

**CITY OF KNOXVILLE, TENNESSEE**

**Notes to Financial Statements**

**June 30, 2004**

(amounts expressed in thousands)

**NOTE 15 - MANAGEMENT AGREEMENTS (continued)**

*Knoxville Municipal Golf Course* - The City entered into an agreement on March 25, 1983, with C. E. Roberts, Inc. to develop and operate the Knoxville Municipal Golf Course from December 23, 1982, to December 23, 2007. Under terms of the lease, Roberts shall remit one dollar per year to the City as well as place 20% of its annual net income in a sinking fund reserved specifically for capital improvements to the golf course.

*Parking Garages* - The City entered into agreements with Republic Parking Systems, Inc. whereby Republic Parking Systems, Inc. will manage and operate the State Street and Main Avenue Parking Garages. The term of the agreements is for one year beginning July 10, 2004. Under the agreement, Republic Parking Systems, Inc. will receive \$119.2 for the State Street Garage and \$100.4 for the Main Avenue Garage payable in twelve monthly installments. The City must also make incentive payments equal to 10.0% of the revenue of each garage that exceeds the revenue of the previous year.

*IJAMS Nature Park* - The City entered into an agreement on August 2, 1993, with the IJAMS Nature Park whereby IJAMS will provide management and operation of a nature park. The agreement has been extended through July 31, 2005. The agreement calls for a management fee of \$109.

*Knoxville Convention Center* - The City entered into an agreement on November 22, 2000, with SMG to manage the first five years of operations of the Convention Center. The agreement calls for a fixed fee of \$275 in 2004, \$300 in 2005 and \$325 in 2006 and 2007.

**NOTE 16 - COMMITMENTS AND CONTINGENCIES**

*Primary Government*

**Federal financial assistance** - The City participates in a number of federal financial assistance programs. These programs have been audited through June 30, 2004 in accordance with provisions of the Single Audit Act of 1984.

**Urban Growth Plan** - The City and Knox County entered into an agreement that defines City and County growth areas within the County. The agreement prohibits alteration to the Urban Growth Plan through December 31, 2004 and may be automatically extended for an additional three years through December 31, 2007. The agreement prohibits the City from annexing certain property for the four-year period unless certain conditions exist. The County agreed to invest \$5,000 from its current five-year capital plan for the City to make capital projects within its Empowerment Zone. The County will also designate an additional \$2,000 from its capital plan beginning in January 2005. Should the City take actions resulting in the residential annexation during the period of the agreement, all funds provided to the City by Knox County must be returned to the County within 15 days.

*Knoxville Utilities Board*

**Purchased Gas Adjustments** - Knoxville Utilities Board's gas division purchased gas adjustment mechanism allows the Division to flow changes in purchased gas costs through to its customers. These changes in gas costs are reflected as adjustments to the base gas rates established by Knoxville Utilities Board's Board of Commissioners. The purchased gas adjustment is intended to ensure that KUB recovers the total cost of natural gas purchased, transported and/or reserved for delivery to its sales and transportation customers on an equitable basis. The purchased gas adjustment is also intended to ensure that no excess or deficient cost recovery from the Division's customers occurs.

Under the purchased gas adjustment mechanism, the Division tracks the actual over/under recovered amount in the unrecovered purchased gas costs accounts. These accounts are rolled into the purchased gas rate adjustment on June 30 of each year thereby assuring that any over/under recovered amounts are passed on to the Division's customers. The amount of underrecovered costs was \$923 at June 30, 2004.

(continued)

**CITY OF KNOXVILLE, TENNESSEE**

**Notes to Financial Statements**

**June 30, 2004**

(amounts expressed in thousands)

**NOTE 16 - COMMITMENTS AND CONTINGENCIES (continued)**

**Purchased Power Adjustment** - In October 2002, the Electric Division of the Knoxville Utilities Board (KUB) implemented a purchased power adjustment mechanism that allows the Division to promptly adjust its retail electric rates in response to Tennessee Valley Authority (TVA) wholesale rate changes/adjustments, thus ensuring that KUB will recover its cost of electric power purchases for resale to its customers.

In May 2002, in response to changes in the electric power industry, KUB and TVA executed an amendment to their wholesale power supply contract under which, among other things, TVA relinquishes its regulatory authority over KUB retail electric rates. Since TVA no longer has contractual authority to adjust KUB's retail electric rates, KUB needed an alternative means of promptly adjusting its electric rates in response to TVA wholesale rate changes/adjustments.

In October 2003, TVA increased its wholesale power rates for its electric power distributors, including KUB. The KUB Board of Commissioners flowed this wholesale cost increase directly through to its retail electric customers, resulting in an increase of approximately 5.7% for residential customers and 5.7 to 7.0 percent for commercial customers. With the exception of wholesale reactive demand charges (which was deferred by TVA until April 2004), the KUB Board of Commissioners passed through this wholesale rate increase by adjusting its electric retail rate schedules rather than using the purchased power adjustment mechanism. The increase in wholesale reactive demand charges was flowed through to KUB's retail customers by means of the purchased power adjustment in April 2004.

In March 2004, the KUB Board of Commissioners modified the purchase power agreement mechanism to ensure that the effective date of any purchased power adjustment appropriately corresponds to any applicable TVA wholesale rate change, and to update the purchased power adjustment mechanism to reflect new retail electric rate schedules adopted by the KUB Board of Commissioners in October 2003.

**Natural Gas Supply Contract Commitments** - For the year ended June 30, 2004, the Gas Division of the Knoxville Utilities Board hedged 74% of its total gas purchases via gas supply contracts. As of June 30, 2004, the Gas Division had hedged the price on approximately 40% of its anticipated gas purchases for fiscal year 2005.

The Knoxville Utilities Board contracts separately for the purchase, transportation and storage of natural gas. Purchase commitments for the next five years are as follows:

	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>
Demand:					
Transportation	\$ 13,830	\$ 14,669	\$ 14,495	\$ 12,906	\$ 12,223
Storage	2,509	2,408	2,528	2,528	2,528
Supply reservation	<u>14</u>	<u>5</u>	<u>-</u>	<u>-</u>	<u>-</u>
Demand total	<u>\$ 16,353</u>	<u>\$ 17,082</u>	<u>\$ 17,023</u>	<u>\$ 15,434</u>	<u>\$ 14,751</u>
Commodity:					
Baseload	<u>\$ 26,200</u>	<u>\$ 106</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

**Other Commitments and Contingencies**

In May 2003 the Knoxville Utilities Board (KUB) entered into an Agreed Order with the Tennessee Department of Environment and Conservation to address sanitary sewer overflows on the wastewater system. The Order required the remediation of all sanitary sewer overflows that occurred during 2001 and 2002 to be completed by 2011, and remediation of all sanitary sewer overflows that occur during the interim to be completed by 2014. The Order provided for a variety of planning and reporting activities including the posting of sanitary sewer overflows on KUB's website, the submittal of a sewer overflow response plan, a sanitary sewer overflows evaluation report, a public information plan, a corrective action plan and engineering report, a capacity assurance program, and a management operations and maintenance program.

(continued)

**CITY OF KNOXVILLE, TENNESSEE**

**Notes to Financial Statements**

**June 30, 2004**

(amounts expressed in thousands)

**NOTE 16 - COMMITMENTS AND CONTINGENCIES (continued)**

In September 2003, the Tennessee Clean Water Network filed suit in federal court against KUB for violations of the federal Clean Water Act, in relation to sanitary sewer overflows and other operational/treatment issues on the KUB wastewater system. The City of Knoxville subsequently intervened as a party to the suit against KUB. Subsequent to the filing of this suit, the Environmental Protection Agency Region 4 and the Department of Justice reviewed the terms of the Order. Following the Environmental Protection Agency and the Department of Justice's review all parties requested, and the Court granted, a stay of the federal suit pending negotiations between the Department of Justice, the Environmental Protection Agency, the Tennessee Clean Water Network, the City and KUB on all issues related to the suit. These negotiations commenced in January 2004 and were still in progress as of June 30, 2004.

In November 2004, the Department of Justice, the Environmental Protection Agency, the Tennessee Clean Water Network, the City and KUB reached tentative agreement on settlement of all disputed issues in the Federal Clean Water Act lawsuit regarding operational/treatment issues on KUB's wastewater system. The terms of the tentative settlement, among other things, incorporates all provisions of the Tennessee Department of Environment and Conservation Agreed Order and extends the deadline for final compliance from June 30, 2014 to June 30, 2016. The terms of the tentative agreement will:

- Incorporate all provisions of the Tennessee Department of Environment and Conservation Agreed Order and extend the deadline for final compliance from June 30, 2014 to June 30, 2016.
- Require the evaluation of the wet-weather performance and capacity of KUB's wastewater treatment plants, including the development of any recommendations for needed improvements to operational practices or facilities and corresponding schedules for implementation.
- Require KUB to pay a civil penalty of \$167 to the United States Government.
- Require KUB to fund an environmental project of the State of Tennessee in the amount of \$167.
- Require KUB to fund a Supplemental Environmental Project totaling \$2 million over a ninety-six (96) month period beginning with the date the tentative agreement is approved by the Federal Judge.
- Subject KUB to certain stipulated penalties if it fails to comply with the provisions of the tentative agreement.
- Resolve the Federal Clean Water Act lawsuit between the Tennessee Clean Water Network and KUB.
- Require KUB to pay reasonably related legal/consulting expenses of the Tennessee Clean Water Network. KUB estimates these expenses not to exceed \$100.

The civil penalty due the United States Government and the funding of the State of Tennessee environmental project will be paid by KUB upon final approval of the tentative agreement by the Federal Judge. These amounts total \$334. The initial payment for the Supplemental Environmental Project, \$150, will be paid by KUB within thirty days of final approval. In addition, the tentative agreement requires KUB pay any reasonably related legal/consulting expenses of the Tennessee Clean Water Network. KUB estimates these legal/consulting expenses not to exceed \$100. KUB has recognized a liability for the aforementioned expenses, totaling \$584, on its fiscal year 2004 financial statements.

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**CITY OF KNOXVILLE, TENNESSEE**

**Notes to Financial Statements**

**June 30, 2004**

(amounts expressed in thousands)

**NOTE 16 - COMMITMENTS AND CONTINGENCIES (continued)**

One of the requirements of the Tennessee Department of Environment and Conservation Agreed Order and the tentative agreement is development of a Corrective Action Plan and Engineering Report, that includes the capital and maintenance projects necessary for KUB to comply with the Agreed Order and the tentative agreement. Based on the draft Corrective Action Plan and Engineering Report, in order to comply with the Agreed Order and the tentative agreement, KUB is estimating its Wastewater Division will spend a total of \$530 million in capital investments over the next ten years, plus an additional \$37 million in operating and maintenance expenditures over total base level operating and maintenance over the next ten years.

During fiscal year 2003 and 2004 KUB was issued Notices of Violation and/or penalty assessments by the City for sanitary sewer overflows. KUB appealed all penalty assessments to the City of Knoxville Board of Environmental Appeals. The Board of Environmental Appeals held hearings and issued rulings on some, but not all, of the penalty assessments on appeal before it, affirming the City's right to issue penalties but modifying the amounts of some of those penalties. The remainder of the penalty assessments appealed to the Board of Environmental Appeals were pending as of June 30, 2004. Those penalty assessments, which had been ruled upon by the Board of Environmental Appeals, were appealed by KUB to the Circuit Court for Knox County, Tennessee ("Circuit Court") where they were also pending as of June 30, 2004. The City and KUB entered into facilitated negotiations to resolve the regulatory issues and all penalty assessments pending before the Board of Environmental Appeals and the Circuit Court. These negotiations were in progress as of June 30, 2004.

In November 2004, the City and KUB settled their dispute over regulatory issues and the associated notice of violations and/or penalty assessments by the City against KUB for sanitary sewer overflows. Under the terms of agreement with the City, the City will dismiss without prejudice all notice of violations issued against KUB to date and all penalties assessed against KUB to date totaling over \$600.

**NOTE 17 - POST-RETIREMENT BENEFITS**

Former City employees are allowed to maintain health care coverage comparable to what they had at retirement. Premium payments are the responsibility of the retiree.

In addition to providing pension benefits, the Knoxville Utilities Board provides certain health care and life insurance benefits for retired employees, their spouses and dependent children. The cost associated with the post-retirement benefits were incurred by the Knoxville Utilities Board Pension Plan. As of January 1, 2002, the pension plan no longer funds the retiree medical health benefits. The cost of retired health care and life insurance benefits is recognized as expense as claims are paid. Substantially all of the Knoxville Utilities Board's employees hired on or before July 1, 1999, are eligible for these benefits, if they meet the Rule of 80 upon termination of employment, with a minimum of 20 years of service or if they had 25 years of service as of January 1, 1998. Approximately 1,409 retirees and dependents were eligible to receive such benefits at June 30, 2004. Knoxville Utilities Board's portion of total benefits and related administrative expenses for 2004 was approximately \$5,313.

**NOTE 18 - BUSINESS AND CREDIT CONCENTRATIONS**

The Metropolitan Knoxville Airport Authority is dependent to a large extent on one major airline in that a significant portion of aviation revenue is generated by that airline. The airline accounted for approximately \$391 in aviation area revenue during 2004. In addition, a significant portion of terminal area revenue is directly and indirectly generated from that airline's passengers, which accounted for approximately 18% of 2004 passengers.