,961
Other	<u>58,169</u>	<u>45,732</u>
Total	<u>66,657,513</u>	<u>69,988,022</u>
Other Income:		
Interest	655,969	1,815,338
Grant Revenue	6,500	193,019
Miscellaneous Non-Operating Revenue	1,094,141	1,079,723
Charges for New Service	<u>172,777</u>	<u>46,325</u>
Total Other Income	<u>1,929,387</u>	<u>3,134,405</u>
Total Revenues	<u>\$ 68,586,900</u>	<u>\$ 73,122,427</u>

UTILITY BOARD OF THE CITY OF KEY WEST, FLORIDA

SCHEDULE OF REVENUES AND EXPENDITURES - BUDGET TO ACTUAL

FOR THE YEAR ENDED SEPTEMBER 30, 2002

	Budget		Actual	Variance- Favorable (Unfavorable)
	Original	Final		
Revenues:				
Operating Revenues	\$67,390,689	\$67,390,689	\$64,455,430	\$ (2,935,259)
Other Operating Revenues	2,547,755	2,559,255	2,374,860	(184,395)
Interest	1,240,536	1,240,536	603,037	(637,499)
Non-Operating Revenues	<u>279,037</u>	<u>527,761</u>	<u>1,100,641</u>	<u>572,880</u>
Total Revenues	<u>71,458,017</u>	<u>71,718,241</u>	<u>68,533,968</u>	<u>(3,184,273)</u>
Expenditures:				
Production Expenses - Diesel	727,807	666,131	779,761	(113,630)
Purchased Power and Other Power				
Supply Expenses	38,922,500	38,922,500	35,379,069	3,543,431
Transmission Expenses	3,926,108	3,795,665	3,485,983	309,682
Distribution Expenses	2,891,124	3,147,557	3,241,386	( 93,829)
Customer Accounts and				
Collection Expenses	1,074,248	1,093,043	1,060,399	32,644
Administrative and General				
Expenses	11,118,686	11,481,948	11,814,813	(332,865)
Senior Lien Debt Service	9,003,498	9,003,498	8,616,079	387,419
Junior Lien Debt Service	379,950	379,950	362,057	17,893
Dividend to City of Key West	<u>310,159</u>	<u>310,159</u>	<u>334,485</u>	<u>(24,326)</u>
Total Expenditures	<u>68,354,080</u>	<u>68,800,451</u>	<u>65,074,032</u>	<u>3,726,419</u>
Excess of Revenues Over Expenditures	<u>\$ 3,103,937</u>	<u>\$ 2,917,790</u>	3,459,936	<u>\$ 542,146</u>
Adjustments:				
Depreciation			(6,500,687)	
Principal Portion of Budgeted Debt Service			4,850,000	
Capitalized Overhead			1,676,235	
Interest Accrued but Unfunded			(1,226,986)	
Amortization of Issuance Costs			(259,703)	
Capital Contributions			127,323	
Amortization of Loss on Refunding Bonds			<u>(60,626)</u>	
Change in Net Assets, GAAP Basis			<u>\$ 2,065,492</u>	

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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 as of September 30, 2002 and 2001 and the related Statements of Revenues, Expenses and Changes in Net Assets for the years then ended, and have issued our report thereon dated December 2, 2002.

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, in so 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.



Marva Green P.A., Inc.  
Certified Public Accountants

December 2, 2002

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INDEPENDENT AUDITORS' REPORT ON COMPLIANCE AND ON INTERNAL CONTROL OVER  
FINANCIAL REPORTING

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 ("KES") as of and for the year ended September 30, 2002, and have issued our report thereon dated December 2, 2002. We conducted our audit in accordance with United States generally accepted auditing standards 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 KES' 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 KES' 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.

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

A handwritten signature in black ink, appearing to read "M Green CPA". The signature is fluid and cursive, with the letters "M", "G", and "C" being particularly prominent.

Marva Green P.A., Inc.  
Certified Public Accountants

December 2, 2002

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INDEPENDENT AUDITORS' MANAGEMENT LETTER AND MANAGEMENT'S RESPONSE

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

In planning and performing our audit of the financial statements of the Utility Board of the City of Key West, Florida ("KEYS") for the years ended September 30, 2002 and 2001 we considered KEYS' internal controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. Although our audit was not designed to provide assurance on internal control, we noted no significant matters involving internal control and its operation.

Reported in Prior Year's Management Letter, Not Implemented  
As of September 30, 2002

None

Current Year Findings

Property, Plant and Equipment

Observation: KEYS allocates a portion of its administrative expenses to capital projects as capitalized overhead. Until recently, KEYS kept a separate subsidiary ledger which allocated capitalized overhead by project. Now, all capitalized overhead is posted to one construction work in progress general ledger account with no subsidiary project detail. Overhead attributable to a completed project is calculated at the time of completion and removed from the capitalized overhead "pool." It was noted that the unallocated capitalized overhead account in construction in process had increased, although the 2002 allocable overhead had decreased at a time when the balance of the construction in process account had remained relatively constant from 2001 to 2002. Upon investigation by KEYS staff, it appears that overhead applied to completed projects was understated, and construction work in process overhead was overstated.

Recommendation: KEYS should return to its previous practice of allocating capitalized overhead by each project in process.

Management's Response: Upon conversion to a new financial computer system in November 1998, the stand-alone Construction Work in Progress (CWIP) system was eliminated. The CWIP system was a subsidiary system, which maintained allocated overhead by project. KEYS agrees that it would be advantageous to maintain detailed overhead by project. Commencing FY '03, separate overhead accounts have been established in the existing financial system, which will provide even more project detail than the former CWIP system.

Observation: There were numerous retirements described as sales, although there were no sales proceeds recorded as an addition to accumulated depreciation in accordance with FERC procedures. Proceeds from the sale of fixed assets have been reported as miscellaneous income because of their immaterial amount. In the event that there are material sales proceeds, it is possible that the financial statements will be misstated because established procedures are not in accordance with regulatory financial reporting requirements.

Recommendations: FERC accounting procedures should be followed. If management decides to depart from FERC requirements, the reason for the departure and its materiality to the financial statements should be documented at the time of departure.

Management's Response: KEYS will follow FERC accounting procedures regarding the accounting for proceeds from the sale of assets, beginning October 1, 2002, regardless of the amount involved.

#### Other Required Disclosures

Marva Green was the Auditor in charge for the audit of KEYS. We attest that the auditor in charge met the educational requirements pursuant to Chapter 11.45 Florida Statutes.

KEYS was not in a state of financial emergency as described in Florida Statutes, Section 218.503(1).

KEYS was in compliance with the requirements of Florida Statutes 218.415 concerning local government investment policies.

We have applied financial condition assessment procedures pursuant to the Rules of the Auditor General Section 10.556 (8) and Section 10.554 (1)(g) 6.c.

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

*MG CPA*

Marva Green P.A., Inc.  
Certified Public Accountants

December 2, 2002