

CITY OF LAKELAND, FLORIDA
DEPARTMENT OF ELECTRIC UTILITIES

FINANCIAL STATEMENTS

SEPTEMBER 30, 2005 AND 2004

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INDEPENDENT AUDITORS' REPORT

Honorable Mayor, City Commissioners
and City Manager
City of Lakeland, Florida

We have audited the accompanying financial statements of the Department of Electric Utilities of the City of Lakeland, Florida, as of September 30, 2005 and 2004, as listed in the table of contents. These financial statements are the responsibility of the City's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note A, the financial statements present only the Department of Electric Utilities of the City of Lakeland, Florida, and do not purport to, and do not, present fairly the financial position of the City of Lakeland, Florida, as of September 30, 2005 and 2004, and the changes in its financial position and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Department of Electric Utilities of the City of Lakeland, Florida, as of September 30, 2005 and 2004, and the changes in financial position and cash flows thereof for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note B, the Department of Electric Utilities of the City of Lakeland, Florida has changed its policy for the calculation and classification of prepaid maintenance and inventory costs in 2005.

The *Management's Discussion and Analysis* on pages 3 through 7 is not a required part of the basic financial statements but is supplementary information required by the accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Carter, Belmont + Atkinson, P.A.

February 20, 2006
Lakeland, Florida

CITY OF LAKELAND, FLORIDA
DEPARTMENT OF ELECTRIC UTILITIES

Management's Discussion and Analysis

The Management's Discussion and Analysis section provides a narrative overview of the City of Lakeland's Department of Electric Utilities' (Lakeland Electric) financial activities for the fiscal year ending September 30, 2005. Readers are encouraged to consider the information presented in this section in conjunction with additional information contained in the financial report. The following condensed Balance Sheet and Statement of Revenues, Expenses and Changes in Net Assets summarizes the financial condition and operations of Lakeland Electric for the years ended September 30, 2005 and 2004 respectively:

| | (In Thousands) | |
|--|--------------------|-------------------|
| | September 30 | |
| | 2005 | 2004 |
| <u>Assets</u> | | |
| Utility plant, net | \$ 622,200 | \$ 637,199 |
| Current assets | 137,549 | 112,740 |
| Noncurrent assets | 104,280 | 106,395 |
| | <u>\$ 864,029</u> | <u>\$ 856,334</u> |
| <u>Liabilities and Net Assets</u> | | |
| Current liabilities | \$ 91,740 | \$ 7,635 |
| Noncurrent liabilities | 497,985 | 563,984 |
| Net assets invested in capital assets, net of related debt | 156,244 | 160,701 |
| Unrestricted net assets | 118,060 | 124,014 |
| | <u>\$ 864,029</u> | <u>\$ 856,334</u> |
| <u>Revenues, Expenses and Changes in Net Assets</u> | | |
| OPERATING REVENUES | | |
| Sales of energy - retail | \$ 287,753 | \$ 254,064 |
| Sales of energy and capacity sales - wholesale | 42,333 | 37,724 |
| Other electric operating revenue | 10,444 | 6,774 |
| | <u>340,530</u> | <u>298,562</u> |
| OPERATING EXPENSES | | |
| Fuel and purchased power | 203,486 | 154,285 |
| Energy supply | 22,199 | 21,897 |
| Energy delivery | 16,288 | 17,310 |
| Customer service and accounting | 8,675 | 9,056 |
| Administrative and general | 21,524 | 20,289 |
| Depreciation | 37,502 | 36,429 |
| | <u>309,674</u> | <u>259,266</u> |
| OPERATING INCOME | 30,856 | 39,296 |
| NON-OPERATING ACTIVITY | | |
| Investment and other income | 1,917 | 1,536 |
| Interest and amortization | (25,818) | (25,722) |
| Transfers to other funds | (17,366) | (21,003) |
| | <u>(41,267)</u> | <u>(45,189)</u> |
| CHANGE IN NET ASSETS | <u>\$ (10,411)</u> | <u>\$ (5,893)</u> |

CITY OF LAKELAND, FLORIDA
DEPARTMENT OF ELECTRIC UTILITIES

Management's Discussion and Analysis (continued)

Financial Highlights

- Operating revenues for the fiscal year 2005 were \$340.5 million, which was an increase of \$41.9 million from the previous year. Non-fuel retail revenues increased by approximately \$3.0 million from 2004 to 2005. Despite relatively mild weather during fiscal 2005, total retail sales volume increased by 1.1 percent. The residential sector of the market grew at a faster rate than the commercial and industrial sector. Given that residential rates are higher than rates for the commercial and industrial sector, this pattern resulting in higher average revenue per kwh for the year.
- Fuel and purchased power expenses increased by \$49.2 million, or 32 percent from the previous fiscal year. Lakeland Electric's average cost for natural gas was approximately 39 percent higher than in the previous fiscal year. Additionally, total purchased power expenses increased substantially over the prior year because of the escalation in fuel costs which affected all utilities; and because Lakeland Electric's largest generation unit, McIntosh Unit 5, was down for an eight week period ending July 31 due to a damaged rotor within the gas turbine assembly.
- Lakeland Electric implemented cost cutting measures across all divisions which resulted in a minimal gross increase in non-fuel operating costs of \$0.1 million or 0.2 percent. These measures included a 6 percent reduction in the total workforce within Lakeland Electric. Total fixed and variable operating and maintenance costs (excluding fuel and depreciation) fell from an average of \$19.63 per 1,000 kwh in 2004 to \$19.25 in 2005. The Energy Delivery business unit dedicated much of its resources during the first half of the fiscal year to hurricane restoration projects which were eligible for state and federal disaster recovery funds. These cost recoveries helped to decrease their net spending by \$1.0 million compared to the previous year. A reduction in the pension funding requirement resulted in a \$0.6 million year-end credit to pension expense. Most of the cost savings were offset by increases in gross receipts tax, bad debt expense, and normal inflation.
- Operating income fell to \$30.9 million in fiscal year 2005 from \$39.3 million in the previous year primarily because of increased losses associated with an unfavorable wholesale power contract (see Economic Factors).
- The cost saving efforts have resulted in a substantial increase in the profitability of retail operations from a profit of \$20.1 million on this component of the operations in 2004 (measured before transfers but including depreciation expense) to a profit of \$22.7 million for 2005.
- Deferred Regulatory Charges of \$12.2 million are included in Lakeland Electric's current assets. This represents a receivable from retail customers for the cumulative difference between fuel costs incurred to serve retail load and fuel revenues realized. The electric utility recovers 100 percent of fuel costs from retail customers in the form of a fuel charge that is revised quarterly as needed based on a forecast of fuel costs for the following 12 months. At the end of the previous fiscal year, the Deferred Regulatory Charges balance was \$6.0 million. The shortfall grew as a result of escalating natural gas costs and the necessity to buy wholesale power due to unscheduled maintenance outages. In response to the rising costs, retail customer fuel rates were increased four times during the fiscal year and subsequently in December 2005.
- Lakeland Electric funds the cost of capital improvements through a combination of bond financing and cash generated from retail utility rates. The annual dollar value of capital improvements financed from electric rates has remained relatively steady over the course of the past five years at approximately \$21.6 million each year. However, the capital improvements plan prepared by Lakeland Electric projects future spending at approximately twice that annual rate for the four year period 2007 thru 2010. This includes an average of \$23.5 million in annual spending for transmission and distribution system improvements necessary to finance the substantial growth in residential housing anticipated within the service territory over the next five years and \$21.5 million in average annual spending on the upgrades to the existing fleet of power generation.

CITY OF LAKELAND, FLORIDA
DEPARTMENT OF ELECTRIC UTILITIES

Management's Discussion and Analysis (Continued)

Financial Highlights (Continued)

- Lakeland Electric provides a dividend to the General Fund each year in the form of a cash transfer. The total amount of this dividend for fiscal year 2005 was \$16.1 million or 10.8 percent of non-fuel operating revenues of Lakeland Electric. This represents a decrease from the dividend of \$20.2 million paid in 2004, which represented 13.8 percent of gross revenues. The reduction in the dividend from 2004 levels represents measures to mitigate a portion of the effect of increased losses. At current levels, the dividend paid to the General Fund represents approximately 20 percent of the General Fund's budget.
- An electric utility accounting consultant was employed during fiscal year 2004 to review certain accounting policies and practices and to make recommendations, that in his opinion, were appropriate. The consultant's final report, which was presented to the Lakeland City Commission during fiscal year 2005, contained various recommendations including: suggested changes in inventory valuation and accounting practices; the need to conduct a depreciation and plant asset valuation study; greater conformity to utility fixed asset accounting practices; a need for additional training; and a recommendation to attract personnel who are well trained in the area of electric utility accounting when possible. As of September 30, 2005 Lakeland Electric has made substantial efforts toward complying with the consultant's recommendations.

Capital Assets

The following table contains a summary of Lakeland Electric plant investment net of accumulated depreciation as of the September 30, 2005 and 2004:

| | (In Thousands) | |
|--|-------------------|-------------------|
| | September 30 | |
| | 2005 | 2004 |
| Land | \$ 15,254 | \$ 11,082 |
| Construction in process | 20,385 | 27,215 |
| Buildings | 20,916 | 21,751 |
| Machinery and equipment | 20,641 | 22,377 |
| Electric transmission and distribution | 216,143 | 215,037 |
| Electric plants in service | 328,861 | 339,737 |
| | <u>\$ 622,200</u> | <u>\$ 637,199</u> |

The generating capacity of the production units owned by the City is 984 megawatts (MW). The most cost effective unit in the generating fleet is the 365 MW McIntosh 3 coal unit, of which 60 percent or 219 MW is owned by Lakeland Electric. During recent fiscal years Lakeland Electric has placed a 360 MW combined cycle natural gas unit and a 50 MW internal combustion peaking facility into service. Lakeland Electric has sufficient generation and transmission capacity to cover its projected load requirements for at least the next five years.

As can be seen in the above schedule, there was a net decrease in fixed assets during fiscal year 2005 as depreciation and retirements exceeded additions. Management is now concentrating on long term capital improvement issues such as the replacement of older generation units and enhancements to the electric delivery system.

CITY OF LAKELAND, FLORIDA
DEPARTMENT OF ELECTRIC UTILITIES

Management's Discussion and Analysis (Continued)

Debt

At September 30, 2005, Lakeland Electric had \$471.4 million in net long-term debt outstanding compared to \$484.3 million at the end of 2004 as shown in the following table:

| | (In Thousands) | |
|--|----------------|------------|
| | September 30 | |
| | 2005 | 2004 |
| Electric System Revenue Bonds: | | |
| Series 1999A | \$ 193,785 | \$ 194,180 |
| Series 1999B | 81,310 | 94,165 |
| Series 1999C | 64,525 | 64,525 |
| Series 2001A | 90,000 | 90,000 |
| Series 2001B | 30,000 | 30,000 |
| Series 2003 | 47,860 | 47,860 |
| | 507,480 | 520,730 |
| Less current portion | (15,095) | (13,250) |
| Less unamortized loss on refunding | (22,148) | (24,677) |
| Unamortized bond discount (net of premium) | 1,153 | 1,503 |
| | \$ 471,390 | \$ 484,306 |

Lakeland Electric has three interest rate swap transactions outstanding. One of the three is used to synthetically fix a \$47.86 million variable rate issue to a fixed rate of approximately 4.0 percent. The other two capitalize on the relationship between the tax exempt BMA short-term interest rate index and the taxable short-term LIBOR interest rate index. For fiscal 2005, these two swap transactions yielded a positive cash flow of approximately \$0.5 million.

Economic Factors

As indicated in Note N, coverage on bonded debt of Lakeland Electric remains very strong at 2.77 times the annual debt service requirement for the fiscal year ended 2005. Per the enabling bond ordinance, an amount equal to 20 percent of the fund balance of Lakeland Electric is included as a component of net revenues in preparing this calculation. Removing this aspect of the coverage calculation yields a coverage ratio of 1.87.

In December 2000 Lakeland Electric entered into a contract with the Florida Municipal Power Association (FMPA) that allows FMPA the option of taking up to 100 MW of energy per hour at a fixed price. The contract contains a fuel escalation clause that has not kept pace with the rapid increase in natural gas prices, creating significant losses to Lakeland Electric. During FY 2005 the FMPA purchased 655,200 megawatt-hours (MWH) under the contract compared to 544,300 MWH in FY 2004. The 20 percent increase was a direct result of natural gas prices. The total loss on the contract for the fiscal year 2005, including all fuel and variable O&M expenses, and including the capacity revenues associated with the contract was \$18.8 million. The comparable fiscal year 2004 loss was \$7.3 million. Because the under-recovery of fuel on the FMPA contract is not being passed along to retail customers as a component of the fuel charge; these losses are being absorbed by Lakeland Electric.

During fiscal year 2004 Lakeland Electric negotiated with FMPA to shorten the length of the contract by three years from December 2010 to December 2007. The negotiated settlement also calls for the non-binding scheduling of the FMPA's monthly requirements under the contract in order for Lakeland Electric to better manage its resources. Lakeland Electric currently has 68 percent of the estimated natural gas required to service the remainder of that contract at a price of \$8.61 per mmbtu. Future losses from the FMPA contract could possibly be as high, or higher than previous levels however, Lakeland Electric cannot reasonably estimate the total potential contractual loss because of the volatility of natural gas prices and the associated impact on and uncertainty of future volumes. In addition, Lakeland Electric will continue to pursue opportunities to satisfy the energy requirements related to the contract at a lower cost. The losses associated with the FMPA contract are being absorbed internally and are not being recovered through Lakeland Electric's rate structure. The management of Lakeland Electric expects to resume a normal level of profitability after the contract expires.

CITY OF LAKELAND, FLORIDA
DEPARTMENT OF ELECTRIC UTILITIES

Management's Discussion and Analysis (Concluded)

Economic Factors (Continued)

A continued upward trend in fuel costs (natural gas, coal, oil, and petroleum coke) can be expected, with the probability of significant fluctuations in oil and natural gas. Lakeland Electric is continuing its efforts to manage this risk through its fuel hedging program. A consulting firm has provided additional expertise in managing natural gas costs. During fiscal year 2005, the fuel hedging program met the overall established objectives of the Risk Oversight Committee, which was formed by Management, to monitor the fuel hedging program.

Lakeland Electric expects to see continued growth in retail revenue with an anticipated increase in the customer base of about 2 percent. The average demand for energy placed on the system from retail customers is approximately 330 MW, with peak demand during very warm or cold periods of between 578 and 694 MW.

Using This Annual Report

This annual report includes the balance sheet, statement of revenues, expenses and change in net assets, statement of cash flows and notes to the financial statements for Lakeland Electric, which is an enterprise fund of the City of Lakeland. Please refer to the annual report of the City of Lakeland for more information about the City of Lakeland as a whole.

Requests for Information

This financial report is designed to provide a general overview of Lakeland Electric's finances. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the Assistant Finance Director - Electric, Lakeland Electric, 501 East Lemon St, Lakeland, FL 33801.

CITY OF LAKELAND, FLORIDA
DEPARTMENT OF ELECTRIC UTILITIES

BALANCE SHEETS

| | September 30 | |
|--|------------------|------------------|
| | 2005 | 2004 |
| <u>ASSETS</u> | | |
| UTILITY PLANT | | |
| Utility plant in service | \$ 1,035,405,274 | \$ 1,011,155,618 |
| Less accumulated depreciation | 433,590,422 | 401,171,011 |
| | 601,814,852 | 609,984,607 |
| Construction in progress | 20,385,220 | 27,214,886 |
| Total utility plant | 622,200,072 | 637,199,493 |
| CURRENT ASSETS | | |
| Cash and cash equivalents | 16,817,168 | 6,789,953 |
| Investments | 2,683 | 1,952 |
| Accounts receivable | 51,403,731 | 43,928,704 |
| Less allowance for uncollectibles | (805,816) | (938,597) |
| Inventories | 25,780,858 | 23,515,568 |
| Deferred regulatory charges | 12,167,670 | 6,035,022 |
| Designated assets | 28,074,648 | 32,680,188 |
| Other current assets | 4,107,803 | 726,812 |
| Total current assets | 137,548,745 | 112,739,602 |
| NONCURRENT ASSETS | | |
| Restricted assets | 9,110,765 | 7,634,775 |
| Designated assets | 86,073,058 | 89,928,839 |
| Other assets | 9,096,088 | 8,831,477 |
| Total noncurrent assets | 104,279,911 | 106,395,091 |
| TOTALS | \$ 864,028,728 | \$ 856,334,186 |
| <u>LIABILITIES</u> | | |
| CURRENT LIABILITIES, payable from current assets | | |
| Accounts payable | \$ 40,722,505 | \$ 22,837,159 |
| Accrued liabilities | 3,065,192 | 2,871,146 |
| Due to other funds | 137,473 | 137,473 |
| Deferred revenue | 19,740,363 | 4,949,433 |
| Current liabilities payable from designated assets | 28,074,648 | 32,680,188 |
| Total current liabilities, payable from current assets | 91,740,181 | 63,475,399 |
| NONCURRENT LIABILITIES | | |
| Long-term debt, less current portion | 471,389,624 | 484,305,626 |
| Accrued liabilities, less current portion | 16,659,495 | 15,241,240 |
| Advances from other funds, less current portion | 824,838 | 962,311 |
| Restricted liabilities | 9,110,765 | 7,634,775 |
| Total noncurrent liabilities | 497,984,722 | 508,143,952 |
| Total liabilities | 589,724,903 | 571,619,351 |
| <u>NET ASSETS</u> | | |
| Invested in capital assets, net of related debt | 156,243,717 | 160,700,821 |
| Unrestricted | 118,060,108 | 124,014,014 |
| Total net assets | 274,303,825 | 284,714,835 |
| TOTALS | \$ 864,028,728 | \$ 856,334,186 |

See accompanying notes to financial statements

CITY OF LAKELAND, FLORIDA
DEPARTMENT OF ELECTRIC UTILITIES

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

| | <u>Year ended September 30</u> | |
|---|--------------------------------|-----------------------|
| | <u>2005</u> | <u>2004</u> |
| OPERATING REVENUES | | |
| Sales of energy - retail | \$ 287,753,274 | \$ 254,064,072 |
| Sales of energy and capacity sales - wholesale | 42,333,082 | 37,724,222 |
| Other electric operating revenue | 10,443,584 | 6,773,888 |
| Total operating revenues | <u>340,529,940</u> | <u>298,562,182</u> |
| OPERATING EXPENSES | | |
| Fuel and purchased power | 203,486,274 | 154,284,500 |
| Energy supply | 22,199,220 | 21,897,231 |
| Energy delivery | 16,288,469 | 17,309,511 |
| Customer service | 8,674,601 | 9,056,497 |
| State tax on electric sales | 7,316,145 | 6,417,390 |
| Administrative and general | 14,206,481 | 13,871,422 |
| Total operating expenses | <u>272,171,190</u> | <u>222,836,551</u> |
| OPERATING INCOME BEFORE DEPRECIATION | 68,358,750 | 75,725,631 |
| Less depreciation | <u>37,502,433</u> | <u>36,429,315</u> |
| OPERATING INCOME | <u>30,856,317</u> | <u>39,296,316</u> |
| NONOPERATING REVENUES (EXPENSES) | | |
| Investment revenue (less \$157,131 capitalized in 2004) | 2,632,729 | 2,033,743 |
| Net decrease in the fair value of cash equivalents | (1,204,790) | (184,821) |
| Miscellaneous revenue | 488,815 | 643,434 |
| Interest expense and fiscal charges (less \$539,433, and \$608,568 capitalized in 2005 and 2004, respectively) | (23,336,036) | (23,256,994) |
| Amortization expense | (2,482,058) | (2,465,065) |
| Loss on disposal of fixed assets | - | (955,911) |
| | <u>(23,901,340)</u> | <u>(24,185,614)</u> |
| INCOME BEFORE TRANSFERS | 6,954,977 | 15,110,702 |
| TRANSFERS TO OTHER FUNDS | <u>(17,365,987)</u> | <u>(21,003,909)</u> |
| CHANGE IN NET ASSETS | (10,411,010) | (5,893,207) |
| NET ASSETS, beginning of year | 284,714,835 | 286,394,128 |
| Cumulative effect of change in accounting principle | - | 4,213,914 |
| NET ASSETS, end of year | <u>\$ 274,303,825</u> | <u>\$ 284,714,835</u> |

See accompanying notes to financial statements

CITY OF LAKELAND, FLORIDA
DEPARTMENT OF ELECTRIC UTILITIES

STATEMENTS OF CASH FLOWS

| | Year ended September 30 | |
|---|-------------------------|----------------|
| | 2005 | 2004 |
| Cash flows from operating activities: | | |
| Receipts from customers | \$ 348,725,486 | \$ 301,526,253 |
| Payments for interfund services | (8,290,354) | (3,697,127) |
| Payments to suppliers | (226,962,980) | (178,299,353) |
| Payments to employees | (29,670,438) | (30,426,406) |
| Net cash provided by operating activities | 83,801,714 | 89,103,367 |
| Cash flows used in noncapital financing activities: | | |
| Increase in meter deposits payable, net | 1,472,831 | 846,099 |
| Operating transfers to other funds | (16,423,894) | (21,003,909) |
| Cash flows used in noncapital financing activities | (14,951,063) | (20,157,810) |
| Cash flows used in capital financing activities: | | |
| Interest paid on long-term debt issued to finance capital assets | (23,383,249) | (24,117,947) |
| Net issuance / repayment of interfund loans | (117,337) | (132,332) |
| Payments on and maturities of long-term debt | (13,250,000) | (11,745,000) |
| Purchase of capital assets | (21,773,648) | (39,306,075) |
| Cash flows used in capital financing activities: | (58,524,234) | (75,301,354) |
| Cash flows provided by investing activities: | | |
| Investment revenue | 2,632,729 | 2,033,743 |
| Net decrease in the fair value of cash equivalents | (1,204,790) | (186,775) |
| Cash flows provided by investing activities | 1,427,939 | 1,846,968 |
| Net increase (decrease) in cash and cash equivalents | 11,754,356 | (4,508,829) |
| Cash and cash equivalents, beginning of year | 112,327,502 | 116,836,331 |
| Cash and cash equivalents, end of year | \$ 124,081,858 | \$ 112,327,502 |
| Adjustments to reconcile operating income to net cash provided by operating activities: | | |
| Operating income | \$ 30,856,317 | \$ 39,296,316 |
| Depreciation | 37,502,433 | 36,429,315 |
| Miscellaneous revenue | 488,815 | 643,435 |
| Increase in receivables, net | (7,084,199) | (2,628,797) |
| Decrease (increase) in inventory | (2,265,289) | 3,031,134 |
| Decrease (increase) in other current assets (including prepaid fuel) | (3,380,991) | 331,814 |
| Decrease (increase) in deferred regulatory charges | (6,132,649) | 774,093 |
| Increase in net pension obligation | (607,535) | (824,328) |
| Increase in accounts payable | 17,885,347 | 4,806,668 |
| Increase in accrued liabilities | 1,612,304 | 2,294,284 |
| Increase in deferred revenue | 14,790,930 | 4,949,433 |
| Increase in deposits | 136,231 | - |
| Net cash provided by operating activities | \$ 83,801,714 | \$ 89,103,367 |

See accompanying notes to financial statements

CITY OF LAKELAND, FLORIDA
DEPARTMENT OF ELECTRIC UTILITIES

NOTES TO FINANCIAL STATEMENTS

NOTE A -SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

These financial statements present only the financial position, changes in net assets, and cash flows of the City of Lakeland, Department of Electric Utilities (Lakeland Electric) and not of the City as a whole. Lakeland Electric is an enterprise fund that accounts for the City's electric utility operations. These operations are accounted for in a manner similar to private business enterprises where the stated intent is that the costs (expenses, including depreciation) of providing goods or services to the general public on a continuing basis be financed or recovered primarily through user charges.

Basis of Accounting:

Lakeland Electric uses the accrual basis of accounting in accordance with generally accepted accounting principles (GAAP) as prescribed for enterprise funds by the Governmental Accounting Standards Board (GASB). Lakeland Electric has adopted the uniform system of accounts prescribed by the Federal Energy Regulatory Commission (FERC) for electric operations. Lakeland Electric is required to follow the pronouncements of the Financial Accounting Standards Board (FASB) issued through November 30, 1989 that do not conflict with or contradict GASB pronouncements. Lakeland Electric has elected not to apply FASB pronouncements issued after that date.

Lakeland Electric applies the accounting principles required by Statement of Financial Accounting Standards No. 71 - Accounting for the Effects of Certain Types of Regulation (SFAS 71). Lakeland Electric's rates are designed to recover the cost of providing services, and Lakeland Electric is able to collect those rates from its customers. SFAS 71 requires Lakeland Electric to defer certain expenses and revenues, and record various regulatory assets and liabilities in accordance with rate actions of the Lakeland City Commission.

Cash and Cash Equivalents:

Lakeland Electric has defined Cash and Cash Equivalents to include cash on hand, demand deposits, cash with paying agents, as well as Lakeland Electric's equity in the City's pooled cash (see Note C). Additionally, Lakeland Electric's equity in the City's internal investment pool (see Note C) is considered to be a cash equivalent since Lakeland Electric can deposit or effectively withdraw cash from the pool at any time without prior notice or penalty. Investments that are categorized as cash equivalents on the Balance Sheet are valued at fair market value.

Receivables:

Lakeland Electric has recognized in receivables an estimated amount for services rendered but not yet billed as of September 30, 2005 and 2004, respectively.

Inventories:

Inventories are valued at cost, not in excess of replacement cost, using the weighted average cost method.

Designations:

Lakeland Electric follows the practice of segregating assets, which are designated for some future use. Designations can be rescinded at any time by city commission approval.

Operating/Non-operating Revenue:

Revenues that are earned as a result of the business operations of Lakeland Electric are recorded as operating revenues. Interest earnings and other miscellaneous revenues are recorded as non-operating revenues.

Due to/from Other Funds:

Amounts receivable from or payable to other funds in the City of Lakeland are reflected in the accounts of the fund until liquidated by payment or authorized inter-fund transactions.

CITY OF LAKELAND, FLORIDA
DEPARTMENT OF ELECTRIC UTILITIES

NOTES TO FINANCIAL STATEMENTS
(CONTINUED)

NOTE A -SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Utility Plant:

Lakeland Electric is required to record the acquisition and disposition of assets in accordance with guidelines provided by the Federal Energy Regulatory Commission. Accordingly, fixed assets acquired by Lakeland Electric are recorded at cost for purchased assets. Fixed assets do not include the cost or other value of electric plant contributed. Interest costs on funds used for construction of fixed assets are capitalized as part of the costs of these assets. In accordance with accounting regulations of the Federal Energy Regulatory Commission, electric transformers and certain specialty plant replacement components which are critical in nature are classified as utility plant and depreciated prior to being placed in service.

Routine maintenance, repairs, renewals and replacement costs are charged against operations. Expenditures, which materially increase values, change capacities or extend useful lives are capitalized.

Depreciation is computed using the straight-line method over the estimated useful lives of the assets as follows:

| | |
|------------------------------------|---------------|
| Land improvements | 40 years |
| Buildings | 50 years |
| Utility Plant | 25 - 35 years |
| Improvements, other than buildings | 10 - 45 years |
| Machinery and equipment | 5 - 40 years |

Contributions in Aid of Construction:

Non-refundable payments received from consumers and developers for extension of electric services are accounted for as a reduction of utility plant cost in accordance with accounting procedures required by the Federal Energy Regulatory Commission.

Transfers to Other Funds:

Lakeland Electric accounts for subsidy payments to other funds as transfers to other funds in the statement of revenues, expenses and changes in net assets. Lakeland Electric makes annual transfers to the City of Lakeland as follows:

| | Year Ended September 30 | |
|--|-------------------------|----------------------|
| | 2005 | 2004 |
| Annual dividend to the City of Lakeland | \$ 16,125,086 | \$ 20,873,568 |
| Transfers to City funds for fixed assets | 970,532 | 130,341 |
| Transfers to City Disaster Recovery Fund | 220,266 | - |
| Transfer to Fleet Management Fund for new vehicles | 50,103 | - |
| | <u>\$ 17,365,987</u> | <u>\$ 21,003,909</u> |

Accumulated Unpaid Vacation and Sick Pay:

The amounts of unpaid vacation and sick leave accumulated by Lakeland Electric employees are accrued as expenses when incurred. Total available sick leave hours are multiplied by the current pay rate to determine the accrued liability. The entire unpaid liability for sick leave is classified as a non-current liability based on Lakeland Electric's benefit accrual policies. Lakeland Electric has separated that portion of the liability for vacation time that is expected to be paid from current assets as a current liability. The amount is included in accrued liabilities.

Amortization:

Bond issue costs and bond discount are amortized over the life of the issue using the straight-line method.

CITY OF LAKELAND, FLORIDA
DEPARTMENT OF ELECTRIC UTILITIES

NOTES TO FINANCIAL STATEMENTS
(CONTINUED)

NOTE A -SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Derivatives and Interest Rate Swap Agreements:

In June 2003, the Governmental Accounting Standards Board issued Technical Bulletin No. 2003-1, Disclosure Requirements for Derivatives Not Presented at Fair Value on the Balance Sheets. This guidance addresses the disclosure requirements for derivative instruments not reported at fair value on the Balance Sheets including providing information related to the significance of the outstanding derivatives and their associated risks. Derivative instruments are used by Lakeland Electric in conjunction with debt financing and fuel purchases. Fuel related derivative information is included herein and in Note T – Derivatives and Hedging Activities. Debt related derivative information is included in Note N – Revenue Bonds.

Reclassification:

For comparability, certain fiscal year 2004 amounts have been reclassified to conform to the financial statement presentation for fiscal year 2005.

Other Significant Accounting Policies:

Other significant accounting policies are set forth in the financial statements and the notes thereto.

NOTE B – ACCOUNTING AND REPORTING CHANGE

During fiscal year 2005, there was a policy correction regarding the calculation and classification of prepaid maintenance and inventory costs for replacement parts for McIntosh Unit 5. In prior fiscal years, the related costs (approximately \$4.8 million per year since Fiscal Year 2002) were amortized as maintenance expense over a four year period. Under the corrected policy, most of these costs have been capitalized, and are being amortized as depreciation expense over the estimated useful lives of the related plant assets. Lakeland Electric's beginning net asset balance as previously reported for the year ending September 30, 2004 has been restated based on the cumulative effect of the correction in policy as follows:

| | |
|--|-----------------------|
| Net Assets fiscal year 2004 as originally reported | \$ 278,323,223 |
| Overstatement of expenses in fiscal year 2004 | 2,177,698 |
| Cumulative effect of years prior to fiscal year 2004 | 4,213,914 |
| Net Assets fiscal year 2004 as restated | <u>\$ 284,714,835</u> |

NOTE C - CASH, CASH EQUIVALENTS AND INVESTMENTS

Deposits:

All of the City of Lakeland cash accounts have been pooled and all deposits are in a single financial institution and are carried at cost. The deposits are insured or collateralized. Florida Statutes, Chapter 280, sets forth the qualifications and requirements that a financial institution must meet in order to become a qualified public depository. The statute also defines the amount and type of collateral that must be pledged in order to remain qualified. The financial institution in which the City maintains its deposits is a qualified public depository. Refer to the City of Lakeland, Florida comprehensive annual financial report for additional disclosures.

Custodial credit risk is the risk that in the event of a bank failure, the City of Lakeland's deposits may not be returned. Florida Statutes require deposits by governmental units in a financial institution be collateralized. The City of Lakeland's policy, in accordance with the Florida Security for Public Deposits Act, requires deposits in a financial institution be collateralized and requires the use of only authorized dealers and institutions, qualified public depositories, who meet the standards as set forth by the State of Florida and the Securities and Exchange Commission's Rule 15c3-1. In the event of a failure of a qualified public depository, the remaining public depositories would be responsible for covering any resulting losses. Accordingly, all amounts reported as deposits are deemed as insured or collateralized with securities held by the entity or its agent in the entity's name. The carrying amount (deficit) of Lakeland Electric's share of pooled demand and time deposits with financial institutions as of September 30, 2005 was (\$2,772,466). By comparison, the carrying amount of Lakeland Electric's pooled demand and time deposits in fiscal year 2004 was \$18,891,396. The negative balance in time deposits in fiscal year 2005 is offset by \$126,854,324 in pooled investments.

CITY OF LAKELAND, FLORIDA
DEPARTMENT OF ELECTRIC UTILITIES

NOTES TO FINANCIAL STATEMENTS
(CONTINUED)

NOTE C - CASH, CASH EQUIVALENTS AND INVESTMENTS (CONTINUED)

Cash Equivalents and Investments:

The types of investments in which Lakeland Electric may directly invest are governed by several forms of legal and contractual provisions. Lakeland Electric may directly invest in obligations of, or obligations on which the principal of and interest are unconditionally guaranteed by the United States of America, obligations issued or guaranteed by any agency or instrumentality of the United States of America, interest bearing time deposits or repurchase agreements issued by banks, trust companies or national banking associations which are secured by obligations of or guaranteed by the United States of America or its agencies or instrumentalities. Lakeland Electric also may invest monies with the Florida State Board of Administration or other investments which at the time are legal investments under the laws of the State of Florida. Additionally, the various funds of the City have combined some of their resources into an internal investment pool in order to maximize investment earnings. The pool is comprised of money market funds, time deposits, notes, bonds, amounts invested with the Florida State Board of Administration, other securities, and accrued interest.

Lakeland Electric has an equity interest in the City's internal investment pool. There were no violations of legal or contractual provision for deposits and investments during the year. Information regarding credit risk categories for pooled investments is disclosed in the comprehensive annual financial report for the City. Credit risk is the risk of loss due to the failure of the security issuer or other counterparty. The City of Lakeland's investment policy minimizes credit risk by limiting investments in securities that have higher credit risks, pre-qualifying the financial institutions, brokers/dealers, intermediaries, and advisors with which the City will do business, and diversifying the investment portfolio so that potential losses on individual securities will be minimized. As of September 30, 2005, the City of Lakeland's Investment Pool debt security investments had the following credit quality ratings:

| | Rating |
|--------------------------------|--------|
| Fixed Income Funds: | |
| Enhanced Cash | AAA/V1 |
| 1-3 Year High Quality Bond | AAA/V2 |
| Intermediate High Quality Bond | AAA/V3 |
| Broad Market High Quality Bond | AA/V4 |

Concentration of Credit Risk:

The City of Lakeland limits investments to avoid over concentration in securities from a specific issuer or business sector (excluding US Treasury securities) and continuously invests a portion of the portfolio in readily available funds such as local government investment pools, money market funds or overnight repurchase agreements.

The City of Lakeland's overall investment policy concentration limits and actual concentration limits in investment types as of September 30, 2005 are as follows:

| Type of Security (Market) | % of Total Maximum | % of Total |
|--|--------------------|------------|
| US Government Obligations | 100% | 1.50% |
| Local Government Investment Pools | 100% | 36.65% |
| Certificates of Deposits | 25% | - |
| Federal Agency & Instrumentality Obligations | 100% | 59.20% |
| Collateralized Repurchase Agreements | 15% | 1.20% |
| Other Investment Pools (rated "A" or better) | 10% | - |
| Mutual Funds | 10% | 0.22% |
| State and Local Government Obligations | 5% | - |
| Bankers Acceptance | 5% | - |
| Commercial Paper | 5% | - |
| Money Market Mutual Funds | 10% | 1.23% |

CITY OF LAKELAND, FLORIDA
DEPARTMENT OF ELECTRIC UTILITIES

NOTES TO FINANCIAL STATEMENTS
(CONTINUED)

NOTE C - CASH, CASH EQUIVALENTS AND INVESTMENTS (CONTINUED)

As of September 30, 2005 and 2004, the fair value of the total investment pool and Lakeland Electric's share of the pool was as follows:

| | Reported Amount Fair Value |
|--|-------------------------------|
| <u>As of September 30, 2005:</u> | |
| Total Investment Pool | \$ 267,387,780 |
| Lakeland Electric's Share of the Investment Pool | \$ 126,854,324 |
| <u>As of September 30, 2004:</u> | |
| Total Investment Pool | \$ 245,944,234 |
| Lakeland Electric's Share of the Investment Pool | \$ 93,438,058 |

There are no violations of legal or contractual provisions for deposits and investments held directly by the investment pool during the year.

Cash, cash equivalents and investments are included in the following captions in the accompanying balance sheets:
September 30

| | 2005 | 2004 |
|----------------------------|----------------|----------------|
| Current assets: | | |
| Cash and cash equivalents | \$ 16,817,168 | \$ 6,789,953 |
| Current designated assets: | | |
| Cash and cash equivalents | 28,074,648 | 23,121,125 |
| Designated assets: | | |
| Cash and cash equivalents | 70,079,277 | 74,781,649 |
| Restricted assets | | |
| Cash and cash equivalents | 9,110,765 | 7,634,775 |
| | \$ 124,081,858 | \$ 112,327,502 |

All of the equity investments reported in the City of Lakeland's Electric Utility Fund are donated Metals USA Corporation stock having a fair value of \$2,683 as of September 30, 2005. The amount was \$1,952 as of September 30, 2004.

NOTE D - INVENTORIES

The major classes of inventory consist of the following:

| | September 30 | |
|-------------|---------------|---------------|
| | 2005 | 2004 |
| Fuel oil | \$ 7,346,706 | \$ 3,611,252 |
| Coal | 3,195,032 | 4,709,780 |
| Spare parts | 15,239,120 | 15,194,536 |
| | \$ 25,780,858 | \$ 23,515,568 |

CITY OF LAKELAND, FLORIDA
DEPARTMENT OF ELECTRIC UTILITIES

NOTES TO FINANCIAL STATEMENTS
(CONTINUED)

NOTE E – CURRENT DESIGNATED ASSETS

Designated assets used to pay designated liabilities that are due within a year of the balance sheet date must be classified as current. The corresponding liabilities must also be classified as current. Lakeland Electric has reclassified the following designated assets and liabilities as current designated assets and liabilities on the balance sheet:

September 30, 2005:

| | Debt Service Funds | Capital Expansion | Emergency Repair | Total Designated |
|--|-----------------------|----------------------|---------------------|----------------------|
| Cash and cash equivalents | \$ 352,637 | \$ 3,712,626 | \$ 27,951 | \$ 4,093,214 |
| Cash with paying agent/trustee | 23,981,434 | - | - | 23,981,434 |
| Unrestricted | <u>\$ 24,334,071</u> | <u>\$ 3,712,626</u> | <u>\$ 27,951</u> | <u>\$ 28,074,648</u> |
| Current portion of revenue bonds payable | \$ 15,095,000 | \$ - | \$ - | \$ 15,095,000 |
| Accounts payable | 350,800 | 3,392,112 | - | 3,742,912 |
| Accrued expenses | - | 320,514 | - | 320,514 |
| Accrued interest payable | 8,888,271 | - | - | 8,888,271 |
| Deferred revenue | - | - | 27,951 | 27,951 |
| Current liabilities payable from designated assets | <u>\$ 24,334,071</u> | <u>\$ 3,712,626</u> | <u>\$ 27,951</u> | <u>\$ 28,074,648</u> |

September 30, 2004:

| | Debt Service Funds | Capital Expansion | Emergency Repair | Total Designated |
|--|-----------------------|----------------------|---------------------|----------------------|
| Cash and cash equivalents | \$ 328,593 | \$ 617,190 | \$ (389,091) | \$ 556,692 |
| Cash with paying agent/trustee | 22,564,435 | - | - | 22,564,435 |
| Due from other governments | - | - | 9,559,061 | 9,559,061 |
| Designated assets | <u>\$ 22,893,028</u> | <u>\$ 617,190</u> | <u>\$ 9,169,970</u> | <u>\$ 32,680,188</u> |
| Current portion of revenue bonds payable | \$ 13,250,000 | \$ - | \$ - | \$ 13,250,000 |
| Accounts payable | 125,085 | 492,736 | 2,815,760 | 3,433,581 |
| Accrued expenses | - | 124,454 | 6,354,210 | 6,478,664 |
| Accrued interest payable | 9,517,943 | - | - | 9,517,943 |
| Current liabilities payable from designated assets | <u>\$ 22,893,028</u> | <u>\$ 617,190</u> | <u>\$ 9,169,970</u> | <u>\$ 32,680,188</u> |

NOTE F – OTHER CURRENT ASSETS

Lakeland Electric maintains an index margin account used for fuel hedging which is classified under Other Current Assets, under the category of prepaid fuel. Total Other Current Assets are comprised of the following:

| | September 30 | |
|------------------------|---------------------|-------------------|
| | 2005 | 2004 |
| Prepaid fuel | \$ 4,046,642 | \$ 695,132 |
| Other prepaid expenses | 61,161 | 31,680 |
| | <u>\$ 4,107,803</u> | <u>\$ 726,812</u> |

CITY OF LAKELAND, FLORIDA
DEPARTMENT OF ELECTRIC UTILITIES

NOTES TO FINANCIAL STATEMENTS
(CONTINUED)

NOTE G – DEFERRED REGULATORY CHARGES

SFAS No. 71 requires public utilities to recognize revenues provided either before or after the costs are incurred as assets or liabilities. Lakeland Electric's deferred regulatory charges represent the cumulative under recovery of fuel costs related to retail electric customers.

| | September 30 | |
|--|---------------|---------------|
| | 2005 | 2004 |
| Deferred regulatory charges, beginning balance | \$ 6,035,022 | \$ 12,651,731 |
| Fuel expenses | 203,486,274 | 154,284,500 |
| Less fuel charges recovered | 197,353,626 | 160,901,209 |
| Deferred regulatory charges, ending balance | \$ 12,167,670 | \$ 6,035,022 |

NOTE H – RESTRICTED ASSETS

The revenue bond ordinances and certain other agreements require the restriction of certain assets for specific purposes. The Meter Deposit Reserve is currently Lakeland Electric's only restricted fund. Restricted assets and liabilities payable from restricted assets in Lakeland Electric as of September 30, 2005 and 2004 consist of the following:

| | September 30 | |
|--|--------------|--------------|
| | 2005 | 2004 |
| Cash and cash equivalents | \$ 9,110,765 | \$ 7,634,775 |
| Meter deposits payable | \$ 9,102,706 | \$ 7,629,875 |
| Accrued interest payable | 8,059 | 4,900 |
| Liabilities payable from restricted assets | \$ 9,110,765 | \$ 7,634,775 |

NOTE I - DESIGNATED ASSETS

The City of Lakeland and Lakeland Electric have established long range plans concerning Lakeland Electric. As part of the plan to achieve its objectives, the City Commission has set aside certain assets that will be used to fund its plans for future expansion. Debt service funds are also set aside monthly and designated for the purpose of paying current principle and interest requirements. Designated assets of Lakeland Electric consist of the following:

| September 30, 2005: | Debt Service Funds | Capital Expansion | Emergency Repair | Total Designated |
|----------------------------|-----------------------|----------------------|---------------------|---------------------|
| Cash and cash equivalents | \$ - | \$ 61,886,679 | \$ 8,192,598 | \$ 70,079,277 |
| Accounts receivable | - | 599,692 | 61,985 | 661,677 |
| Due from other governments | - | 1,770,243 | 127,841 | 1,898,084 |
| Advances to other funds | 13,434,020 | - | - | 13,434,020 |
| Designated assets | \$ 13,434,020 | \$ 64,256,614 | \$ 8,382,424 | \$ 86,073,058 |
| | | | | |
| September 30, 2004: | Debt Service Funds | Capital Expansion | Emergency Repair | Total Designated |
| Cash and cash equivalents | \$ 132,360 | \$ 67,422,147 | \$ 7,227,142 | \$ 74,781,649 |
| Accounts receivable | - | 1,428,283 | 264,750 | 1,693,033 |
| Advances to other funds | 13,454,157 | - | - | 13,454,157 |
| Designated assets | \$ 13,586,517 | \$ 68,850,430 | \$ 7,491,892 | \$ 89,928,839 |

CITY OF LAKELAND, FLORIDA
DEPARTMENT OF ELECTRIC UTILITIES

NOTES TO FINANCIAL STATEMENTS
(CONTINUED)

NOTE J - OTHER ASSETS

Other Assets (noncurrent) consist of the following:

| | September 30 | |
|---------------------------------|--------------|--------------|
| | 2005 | 2004 |
| Unamortized bond issue cost | \$ 4,957,822 | \$ 5,300,747 |
| Net pension obligation (assets) | 4,138,266 | 3,530,730 |
| | \$ 9,096,088 | \$ 8,831,477 |

NOTE K - UTILITY PLANT

Utility plant consists of the following:

| Fiscal year 2005: | September 30, 2004 | Additions | Deletions | September 30, 2005 |
|--|-----------------------|---------------|---------------|-----------------------|
| Non-Depreciable Assets: | | | | |
| Land | \$ 11,081,754 | \$ 4,172,577 | \$ - | \$ 15,254,331 |
| Construction in process | 27,214,886 | 34,429,705 | 41,259,371 | 20,385,220 |
| Depreciable Assets: | | | | |
| Buildings | 30,184,466 | - | - | 30,184,466 |
| Machinery and equipment | 39,618,673 | 2,315,107 | 4,677,166 | 37,256,614 |
| Electric transmission and distribution | 321,048,245 | 10,918,398 | 1,458,448 | 330,508,195 |
| Electric production plant in service | 609,222,480 | 35,154,241 | 22,175,053 | 622,201,668 |
| | 1,038,370,504 | 86,990,028 | 69,570,038 | 1,055,790,494 |
| Less accumulated depreciation: | | | | |
| Buildings | 8,433,390 | 834,706 | - | 9,268,096 |
| Machinery and equipment | 17,241,051 | 4,008,912 | 3,692,256 | 17,557,707 |
| Electric transmission and distribution | 106,011,523 | 9,630,717 | 1,276,562 | 114,365,678 |
| Electric production plant in service | 269,485,047 | 23,028,098 | 114,204 | 292,398,941 |
| | 401,171,011 | 37,502,433 | 5,083,022 | 433,590,422 |
| Total utility plant | \$ 637,199,493 | \$ 49,487,595 | \$ 64,487,016 | \$ 622,200,072 |
| | | | | |
| Fiscal year 2004: | September 30, 2003 | Additions | Deletions | September 30, 2004 |
| Non-Depreciable Assets: | | | | |
| Land | \$ 9,454,342 | \$ 1,659,638 | \$ 32,226 | \$ 11,081,754 |
| Construction in process | 27,607,910 | 22,763,370 | 23,156,394 | 27,214,886 |
| Depreciable Assets: | | | | |
| Buildings | 26,818,394 | 3,366,072 | - | 30,184,466 |
| Machinery and equipment | 37,893,006 | 2,633,881 | 908,214 | 39,618,673 |
| Electric transmission and distribution | 323,052,713 | 9,695,944 | 11,700,412 | 321,048,245 |
| Electric plants in service | 580,364,330 | 31,121,230 | 2,263,080 | 609,222,480 |
| | 1,005,190,695 | 71,240,135 | 38,060,326 | 1,038,370,504 |
| Less accumulated depreciation: | | | | |
| Buildings | 7,735,216 | 698,174 | - | 8,433,390 |
| Machinery and equipment | 14,098,354 | 4,465,253 | 1,322,556 | 17,241,051 |
| Electric transmission and distribution | 107,855,880 | 8,945,647 | 10,790,004 | 106,011,523 |
| Electric plants in service | 242,841,472 | 27,585,349 | 941,774 | 269,485,047 |
| | 372,530,922 | 41,694,423 | 13,054,334 | 401,171,011 |
| Total utility plant | \$ 632,659,773 | \$ 29,545,712 | \$ 25,005,992 | \$ 637,199,493 |

CITY OF LAKELAND, FLORIDA
DEPARTMENT OF ELECTRIC UTILITIES

NOTES TO FINANCIAL STATEMENTS
(CONTINUED)

NOTE K - UTILITY PLANT (CONTINUED)

In accordance with Statements of Financial Accounting Standards (SFAS) Nos. 34 and 62, Lakeland Electric has adopted the policy of capitalizing net interest costs on funds used for the construction of fixed assets. In accordance with the provisions of these statements, net interest costs have been capitalized as follows:

| | Year ended September 30 | |
|------------------------------------|-------------------------|----------------------|
| | 2005 | 2004 |
| Amount Capitalized: | | |
| Interest expense | \$ 539,433 | \$ 608,568 |
| Less: Interest revenue | - | 157,131 |
| | <u>\$ 539,433</u> | <u>\$ 451,437</u> |
| Net interest capitalized | | |
| Total interest expense | \$ 23,875,469 | \$ 23,865,562 |
| Less: Interest expense capitalized | 539,433 | 608,568 |
| | <u>\$ 23,336,036</u> | <u>\$ 23,256,994</u> |

NOTE L - UTILITY PLANT PARTICIPATION AGREEMENT

On April 4, 1978, the City entered into a fifty-year participation agreement with the Orlando Utilities Commission. Under the terms of this agreement, the City of Lakeland has a 60 percent interest and Orlando Utilities Commission a 40 percent interest in McIntosh Unit #3, a 364-megawatt coal-fired steam generating unit. The Orlando Utilities Commission constructed, at its expense, a 230 KV transmission line to deliver its share of the output to its service area.

The City has operational control of this project and accounts for its undivided ownership interest based on its pro-rata share of the project's construction costs and operating expenses.

The City of Lakeland issued revenue bonds to cover a portion of its investment in the plant. Orlando Utilities Commission also issued revenue bonds to cover a portion of its investment in the plant and the cost of its 230 KV transmission line. Each participant is solely responsible for its debt issued.

NOTE M – LONG-TERM DEBT

Long term debt consists of the following:

| | September 30 | |
|---|-----------------------|-----------------------|
| | 2005 | 2004 |
| Revenue bonds payable, less current portion | \$ 492,385,409 | \$ 507,480,409 |
| Less unamortized loss on refunding | (22,148,686) | (24,677,209) |
| Plus unamortized bond discount (net of premium) | 1,152,901 | 1,502,426 |
| | <u>\$ 471,389,624</u> | <u>\$ 484,305,626</u> |

CITY OF LAKELAND, FLORIDA
DEPARTMENT OF ELECTRIC UTILITIES

NOTES TO FINANCIAL STATEMENTS
(CONTINUED)

NOTE N - REVENUE BONDS

Revenue bonds payable as of September 30, 2005:

| | Interest Rate % | Final Maturity | September 30, 2004 | Additions | Deletions | September 30, 2005 |
|----------------------|--------------------|-------------------|-----------------------|-------------|----------------------|-----------------------|
| Series 1999A | 3.05 to 5.00 | 10-01-2036 | \$ 194,180,409 | \$ - | \$ 395,000 | \$ 193,785,409 |
| Series 1999B | 5.30 to 6.05 | 10-01-2014 | 94,165,000 | - | 12,855,000 | 81,310,000 |
| Series 1999C | 5.30 to 6.05 | 10-01-2012 | 64,525,000 | - | - | 64,525,000 |
| Series 2001A | Variable | 10-01-2035 | 90,000,000 | - | - | 90,000,000 |
| Series 2001B | 5.00 to 5.50 | 10-01-2018 | 30,000,000 | - | - | 30,000,000 |
| Series 2003 | Variable | 10-01-2037 | 47,860,000 | - | - | 47,860,000 |
| | | | <u>\$ 520,730,409</u> | <u>\$ -</u> | <u>\$ 13,250,000</u> | <u>\$ 507,480,409</u> |
| Less current portion | | | <u>(13,250,000)</u> | | | <u>(15,095,000)</u> |
| | | | <u>\$ 507,480,409</u> | | | <u>\$ 492,385,409</u> |

Series 1992 bonds and a portion of series 1999A were allocated from Lakeland Electric to the Water Utility Fund in fiscal year 2001. During fiscal year 2002, Lakeland Electric assumed long-term debt from the Water Utility Fund in the amount of \$13.3 million, which was offset by an advance (current designated asset) to the Water Utility Fund.

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CITY OF LAKELAND, FLORIDA
DEPARTMENT OF ELECTRIC UTILITIES

NOTES TO FINANCIAL STATEMENTS
(CONTINUED)

NOTE N - REVENUE BONDS (CONTINUED)

The following is a schedule of the debt service requirements, excluding the current portion for outstanding revenue bonds, as of September 30, 2005:

| Fiscal Year(s) | Series 1999A Sr. | | Series 1999B Sr. | |
|----------------|-----------------------|-----------------------|----------------------|----------------------|
| | Principal | Interest | Principal | Interest |
| 2006 | \$ 575,000 | \$ 7,842,294 | \$ 15,585,000 | \$ 4,218,853 |
| 2007 | 600,000 | 7,819,294 | 11,130,000 | 3,198,035 |
| 2008 | 625,000 | 7,795,294 | 12,005,000 | 2,469,020 |
| 2009 | 6,700,719 | 11,683,794 | 12,740,000 | 1,760,725 |
| 2010 | 6,307,218 | 12,082,295 | - | 926,255 |
| 2011-2015 | 32,617,472 | 59,415,091 | 15,310,000 | 3,292,713 |
| 2016-2020 | 52,085,000 | 30,497,575 | - | - |
| 2021-2025 | 21,895,000 | 21,347,750 | - | - |
| 2026-2030 | 27,935,000 | 15,298,750 | - | - |
| 2031-2035 | 35,655,000 | 7,580,250 | - | - |
| 2036-2040 | 8,235,000 | 411,750 | - | - |
| | <u>\$ 193,230,409</u> | <u>\$ 181,774,137</u> | <u>\$ 66,770,000</u> | <u>\$ 15,865,601</u> |

| Fiscal Year(s) | Series 1999C Sr. | | Series 2001A Sr. | | Series 2001B Sr. | |
|----------------|----------------------|----------------------|----------------------|----------------------|----------------------|----------------------|
| | Principal | Interest | Principal | Interest | Principal | Interest |
| 2006 | \$ - | \$ 3,903,763 | \$ - | \$ 1,430,550 | \$ - | \$ 1,561,100 |
| 2007 | 5,095,000 | 3,903,763 | - | 1,430,550 | - | 1,561,100 |
| 2008 | 5,370,000 | 3,595,515 | - | 1,430,550 | - | 1,561,100 |
| 2009 | 5,775,000 | 3,270,630 | - | 1,430,550 | - | 1,561,100 |
| 2010 | 14,865,000 | 2,921,243 | - | 1,430,550 | - | 1,561,100 |
| 2011-2015 | 33,420,000 | 3,064,930 | - | 7,152,750 | 16,350,000 | 6,772,324 |
| 2016-2020 | - | - | - | 7,152,750 | 13,650,000 | 1,387,500 |
| 2021-2025 | - | - | 19,275,000 | 6,554,184 | - | - |
| 2026-2030 | - | - | 28,565,000 | 4,519,703 | - | - |
| 2031-2035 | - | - | 34,460,000 | 2,022,400 | - | - |
| 2036-2040 | - | - | 7,700,000 | 61,196 | - | - |
| | <u>\$ 64,525,000</u> | <u>\$ 20,659,844</u> | <u>\$ 90,000,000</u> | <u>\$ 34,615,733</u> | <u>\$ 30,000,000</u> | <u>\$ 15,965,324</u> |

| Fiscal Year(s) | Series 2003. | | TOTAL | | |
|----------------|----------------------|----------------------|-----------------------|-----------------------|-----------------------|
| | Principal | Interest | Principal | Interest | Total |
| 2006 | \$ - | \$ 1,932,644 | \$ 16,160,000 | \$ 20,889,204 | \$ 37,049,204 |
| 2007 | - | 1,932,644 | 16,825,000 | 19,845,386 | 36,670,386 |
| 2008 | - | 1,932,644 | 18,000,000 | 18,784,123 | 36,784,123 |
| 2009 | - | 1,932,644 | 25,215,719 | 21,639,443 | 46,855,162 |
| 2010 | - | 1,932,644 | 21,172,218 | 20,854,087 | 42,026,305 |
| 2011-2015 | - | 9,663,221 | 97,697,472 | 89,361,029 | 187,058,501 |
| 2016-2020 | - | 9,663,221 | 65,735,000 | 48,701,046 | 114,436,046 |
| 2021-2025 | - | 9,663,221 | 41,170,000 | 37,565,155 | 78,735,155 |
| 2026-2030 | - | 9,663,221 | 56,500,000 | 29,481,674 | 85,981,674 |
| 2031-2035 | 9,040,000 | 9,298,175 | 79,155,000 | 18,900,825 | 98,055,825 |
| 2036-2040 | 38,820,000 | 1,985,342 | 54,755,000 | 2,458,288 | 57,213,288 |
| | <u>\$ 47,860,000</u> | <u>\$ 59,599,621</u> | <u>\$ 492,385,409</u> | <u>\$ 328,480,260</u> | <u>\$ 820,865,669</u> |

CITY OF LAKELAND, FLORIDA
DEPARTMENT OF ELECTRIC UTILITIES

NOTES TO FINANCIAL STATEMENTS
(CONTINUED)

NOTE N - REVENUE BONDS (CONTINUED)

Lakeland Electric's bond coverage calculation changed significantly under the 1999 first lien bond ordinance. The following is a schedule of combined senior and junior lien revenue bond coverage for fiscal year 2005 and the previous five years per the current senior lien ordinance:

| Fiscal Year | Net Revenues Available | Debt Service Principal | Debt Service Interest | Total Debt Service | Coverage from Operations | Bond Ordinance Coverage |
|-------------|------------------------|------------------------|-----------------------|--------------------|--------------------------|-------------------------|
| 2005 | \$ 70,275,504 | \$ 15,095,000 | \$ 22,439,513 | \$ 37,534,513 | 1.87 | 2.77 |
| 2004 | 78,217,987 | 13,250,000 | 22,416,570 | 35,666,570 | 2.19 | 3.08 |
| 2003 | 83,203,722 | 11,745,000 | 23,940,421 | 35,685,421 | 2.33 | 3.03 |
| 2002 | 74,687,403 | 12,550,000 | 25,037,914 | 37,587,914 | 1.99 | 2.82 |
| 2001 | 86,077,891 | 10,085,000 | 25,657,600 | 35,742,600 | 2.41 | 3.22 |
| 2000 | 91,543,249 | 9,520,000 | 22,392,786 | 31,912,786 | 2.87 | 3.65 |

Bond debt coverage for the year ended September 30, 2005 was calculated as follows:

| | | |
|---|-----------------------|-----------------------|
| Charges for services | \$ 340,529,940 | |
| Investment and other income | <u>1,916,754</u> | |
| Total revenue | | \$ 342,446,694 |
| Less cost of operations | | <u>(272,171,190)</u> |
| Net revenues from operations available for debt service | | 70,275,504 |
| Fund balance (as defined by bond ordinance): | | |
| Cash and equivalents | \$ 16,817,168 | |
| Designated current assets: | | |
| Accounts receivable (net of uncollectables) | 50,598,015 | |
| Designated assets: | | |
| Cash and cash equivalents | 70,079,276 | |
| Receivables | 661,678 | |
| Due from other governments | <u>1,898,084</u> | |
| | <u>\$ 168,128,869</u> | |
| 20% of fund balance | | <u>33,625,774</u> |
| Net available revenues plus 20% of fund balance | | <u>\$ 103,901,278</u> |
| Debt service requirement: | | |
| Interest | | \$ 22,439,513 |
| Principal | | <u>15,095,000</u> |
| Total | | <u>\$ 37,534,513</u> |
| Bond coverage | | <u>2.77</u> |
| Bond coverage from operations | | <u>1.87</u> |

CITY OF LAKELAND, FLORIDA
DEPARTMENT OF ELECTRIC UTILITIES

NOTES TO FINANCIAL STATEMENTS
(CONTINUED)

NOTE N - REVENUE BONDS (CONTINUED)

All of the outstanding revenue bonds are secured by a first lien on and pledge of the net revenues of the Electric system. As of September 30, 2005, all funds and accounts required by the bond ordinance were being maintained in conformance with the ordinance.

Interest Rate Swaps:

As a means to partially hedge the variable rate risk exposure associated with the issuance of the \$90 million 2001A Energy System Variable Rate Revenue Bonds in April of 2001, the City entered into a basis swap in May of 2001. Under the swap, the city pays CitiGroup Financial Products Inc (the counterparty) a payment equal to \$90 million (the notional amount) times an interest rate equal to the BMA Municipal Bond Index. In return, the counterparty pays the City an amount equal the notional amount times 74.125 percent of the monthly USD-LIBOR-BBA rate. To the extent the relationship between BMA and LIBOR approximates a marginal tax rate of more than 25.9 percent; the net borrowing cost on the underlying 2001 debt issue will be reduced as a result of this swap. The notional amount remains unchanged over the term of the swap, which ends May 1, 2021. Settlement payments are made quarterly.

As a means to reduce borrowing costs when compared to the market rates paid by issuers of fixed-rate bonds as of November 2002, the City entered into a forward swap in connection with the issuance of the Energy System Variable Rate Refunding Revenue Bonds Series 2003, which were sold in January 2003. Under the swap, the City pays CitiGroup Financial Products Inc (the counterparty) a payment equal to \$47.86 million (the notional amount) times a fixed interest rate of 3.74 percent. In return, the counterparty pays the City an amount equal the notional amount times the actual interest rate paid on the underlying 2003 bonds.

The agreement calls for an alternate rate to be paid by the counterparty to the City equal to 67 percent of the monthly USD-LIBOR-BBA. The alternate rate prevails whenever the relationship between the BMA Municipal Bond Index and the monthly USD-LIBOR-BBA exceeds 67 percent for a period of more than the preceding 180 days. The alternate rate also applies in the event of default on the bonds by the City, a downgrade in ratings issued by S&P or Moody's, conversion of the variable interest rate terms on the underlying bonds to other than a weekly mode, or whenever the City is required to draw on the liquidity facility established on the underlying bonds. To the extent the relationship between BMA and LIBOR approximates a marginal tax rate of more than 33 percent the synthetically fixed rate paid on underlying bonds is equal to 3.74 percent plus approximately .35 percent for liquidity and remarketing fees on the underlying variable rate issue.

The notional amount of the swap will always equal the amount of the outstanding principal on the underlying bonds, which mature serially from October 2034 thru October 2037. Settlement payments are made monthly. As of September 30, 2005, the swap had a negative fair value of \$3.1 million, developed using the Market Quotation method. The negative fair value may be countered by reductions in total net interest payments on the underlying debt resulting from the swap. As of September 30, 2005, the City was not exposed to credit risk because the swap had a negative fair value. The City is exposed to basis risk to the extent the relationship of BMA to LIBOR increases to greater than 33 percent. The derivative contract uses the International Swap Dealers Association Master Agreement, which includes standard termination events, such as failure to pay and bankruptcy. An additional termination event also occurs in the event of a rating downgrade by Moody's or S&P issued to either the City or the counterparty.

As of September 30, 2005, future debt service requirements on the variable-rate debt and net swap payments based on the alternate rate calculation formula are as follows. These calculations are based on an average rate of interest paid on the underlying bonds of 2.42 percent as of September 30, 2005; and effective interest rate of 2.47 percent paid to the City by the counterparty, which represents 67 percent of the monthly USD-LIBOR-BBA as of September 30, 2005. As rates vary, variable rate bond interest payments and net swap payments will vary.

CITY OF LAKELAND, FLORIDA
DEPARTMENT OF ELECTRIC UTILITIES

NOTES TO FINANCIAL STATEMENTS
(CONTINUED)

NOTE N - REVENUE BONDS (CONTINUED)

| Fiscal Year Ending September 30, | Variable-Rate Bonds | | Interest Rate Swaps, Net | Total |
|--|----------------------|----------------------|-----------------------------|-----------------------|
| | Principal | Interest | | |
| 2006 | \$ - | \$ 1,325,722 | \$ 606,922 | \$ 1,932,644 |
| 2007 | - | 1,325,722 | 606,922 | 1,932,644 |
| 2008 | - | 1,325,722 | 606,922 | 1,932,644 |
| 2009 | - | 1,325,722 | 606,922 | 1,932,644 |
| 2010 | - | 1,325,722 | 606,922 | 1,932,644 |
| 2011-2015 | - | 6,628,610 | 3,034,611 | 9,663,221 |
| 2016-2020 | - | 6,628,610 | 3,034,611 | 9,663,221 |
| 2021-2025 | - | 6,628,610 | 3,034,611 | 9,663,221 |
| 2026-2030 | - | 6,628,610 | 3,034,611 | 9,663,221 |
| 2031-2035 | 9,040,000 | 6,378,202 | 2,919,973 | 18,338,175 |
| 2036-2040 | 38,820,000 | 1,361,871 | 623,471 | 40,805,342 |
| | <u>\$ 47,860,000</u> | <u>\$ 40,883,123</u> | <u>\$ 18,716,498</u> | <u>\$ 107,459,621</u> |

As a means to reduce borrowing costs on a portion of the Electric and Water Refunding Revenue Bonds Series 1999A the City entered into an interest rate swap in June 2004. Under the swap, the city pays CitiGroup Financial Products Inc (the counterparty) a payment equal to \$159.3 million (the notional amount) times an interest rate equal to the BMA Municipal Bond index. In return, the counterparty pays the City an amount equal the notional amount times an interest rate equal to 67 percent of the three-month USD-LIBOR-BBA index, plus a spread of .046 percent. To the extent the relationship between BMA and LIBOR approximates a marginal tax rate of more than 33 percent; the net borrowing costs on the underlying debt will be reduced. The notional amount of the swap will always equal the amount of the outstanding amount of that component of the underlying issue consisting of term bonds which mature serially from October 2004 thru October 2036. Settlement payments are made semi-annually.

As of September 30, 2005, the swap had a negative fair value of \$2.9 million, developed using the Market Quotation method. The negative fair value may be countered by reductions in total net interest payments on the underlying debt resulting from the swap. As of September 30, 2005, the City was not exposed to credit risk because the swap had a negative fair value. The City is exposed to basis risk to the extent the relationship of BMA to LIBOR increases to greater than 33 percent. The derivative contract uses the International Swap Dealers Association Master Agreement, which includes standard termination events, such as failure to pay, bankruptcy, or a rating downgrade by Moody's or S&P issued to either the City or the counterparty.

NOTE O – DEFERRED REVENUE

Deferred revenue classified as a current liability consists of the following:

| | September 30 | |
|--|----------------------|---------------------|
| | 2005 | 2004 |
| Deferred revenue on maintenance contract | \$ 936,289 | \$ 4,789,223 |
| Deferred gain on fuel hedges | 18,804,074 | 160,210 |
| | <u>\$ 19,740,363</u> | <u>\$ 4,949,433</u> |

CITY OF LAKELAND, FLORIDA
DEPARTMENT OF ELECTRIC UTILITIES

NOTES TO FINANCIAL STATEMENTS
(CONTINUED)

NOTE P - EMPLOYEE RETIREMENT SYSTEM

The City maintains and administers an Employee Pension and Retirement System Plan which is a single employer, defined benefit pension plan. It covers substantially all full-time, regular employees of the City. The Plan is funded from contributions provided by both the employer and employees. The plan is subject to periodic review by an independent actuary to determine the required funding level upon which the City bases the annual contributions.

Contributions – Employee contributions are recorded in the period in which they are payroll deducted from plan participants. Contributions from the City are made and recorded at the same time. The contribution rates are 8 percent for the employee portion and 14.4 percent for the City portion.

Pension Benefits – Plan participants as of September 30, 2003 may retire, without penalty, after attaining age 60 and contributing 10 or more years to this plan. The monthly benefit is determined by multiplying the average monthly salary by a service and benefit factor. The average monthly salary is computed using the average of the highest total earnings over a consecutive period of 36 months. The service factor is based on the length of continuous service determined as follows: 3 percent per year for the first 25 years of service plus 1 percent per year for all service above 25 years.

Plan participants who enter the plan on or after October 1, 2003 with 10 years or more of service may retire at normal retirement age of 62. The retirement income for an employee who retires on the normal retirement date will equal 2 percent of the highest total earnings over a consecutive period of 60 months multiplied times the number of years of credit service up to 10 years, 3 percent of the same average earnings for the next 20 years of credited service, and 1 percent per year of the same average for each year of service in excess of 30 years.

The Plan includes a provision for an annual across-the-board increase in the benefit paid to all retirees if certain conditions occur. The amount of the annual increase, if any, is a factor of the investment performance of the Plan for the preceding year considered in relation to the actuarially assumed rate of investment return.

Termination Benefits - if a member employee is terminated, either voluntarily or involuntarily, the following benefits are payable: If the employee has less than 10 years of credited service, the employee shall be entitled to a refund of amounts contributed by the employee. If the employee has ten or more years credited service, the employee will be entitled to the accrued monthly retirement benefit to commence on normal retirement date, provided the employee's contributions are left in the fund. A terminated employee may also elect an early retirement benefit as described above. The authority for establishing or amending the benefit provisions and contribution provisions is contained in City ordinances.

For the following information, refer to the City of Lakeland, Florida, Employees' Pension and Retirement System stand-alone financial statements which can be obtained by contacting the City of Lakeland, Finance Department, City Hall, 228 S. Massachusetts Ave., Lakeland, FL 33801-5086:

- Annual pension cost
- Dollar amount of contributions
- Date of Actuarial valuation
- Identification of actuarial method and assumptions
- Required supplemental information

CITY OF LAKELAND, FLORIDA
DEPARTMENT OF ELECTRIC UTILITIES

NOTES TO FINANCIAL STATEMENTS
(CONTINUED)

NOTE Q - BUSINESS SEGMENT

The Lakeland Electric operates in only one business segment, that of providing electric utility service. Its service area is primarily the City of Lakeland, Florida and the immediate area surrounding the City.

NOTE R - POST-EMPLOYMENT BENEFITS

In addition to the pension benefits described in Note P, the City Commission has agreed to offer subsidized post-employment health care benefits to former employees who are receiving retirement benefits from the City.

On May 1, 1989, the City Commission agreed to subsidize 50 percent of the cost of Part A Medicare insurance coverage purchased by any person receiving retirement benefits from the City of Lakeland. This agreement can be rescinded by the City at any time. To date, there have been no participants in this program.

On September 18, 1989, the City Commission agreed to subsidize the cost of health insurance coverage offered to any person receiving retirement benefits from the City of Lakeland. Effective September 22, 2002 the retirees' health insurance premium subsidy of 50 percent was reduced as follows: in fiscal year 2004 to 45 percent, in fiscal year 2005 to 40 percent, and in subsequent fiscal years to 35 percent. Effective October 1, 2002, the health insurance premium subsidy is based on years of service. Retirees are required to make an election as to participation in the City-sponsored health insurance plan upon retirement. Effective January 1, 2004 any employee who wishes to have his/her spouse and dependents insured will be required to have them on the plan for one year prior to retirement. Should a participant at any time elect not to purchase coverage from the City-sponsored plan, all eligibility for future participation in that plan, including rights to the subsidy, are terminated. The subsidy program can be terminated by the City at any time. During the fiscal year ended September 30, 2005, retirees from the Utilities who participated in the plan incurred total costs of \$415,000 paid by the City. The subsidy is funded on a pay-as-you-go basis with the cost being charged to the insurance expense accounts of the fund that paid the salary of each participant during his or her tenure as an employee.

NOTE S - DEFERRED COMPENSATION PROGRAM

The City has a Deferred Compensation Program pursuant to Chapter 75-295, as amended by Chapter 76-279, Florida Statutes. In accordance with the Deferred Compensation Program, the City may, by contract and/or collective bargaining agreement, agree with any City employee to defer up to 25 percent of an employee's gross salary (not to exceed \$13,000 in one year). Under the terms of the program, the City may purchase, at the direction of the employee, fixed or variable life insurance, annuity contracts or mutual fund shares for the purpose of "informally" funding the deferred compensation agreements of the employee. The investments will, at all times, remain solely the property of the employee, held in trust until the employee is eligible to draw the amounts contributed. The compensation deferred under the program is not included in employees' taxable income until such amounts are actually received by employees under the terms of the program.

CITY OF LAKELAND, FLORIDA
DEPARTMENT OF ELECTRIC UTILITIES

NOTES TO FINANCIAL STATEMENTS
(CONTINUED)

NOTE T – DERIVATIVE AND HEDGING ACTIVITIES

Accounting for Derivatives and Hedging Activities:

Fuel related derivative transactions are executed in accordance with fuel hedging policies established by Lakeland Electric's Energy Risk Management Oversight Committee. The primary objective of these policies is to minimize exposure to natural gas price volatility for cash flow and control purposes. The Committee has a defined organizational structure and responsibilities, which include approving all brokerage relationships, counterparty credit worthiness, specific fuel volumes and financial limits in addition to overall program compliance.

Lakeland Electric uses the New York Mercantile Exchange (NYMEX), natural gas futures contracts, and options on futures contracts and index-priced physical purchases of natural gas as tools to establish the cost of natural gas that is included into the cost of natural gas burned in its electric production facilities.

The recording of fuel derivatives, when appropriate, is included on the Statements of Net Assets as either an asset or liability measured at fair market value. Related gains and/or losses are deferred and recognized in the specific period in which the derivative is settled and included as a part of Fuel and Purchased Power cost in the Statements of Revenues, Expenses and Changes in Net Assets. The valuation of market changes for Lakeland Electric's Energy Risk Management Program contracts resulted in a decrease in fuel expenses of \$1.9 million in 2005.

At September 30, 2005, Lakeland had the following futures, options, and physical contracts outstanding in the following amounts:

| Fiscal Year | Thousands of MMBtu | | | | Mark-to-Market Value at 9/30/05 |
|-------------|--------------------|---------------|------------|--------------|------------------------------------|
| | Futures | Options | Swaps | Physicals | |
| 2006 | 6,200 | 12,910 | 830 | 1,390 | \$ 16,073,750 |
| 2007 | 1,950 | 460 | - | 92 | 5,856,214 |
| 2008 | 310 | - | - | - | 798,870 |
| | <u>8,460</u> | <u>13,370</u> | <u>830</u> | <u>1,482</u> | <u>\$ 22,728,834</u> |

NOTE U - LITIGATION

Various suits and claims arising in the ordinary course of operations are pending against Lakeland Electric. While the ultimate effect of such litigation cannot be ascertained at this time, in the opinion of counsel for Lakeland Electric, the liabilities which may arise from such actions would not result in losses which would materially affect the financial position of Lakeland Electric or the results of their operations.

NOTE V - COMMITMENTS AND CONTINGENCIES

Self-Insurance Program:

The City has established a self-insurance fund for worker's compensation, general liability, public official's liability, airport liability, automobile liability, and health insurance. The purpose of this fund is to account for the cost of claims and management fees incurred in conjunction with self-insurance programs. The City makes contributions to the fund based on actuarially computed funding levels. The funding level for Lakeland Electric is determined actuarially based on Lakeland Electric's share of the total City budget, number of vehicles owned and rented, number of employees and payroll. Contributions in excess of these funding levels are accounted for as residual equity transfers in the paying fund. All claims pending at September 30, 2005, have been accrued in the financial statements of the Self-Insurance Fund. An estimated liability for incurred-but-not-reported claims also has been accrued in the financial statements of the Self-Insurance Fund.

CITY OF LAKELAND, FLORIDA
DEPARTMENT OF ELECTRIC UTILITIES

NOTES TO FINANCIAL STATEMENTS
(CONCLUDED)

NOTE V - COMMITMENTS AND CONTINGENCIES (CONTINUED)

This program provides coverage up to a maximum of \$400,000 per employee for worker's compensation claims. The City purchases commercial insurance for claims in excess of this amount up to \$1,000,000 per employee. The program provides coverage of up to a maximum of \$150,000 per employee for health insurance claims. The City purchases commercial insurance for claims in excess of this amount up to \$1,000,000 per employee. Refer to the City of Lakeland, Florida comprehensive annual financial report for additional disclosures.

Contractual Commitments:

Lakeland Electric has contracts for the purchase and delivery of coal requiring the purchase of a minimum number of tons per year.

Lakeland Electric also has contracts for the supply and transportation of natural gas requiring the purchase and transportation of a minimum and a maximum number of cubic feet of natural gas per year.

Lakeland Electric has contracts for the purchase/sale and delivery of electric energy setting a maximum number of megawatts available for purchase.

Since 1996, Lakeland Electric has entered into contracts with major customers to provide their electric energy requirements.

The Department has a long term maintenance contract with Siemens/Westinghouse to provide labor, parts, and materials to cover all planned outages for McIntosh Unit 5, a 360 megawatt combined cycle gas turbine unit. The annual cost is based on a combination of the number of hours the unit operates and the number of equivalent starts experienced. The City renegotiated the contract with Siemens/Westinghouse during fiscal year 2005 and it runs through fiscal year 2011. Although there is not a fixed contract amount, annual payments are expected to range between \$4.1 million and \$5.3 million, the majority of which will be capitalized as replacement parts.

In 2000, Lakeland Electric entered into a contract with the Florida Municipal Power Association (FMPA) that allows the FMPA the option of taking up to 100 megawatts of energy per hour at a fixed cost. Significant increases in fuel costs have resulted in substantial losses to Lakeland Electric under this contract. Management has made a decision that losses related to the FMPA contract will not be passed along to the electric customers. The contract originally ran through December 15, 2010. During fiscal year 2004, management negotiated with the FMPA to reduce the length of the contract by three years so that it now runs through December 15, 2007. The expiration of the contract will allow Lakeland Electric to build the reserves necessary to fund future capital projects.

It is management's opinion that they are in compliance with the requirements of all the aforementioned contracts.

Disaster Recovery:

During fiscal year 2004 Lakeland Electric's service territory was adversely impacted by three hurricanes. All counties in the State of Florida were declared a major disaster by the President for each of the three hurricanes that affected Lakeland Electric's service territory. The disaster declaration provided for up to 100 percent reimbursement of eligible costs. The Federal Emergency Management Agency (FEMA) granted disaster assistance through grants passed through the State of Florida Department of Community Affairs. The last of the hurricanes, Hurricane Jeanne supplied the greatest damage to the Lakeland area when it struck on September 26, 2004, just prior to fiscal year end. Lakeland Electric recorded a contingent liability in fiscal year 2004, offset by financial aid recovery, for hurricane damages that were not repaired as of September 30, 2004. Lakeland Electric recorded gross expenditures of \$10.8 million for recovery efforts from the three hurricanes, of which \$10.0 million was determined to be reimbursable. As of September 30, 2005 all of the restoration work related to the three hurricanes was completed, and all but \$0.1 million of claims was received from FEMA.