Knoxville Utilities Board

Consolidated Financial Statements and Supplemental Information
June 30, 2012 and 2011

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Independent Auditors' Report

To the Board of Commissioners
Knoxville Utilities Board – Consolidated
Knoxville, Tennessee

We have audited the accompanying consolidated financial statements of the Knoxville Utilities Board, an independent agency and reported as a component unit for financial reporting purposes only by the City of Knoxville, Tennessee, as of and for the years ended June 30, 2012 and 2011. These financial statements are the responsibility of Knoxville Utilities Board's management. Our responsibility is to express opinions on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. 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 the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the Knoxville Utilities Board, as of June 30, 2012 and 2011, and the respective changes in financial position, and cash flows, for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated October 18, 2012, on our consideration of the Knoxville Utilities Board's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 3 through 19 and Schedule of Funding Progress on page 43 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the Knoxville Utilities Board's financial statements as a whole. The supplemental schedule on page 46 is presented for the purpose of additional analysis and is not a required part of the financial statements. The accompanying schedule of expenditures of federal awards on page 44 is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit*

Organizations, and is also not a required part of the financial statements. The schedule of expenditures of federal awards is the responsibility of management and was derived from and relate directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the financial statements as a whole. The supplemental schedule has not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we do not express an opinion or provide any assurance on them.

In accordance with *Government Auditing Standards*, the report on our consideration of the Board's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters dated October 18, 2012, has been reissued due to the omission of two federal program contracts on the schedule of expenditures of federal, state and other awards. Since program CFDA 97.036 was considered major, additional audit procedures were performed. The changes to the previously issued report dated October 18, 2012 encompasses the addition of program CFDA 97.036 contract number 34101-0000009205 and contract number 34101-0000009832 to the schedule of expenditures of federal, state and other awards and to the schedule of findings and questioned costs.

Rodefer Moss & Co, PLLC

Knoxville, Tennessee
October 18, 2012
(Except as noted in the last paragraph above,
as to which the date is October 22, 2013)

Knoxville Utilities Board (KUB), comprised of the Electric Division, Gas Division, Water Division, and Wastewater Division (Divisions), is reported as a component unit enterprise fund in the financial statements of the City of Knoxville. KUB's responsibility is to oversee the purchase, production, distribution, and processing of electricity, water, natural gas, and wastewater services. A seven-member Board of Commissioners governs KUB. The Board has all powers to construct, acquire, expand, or operate the Divisions. It has full control and complete jurisdiction over the management and operation of the Divisions including setting rates. KUB's accounts are maintained in conformity with the Uniform System of Accounts of the Federal Energy Regulatory Commission (FERC), the Uniform System of Accounts of the National Association of Regulatory Utility Commissioners (NARUC), and the Governmental Accounting Standards Board (GASB), as applicable.

This discussion and analysis is designed to (a) assist the reader in focusing on significant financial issues, (b) provide an overview of KUB's financial activity, (c) identify major changes in KUB's financial position, and (d) identify any financial concerns.

The Management Discussion and Analysis ("MD&A") focuses on the fiscal year ending June 30, 2012 activities, resulting changes and current known facts, and should be read in conjunction with KUB's consolidated financial statements.

Consolidated Highlights

Financial Highlights

Net assets increased $26.3 million or 3.3 percent in fiscal year 2012, compared to a $27.7 million increase last fiscal year.

Operating revenue decreased $28.9 million or 4 percent, the net result of a decline in sales volumes for all four utility systems, the flow through of higher wholesale power rates to KUB's retail electric customers, additional revenue from electric, water, and wastewater rate increases, and the flow through of lower wholesale natural gas rates to KUB's gas customers. Purchased energy expense (power and natural gas) decreased $27.2 million or 5.6 percent. Margin from sales (operating revenue less purchased energy expense) was down $1.7 million or 0.7 percent compared with the prior fiscal year.

Operating expenses (excluding purchased power and purchased gas expense) decreased $1.5 million, or 0.8 percent. Operating and maintenance (O&M) expenses declined $4.1 million or 3.6 percent. Depreciation and amortization expense increased $2 million or 4.4 percent. Taxes and tax equivalents increased $0.6 million or 2.5 percent.

Lower interest rates on contingency reserve investments resulted in a $0.4 million decrease in interest income. Interest expense increased $1.8 million or 5.7 percent, due to the issuance of $25 million in water revenue bonds during the fiscal year and a full year of interest on $112 million of debt issued the previous year. These items contributed to a net decrease in non-operating revenues (expenses) of $2.1 million compared to the prior year.

Capital contributions increased $0.9 million, the result of growth in contributed assets from developers due to new construction in the water and wastewater service areas.

Total plant assets (net) increased $97.6 million or 7.7 percent over the last fiscal year.

In December 2011, the Water Division issued $25 million of new long-term debt to fund capital system improvements.

In April 2012, $94.6 million of outstanding debt was refunded, which will result in a cost savings of $15.4 million over the term of the debt ($12.3 million on a net present value basis). As a result of the refunding, the principal owed was reduced by $5.7 million.

Long-term debt represented 47 percent of KUB’s capital structure, compared to 47.9 percent last year. Capital structure equals long-term debt (including the current portion of revenue bonds and notes, as applicable, due to be retired next fiscal year), plus net assets.

Other Highlights

As of June 30, 2012, KUB served 442,500 customers. During the year, 2,700 new customers were added, representing growth of less than 1 percent.

A historically mild winter had a significant impact on energy sales for fiscal year 2012. The winter was 23 percent warmer than normal and, as a result, electric sales volumes were 4.6 percent lower than the prior fiscal year and natural gas sales volumes were 13.3 percent lower.

KUB refunded $94.6 million in outstanding bonds at lower interest rates, which will provide debt service savings of $15.4 million over the life of the bonds.

KUB achieved its goal of reducing full-time staffing to 875 full-time employees by June 30, 2012. KUB’s full-time staffing level as of fiscal year-end was 872. The staffing goal was a key component of KUB’s recession response plan, which was initiated in January 2009. Prior to setting this goal, KUB’s long-term staffing plan anticipated 980 full-time employees by June 2012. Achieving the goal will provide approximately $5 million in annual savings.

Two historic storm events, with combined restoration costs of $8.4 million, impacted the KUB electric system during fiscal year 2011. KUB received $4.2 million in reimbursements from the Federal Emergency Management Agency (FEMA) during fiscal year 2012. KUB anticipates an additional $2.1 million in reimbursements from FEMA in fiscal year 2013.

KUB was awarded a grant from the Department of Energy in October 2009 through the DOE’s Smart Grid Investment Grant Program. The grant, which totals $3.58 million, will be used to help fund a smart grid pilot project in the University of Tennessee and surrounding areas. The pilot includes the installation of over 6,000 digital electronic smart meters and an advanced metering infrastructure (AMI) communications backbone, which will provide coverage for KUB’s entire service territory. The communications infrastructure will enable KUB to remotely read meters, and also provide remote service connection/disconnection capabilities. The term of the pilot is approximately three years. During fiscal year 2012, KUB installed the AMI communication backbone. The grant funded $2.1 million of pilot expenditures for fiscal year 2012.

Each of KUB’s four wastewater treatment plants received an award from the National Association of Clean Water Agencies for outstanding permit compliance in 2011. KUB also received a National Biosolids Partnership certification in December 2011 following an independent review and audit (Biosolids are nutrient-rich organic matter produced by wastewater treatment that can be recycled as fertilizer).

Century II Infrastructure Program

In 2007 KUB launched Century II, a new infrastructure management program, which included the assessment of each utility system's infrastructure and the appropriateness of current life cycle replacement programs. KUB placed it's electric and water Century II programs on hold in 2009 in response to the economic recession in an effort to help customers struggling in a difficult economy. Although major increases to infrastructure replacement funding were delayed, significant investments were made to maintain reliability and system integrity. In April 2011, management provided an updated assessment of the overall condition of each utility system's infrastructure to the KUB Board of Commissioners. The assessment concluded that current funding levels were appropriate to support the natural gas system infrastructure replacement program and the wastewater capital program, however, given the critical infrastructure needs of the electric and water distribution systems, management recommended the KUB Board endorse a plan to resume the Century II electric and water programs in fiscal year 2012. A ten-year funding plan was developed to support the implementation of the electric and water Century II programs, including a combination of rate increases and debt issues to fully fund the programs for the next ten years.

In September 2011, the Board adopted a resolution, which endorsed the Century II electric and water programs and the associated ten-year funding plans. The resolution also adopted the initial three electric and water rate increases, the first of which were effective October 1, 2011, and January 1, 2012, respectively. Each of the electric rate increases will generate an additional $5 million in annual electric sales revenue. For residential electric customers this will result in an increase of $1 in their monthly electric bills for each of the rate increases. Each of the water rate increases will generate an additional $1.7 million in annual water sales revenue. For residential water customers this will result in an increase of $1 in their monthly water bills for each of the rate increases.

With Board approval, KUB immediately began implementing the accelerated pace of infrastructure replacement for the electric and water systems. For the fiscal year ended June 30, 2012, KUB exceeded its target replacement levels for all of its Century II programs, while maintaining its overall capital budget. For the electric system, 2,800 poles were replaced, exceeding the target level of 2,300; 17.5 miles of underground electric cable were replaced, exceeding the target level of 12.5 miles. For the water system, 11.5 miles of galvanized water main were replaced, exceeding the target level of 10 miles; 4.1 miles of cast iron water main were replaced, exceeding the target level of 3.5 miles. For the natural gas system, 9.75 miles of cast iron/ductile iron gas main were replaced, exceeding the target level of 8 miles. For the wastewater system, 29 miles of wastewater system main were rehabilitated or replaced, exceeding the target level of 25 miles.

Consent Decree

In February 2005, a Consent Decree was entered into federal court regarding the operation of KUB's wastewater system. Under the terms of the Consent Decree, the remediation of identified sanitary sewer overflows ("SSOs") on KUB's wastewater system must be completed by June 30, 2016. KUB anticipates the Division will spend approximately $530 million in capital investments in order to comply with the terms of the Consent Decree related to the collection system. The Consent Decree also required KUB to perform an evaluation of the wet-weather performance and capacity of its wastewater treatment plants.

In July 2007, KUB submitted a Composite Correction Plan (CCP) for its wastewater treatment plants to EPA for review. The development and filing of the CCP was a requirement of the federal order of February 2005. The CCP includes recommended improvements to KUB's Kuwahee and Fourth Creek treatment plants to address wet weather capacity issues noted in prior assessments. The EPA approved the CCP in January 2009 including a recommended schedule of plant improvements that extends beyond the expiration date of the original Consent Decree. An amendment to the Consent Decree incorporating and establishing this schedule was agreed to by all parties and was entered on June 23, 2009. The purpose of the Amendment is to allow KUB to complete a portion of work outlined in the CCP after the Consent Decree deadline of June 30, 2016. The CCP provides for a biologically enhanced high-rate clarification (the "BEHRC") secondary treatment system to be installed at the Fourth Creek treatment plant by June 30, 2018 and at the Kuwahee treatment plant by June 30, 2021. The total cost of such improvements is estimated to be approximately $120 million.

KUB's total estimated capital investment to comply with the terms of the Consent Decree is $650 million.

During fiscal year 2006, KUB launched the Private Lateral Program (PLP), as required by the Consent Decree, under which KUB tests private collection system laterals on its wastewater system over a ten-year period. Defective laterals and improper connections can introduce rainwater overloading the wastewater system and add pollution to area waterways. If a private lateral fails the respective inspection test, then the customer is required to have the lateral repaired/replaced within a specified time period. The $2 million SEP provides funding for lateral repairs/replacements for eligible low-income customers. All of the SEP funds were disbursed as of April 2012.

KUB's funding plan for the Consent Decree includes approximately $680 million in bond issues through June 2021 plus a series of rate increases phased in over the term of the order. Bond proceeds fund all wastewater capital projects, the majority of which are related to the Consent Decree. As of June 30, 2012, the Wastewater Division had issued $360 million in bonds to fund system capital improvements since the inception of the Consent Decree. The KUB Board of Commissioners approved two 50 percent rate increases, which went into effect in April 2005 and January 2007, respectively. The Board also approved an 8 percent rate increase, which was effective in September 2008, and a 12 percent rate increase, which was effective in April 2011. The Board also adopted a 12 percent rate increase to be effective October 2012. KUB anticipates additional bond issues and rate increases over the next decade to help fund PACE 10.

KUB continues to be in compliance with Consent Decree requirements. In August 2004, KUB launched PACE 10, an accelerated ten-year program to help improve Knoxville's waterways, the quality of life, and the economic well being of the community. As part of the PACE 10 program, KUB has installed storage tanks providing 34 million gallons of wastewater storage to control wet-weather overflows and rehabilitated or replaced approximately 203 miles of collection system pipe. KUB also continues to maintain a proactive operations and maintenance plan for the wastewater collection system including inspection, cleaning, grease control, and private lateral enforcement. The result of the PACE 10 program has been a substantial reduction in sanitary sewer overflows.

During fiscal year 2012, the Wastewater Division incurred $60.5 million in total expenditures related to Consent Decree requirements, including $3.7 million for operating costs and $56.8 million in capital improvements. During the fiscal year, $20.4 million was spent on sewer mini-basin rehab and replacement. Trunk line replacement and rehabilitation accounted for $17 million of capital expenditures during the fiscal year. Upgrades currently in progress at the Kuwahee and Fourth Creek Treatment Facilities accounted for $11.8 million of fiscal year 2012 capital expenditures. As of June 30, 2012, the Wastewater Division had spent $371.5 million in capital investments to meet the requirements of the Consent Decree.

Cash Budget Appropriations

KUB's Board of Commissioners adopted a total cash budget of $869.4 million for fiscal year 2012. At fiscal year-end, cash expenditures were $56.5 million under budget primarily due to a $53.2 million decrease in purchased energy expense as a result of lower than expected purchases due to milder winter weather and lower than projected wholesale energy rates. Operating receipts were down $59.4 million compared to budget as a result of lower than expected sales and the flow through of lower than anticipated energy costs. O&M expenditures were $3.4 million under budget, reflecting labor-related savings. Capital expenditures were on budget. $59.1 million in bond proceeds were transferred to the general fund to pay for capital during fiscal year 2012, $16.7 million more than expected, which was due to the timing of capital projects during fiscal year 2011. KUB's general fund balance was $11.3 million higher than anticipated at year-end. The numbers below are presented on a cash basis.

KUB Consolidated Cash Report
As of June 30, 2012

(in thousands of dollars)	FY 2012 Budget	FY 2012 Actual FYTD	Dollar Variance*	Percent Variance
Beginning Balance General Fund	$139,547	$139,547		
Operating Receipts	776,160	714,808	(61,352)	-7.9%
Disbursements				
Purchased Energy Expense	521,808	468,596	53,212	-10.2%
Operation & Maintenance Expense	115,460	112,086	3,374	-2.9%
Capital Expenditures	152,711	152,387	324	-0.2%
Debt Service & Taxes	79,388	79,776	(388)	0.5%
Total Disbursements	869,367	812,845	56,522	-6.5%
Bond Proceeds	42,424	59,096	16,672	39.3%
Net Flow-throughs and Transfers	317	(248)	(565)	-100%
Ending General Fund Balance	$ 89,081	$ 100,358	$ 11,277	12.7%

**(-) indicates a decrease to cash*

KUB Consolidated Financial Statements

KUB's financial performance is reported under three basic consolidated financial statements: the Statement of Net Assets; the Statement of Revenues, Expenses and Changes in Net Assets; and the Statement of Cash Flows.

Statement of Net Assets

KUB reports its assets, liabilities, and net assets in the Statement of Net Assets. Assets are classified as current, restricted, plant in service, or other assets.

Liabilities are classified as current, other, or long-term debt. Net assets are classified as invested in capital assets, net of related debt; restricted; or unrestricted. Net assets tell the user what KUB has done with its accumulated earnings, not just the balance.

Invested in capital assets, net of related debt, reflects the book value of all capital assets less the outstanding balances of debt used to acquire, construct, or improve those assets.

Restricted net assets are assets that have been limited to specific uses by KUB's bond covenants or through resolutions passed by the KUB Board of Commissioners.

Unrestricted net assets are a residual classification; the amount remaining after reporting net assets as either invested in capital or restricted is reported there.

Statement of Revenues, Expenses and Changes in Net Assets

KUB reports its revenues and expenses (both operating and non-operating) on the Statement of Revenues, Expenses and Changes in Net Assets. In addition, any capital contributions or assets donated by developers are reported on this statement.

Total revenue less total expense equals the change in net assets for the reporting period. Net assets at the beginning of the period is increased or decreased, as applicable, by the change in net assets for the reporting period.

The change in net assets for the reporting period is added to the net assets segment of the Statement of Net Assets.

Statement of Cash Flows

KUB reports cash flows from operating activities, capital and related-financing activities, and investing activities on the Statement of Cash Flows. This statement tells the user the sources and uses of cash during the reporting period.

The statement indicates the beginning cash balance and ending cash balance and the means by which it was either increased or decreased during the reporting period.

The statement also reconciles cash flow to operating income as it appears on the Statement of Revenues, Expenses and Changes in Net Assets.

Condensed Financial Statements

Statement of Net Assets

The following table reflects the condensed consolidated Statement of Net Assets for KUB compared to the prior year.

Statements of Net Assets
As of June 30

(in thousands of dollars)	2012	2011
Current and other assets	$ 338,631	$ 409,140
Capital assets, net	1,367,479	1,269,924
Total assets	1,706,110	1,679,064
Current and other liabilities	150,228	147,156
Long-term debt outstanding	720,575	722,940
Total liabilities	870,803	870,096
Net assets		
Invested in capital assets, net of related debt	621,993	529,826
Restricted	11,228	10,426
Unrestricted	202,086	268,716
Total net assets	$ 835,307	$ 808,968

Normal Impacts on Statement of Net Assets

The following is a description of activities which will normally impact the comparability of the Statement of Net Assets presentation.

- Change in net assets (from Statement of Revenues, Expenses and Changes in Net Assets): impacts (increase/decrease) current and other assets and/or capital assets and unrestricted net assets.
- Issuing debt for capital: increases current and other assets and long-term debt.
- Spending debt proceeds on new capital: reduces current assets and increases capital assets.
- Spending of non-debt related current assets on new capital: (a) reduces current assets and increases capital assets and (b) reduces unrestricted net assets and increases invested in capital assets, net of related debt.
- Principal payment on debt: (a) reduces current and other assets and reduces long-term debt and (b) reduces unrestricted net assets and increases invested in capital assets, net of related debt.
- Reduction of capital assets through depreciation: reduces capital assets and invested in capital assets, net of related debt.

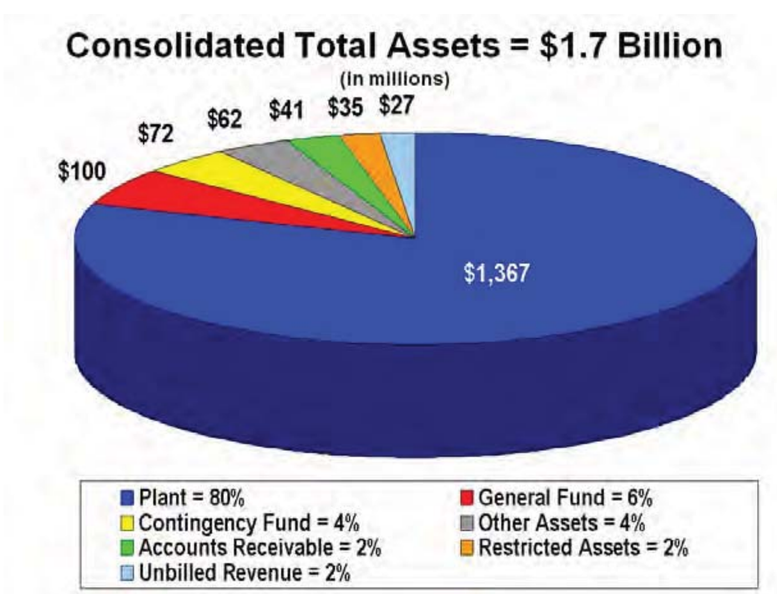
Current Year Impacts and Analysis

Current and Other Assets
Current and other assets decreased $70.5 million or 17.2 percent. General fund cash (including cash and cash equivalents, short-term investments, and long-term investments) decreased $39.2 million or 28.1 percent, due to the use of general fund cash to fund a portion of the year's capital improvements. Accounts receivable was $9 million or 17.8 percent lower than last year, partially due to lower June sales in all divisions compared to the prior year. The cost of gas in storage rose $3 million or 27.2 percent, due to an increase in the volume of stored gas compared to last year. The total of unused bond proceeds, $13.8 million, represented the remainder of $25 million in water bonds issued in December 2011. During fiscal year 2012, $47.8 million of unused proceeds available at the end of the prior year were expended to fund capital system improvements in the Electric, Gas, and Wastewater Divisions. This amount contributed to the overall decrease in restricted assets.

In the previous fiscal year, KUB instituted a deferred accounting component to its Purchased Power Adjustment to ensure appropriate cost recovery over the long-term. As of June 30, 2012, KUB had under recovered $17.7 million in wholesale power costs, which reflected a $1.7 million increase in net assets compared to the prior year. This under recovery of wholesale power costs will be recovered from KUB's electric customers through future adjustments to electric rates via the Purchased Power Adjustment.

The Gas Division under recovered $3.9 million in wholesale gas costs from its customers in fiscal year 2012, as compared to a $1.1 million over recovery in fiscal year 2011. This under recovery of costs will be flowed back to gas customers next fiscal year through adjustments to natural gas rates via the Purchased Gas Adjustment. The net effect was a $2.8 million addition in assets.

Capital Assets
Capital assets (net) increased $97.6 million or 7.7 percent. Major plant additions (reflected in both plant additions and work in progress) during fiscal year 2012 included $45 million for PACE 10 projects for the wastewater collection system, $11.8 million for Composite Correction Plan projects for the wastewater system, $22.7 million for electric distribution system improvements, $17.3 million for cast iron gas main replacement and construction of new gas mains, $7 million for water main replacement, $6.8 million for pole replacements for the electric system, $4.5 million for water plant and system improvements, and $2.8 million for smart grid infrastructure.

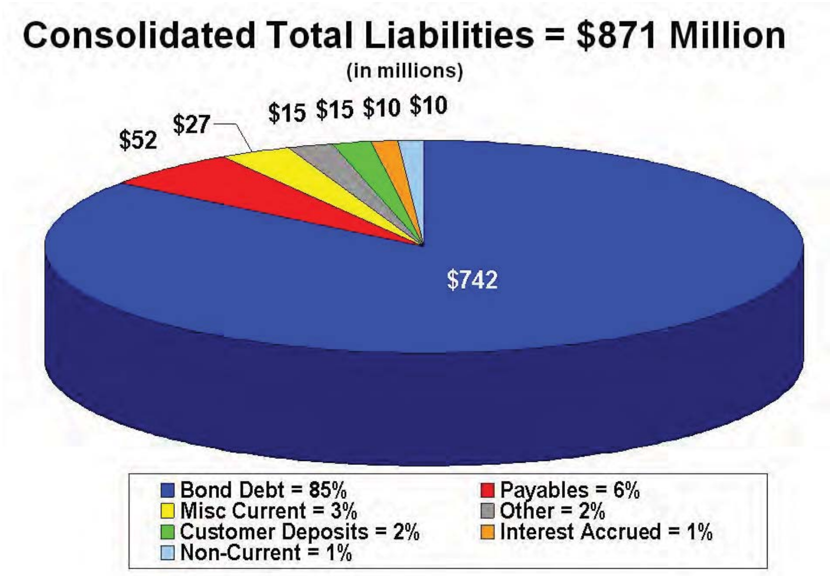


Current and Other Liabilities

Current and other liabilities increased $3.1 million. The net unamortized cost of debt increased $5 million primarily reflecting premiums received in the refunding of $94.6 million of outstanding debt in April 2012. In addition, the liability for the current portion of debt related to bonds rose $1.9 million compared to the prior year. These increases were partially reduced by a $3.5 million decrease in liability for the funding of post employment medical benefits.

Long-term Debt

Long-term debt decreased $2.4 million or 0.3 percent. In December 2011, the Water Division issued $25 million in long-term bonds. In April 2012, KUB refunded $94.6 million in debt, resulting in a net reduction in outstanding debt of $5.7 million. During the fiscal year, $19.8 million of bond debt was repaid which contributed to the overall decrease in debt.



Net Assets

Investments in capital assets, net of debt increased $92.2 million or 17.4 percent, primarily due to the $26.3 million increase in net assets (as reported on the Statement of Revenue, Expenses and Changes in Net Assets), the expending of $59 million in proceeds from prior and current year bond issues on capital infrastructure during the year, and a $2.4 million decrease in long-term debt. Restricted net assets increased $0.8 million compared to the prior year. Unrestricted net assets decreased $66.6 million or 24.8 percent, reflecting the reduced balances of unused bond proceeds and general fund cash at fiscal year end.

Statement of Revenues, Expenses and Changes in Net Assets

The following table reflects the condensed consolidated Statement of Revenues, Expenses and Changes in Net Assets for KUB compared to the prior year.

Statements of Revenues, Expenses and Changes in Net Assets
For the Years Ended June 30

(in thousands of dollars)	2012	2011
Operating revenues	$ 693,531	$ 722,442
Less: Purchased power expense	456,038	483,253
Margin from sales	237,493	239,189
Operating expenses		
Treatment	12,624	13,000
Distribution and collection	53,940	56,559
Customer service	11,100	11,755
Administrative and general	31,066	31,492
Depreciation and amortization	47,613	45,603
Taxes and tax equivalents	24,552	23,950
Total operating expenses	180,895	182,359
Operating income	56,598	56,830
Interest income	1,504	1,876
Interest expense	(34,077)	(32,245)
Other income/(expense)	(767)	(910)
Change in net assets before capital contributions	23,258	25,551
Capital contributions	3,081	2,181
Change in net assets	$ 26,339	$ 27,732

Normal Impacts on Statement of Revenues, Expenses and Changes in Net Assets

The following is a description of activities which will normally impact the comparability of the Statement of Revenues, Expenses and Changes in Net Assets presentation.

- Operating revenue is largely determined by volume of sales for the fiscal year. Any change (increase/decrease) in retail rates would also be a cause of change in operating revenue.
- Purchased energy expense is determined by volume of power purchases from TVA and volume of natural gas purchases for the fiscal year. Also, any change (increase/decrease) in wholesale power and/or gas rates would result in a change in purchased energy expense.
- Operating expenses (distribution, customer service, administrative and general) are normally impacted by changes in areas including, but not limited to, labor cost (staffing, wage rates), active employee and retiree medical expenses, and system maintenance.
- Depreciation expense is impacted by plant additions and retirements during the fiscal year.
- Taxes and equivalents are impacted by plant additions/retirements, changes in property tax rates, and gross margin levels.

- Interest income is impacted by level of interest rates and investments.

- Interest expense on debt is impacted by level of outstanding debt and the interest rate(s) on the outstanding debt.

- Other income/(expenses) is impacted by non-operating revenues, netted against miscellaneous non-operating expenses.

- Capital contributions are impacted by a donation of facilities/infrastructure to KUB by developers and governmental agencies. The contributions are recognized as revenue and recorded as plant in service based on the fair market value of the asset(s).

Current Year Impacts and Analysis

Net assets increased $26.3 million, compared to a $27.7 million increase last fiscal year.

Operating revenue declined $28.9 million or 4 percent for the fiscal year ending June 30, 2012. Electric Division operating revenue decreased $15.5 million, the net result of a 4.6 percent decline in sales volumes, additional revenue from a one percent electric margin rate increase, and the flow through of higher wholesale power rates. Gas Division revenue decreased $19.5 million or 18.4 percent for the fiscal year, the result of lower wholesale gas prices, which flowed through to KUB's gas customers, and a 13.3 percent decline in natural gas sales volumes. Water Division revenue increased $1.1 million or 2.9 percent, the result of additional revenue from a five percent rate increase, which was effective January 2012. Wastewater Division revenue was $4.7 million higher than the previous year, reflecting a full year of revenue from a twelve percent rate increase effective April 2011.

Wholesale energy expense decreased $27.2 million or 5.6 percent. Both purchased power and natural gas volumes were significantly impacted by the mildest winter in KUB's service territory in 25 years. Purchased power expense decreased $14.6 million compared to last year, the net result of higher wholesale power rates and lower sales volumes. Purchased gas cost fell $13 million, the combined result of a decline in sales volumes and lower wholesale natural gas prices.

Margin from sales (operating revenue less purchased energy expense) declined $1.7 million compared to the previous year, the net result of lower billed sales volumes in all divisions, a full year of margin from the prior year wastewater rate increase, and a partial year's revenue from the electric and water rate increases.

Operating Expenses

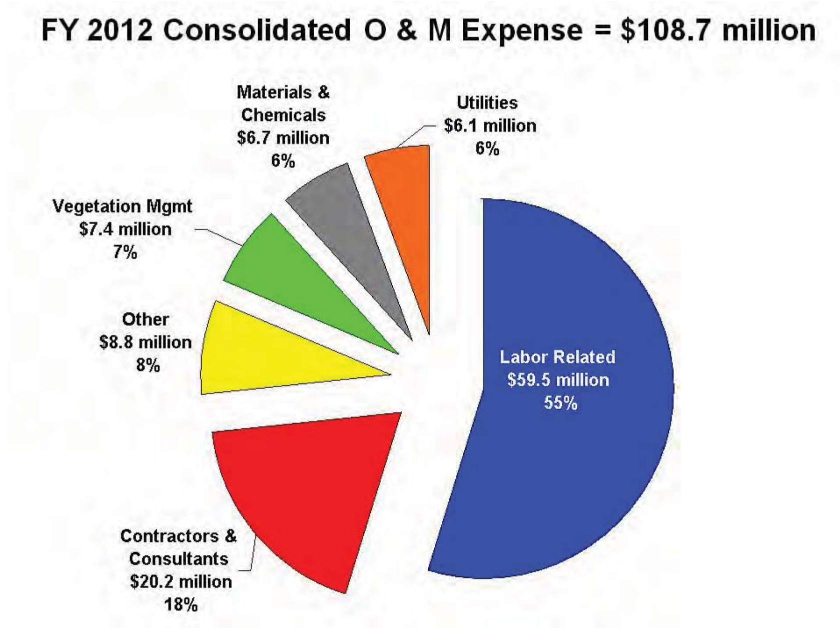
Operating expenses (excluding wholesale purchased energy expense) decreased $1.5 million or 0.8 percent compared to last fiscal year.

- Treatment expenses were $0.4 million or 2.9 percent lower than the prior year, reflecting a decrease in labor-related expenses.

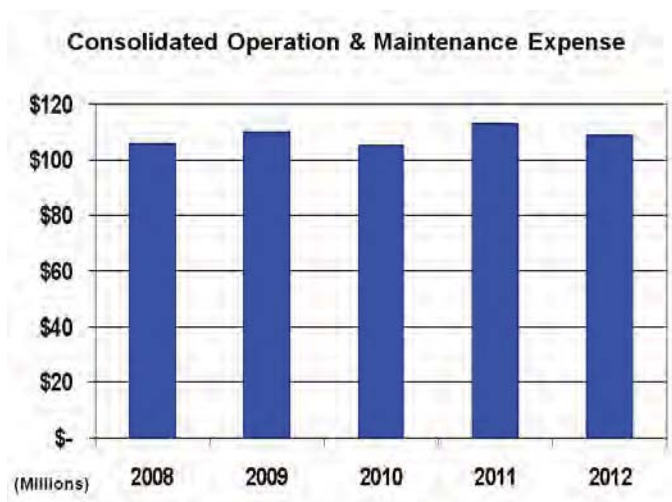
- Distribution and collection expenses decreased $2.6 million or 4.6 percent. Prior year expenditures of $3.7 million for the gas saddle inspection and replacement program and $1.7 million for electric system storm restoration for the April and June 2011 storm events (net of accrued FEMA reimbursement) offset current year increases, including higher vegetation management and facilities maintenance costs.

- Customer service expenses declined $0.7 million or 5.6 percent, due to a $1.1 million decline in labor-related expenses compared with the prior year.

- Administrative and general expenses decreased $0.4 million or 1.4 percent, due to a $0.3 million decline in labor-related expenses compared with the prior year.



Operation and Maintenance (O&M) expenses have increased at an annual rate of 0.7 percent over the past five years, reflecting cost management initiatives implemented by KUB, including a reduction in full-time staffing from 967 full-time employees in 2008 to 872 by June 30, 2012.



- Depreciation and amortization expense increased $2 million or 4.4 percent. $110.7 million in assets were added during fiscal year 2011. KUB recorded a full year of depreciation expense on these capital investments during fiscal year 2012.

- Taxes and tax equivalents increased $0.6 million or 2.5 percent. Tax equivalent payments to taxing jurisdictions in which KUB's utility systems are located are based on a combination of net plant values and margin from sales. This increase was primarily due to the rise in KUB's plant values and margin from sales in fiscal year 2011.

Interest income decreased $0.4 million or 19.8 percent due to less interest earned on investments, the result of lower interest rates.

Interest expense increased $1.8 million or 5.7 percent, reflecting interest expense on $112 million in bonds sold in December 2010 and $25 million in bonds sold in December 2011.

Other income (net) increased $0.1 million. The market value of contingency fund investments increased $0.1 million.

Capital contributions were $0.9 million higher than last fiscal year. Capital contributions for the water and wastewater systems each increased $0.6 million, while electric system contributions were down $0.3 million.

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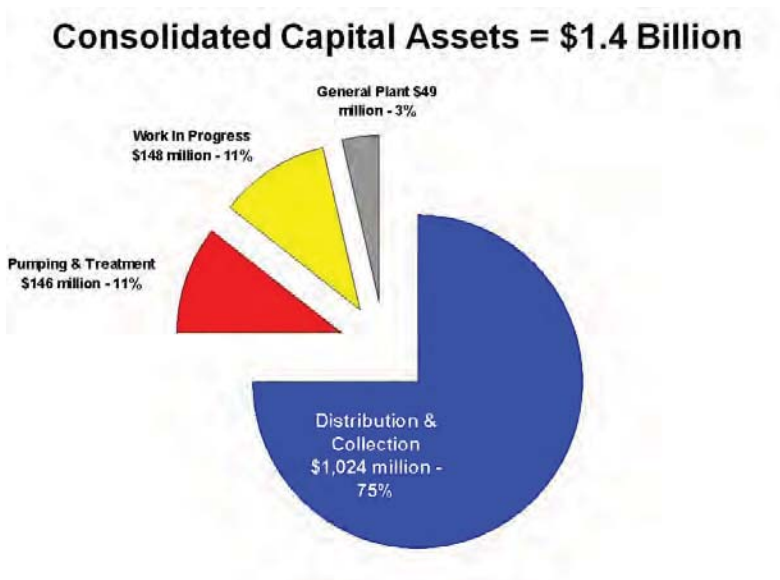
Capital Assets and Debt Administration

Capital Assets

As of June 30, 2012, KUB had $1.4 billion invested in capital assets, as reflected in the schedule below, which represents a net increase (including additions, retirements, and depreciation) of $97.6 million or 7.7 percent over the end of the last fiscal year.

Capital Assets
As of June 30
(Net of Depreciation)

(in thousands of dollars)	2012	2011
Production plant	$ 103	$ 117
Pumping & treatment plant	145,983	133,271
Distribution & collection plant:		
Mains	563,475	552,666
Services and meters	81,478	81,652
Electric station equipment	25,181	28,492
Poles, towers and fixtures	63,621	58,819
Overhead conductors	69,161	66,520
Line transformers	48,486	48,245
Others	172,735	149,147
Total distribution & collection plant	1,024,137	985,541
General plant	49,208	43,143
Total plant	1,219,431	1,162,072
Work in progress	148,048	107,852
Total net plant	$ 1,367,479	$ 1,269,924



Major capital asset additions during the year were as follows:

- $45 million related to PACE 10 projects.
  - $20.4 million for sewer mini-basin rehabilitation and replacement
  - $17 million for sewer trunk line replacement and rehabilitation
  - $3.2 million for pump station design and construction
  - $2.7 million for storage tank design and construction

- $11.8 million for Composite Correction Plan projects.
  - $9.3 million for upgrades to the Kuwahee Wastewater Treatment Plant
  - $2.5 million for upgrades at the Fourth Creek Wastewater Treatment Facility

- $22.7 million for electric distribution system improvements.

- $17.3 million for gas main replacement and construction of new mains for the gas system.

- $7 million for pipe replacement for the water system.

- $6.8 million for pole replacements for the electric system.

- $4.5 million for water plant and system improvements.

- $2.8 million for smart grid infrastructure.

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Debt Outstanding

As of June 30, 2012, KUB had $742.2 million in outstanding debt (including the current portion of revenue bonds) compared to $742.7 million last year, a decrease of $0.5 million. KUB's weighted average cost of debt as of June 30, 2012 was 4.5 percent (the effective weighted average cost of debt is 4.14 percent, which reflects the Build America Bond rebate for a portion of the outstanding debt).

During fiscal year 2012, $19.8 million in bonds were repaid, reducing outstanding debt levels.

During the fiscal year, $25 million in long-term bonds were issued to finance capital improvements for the water system.

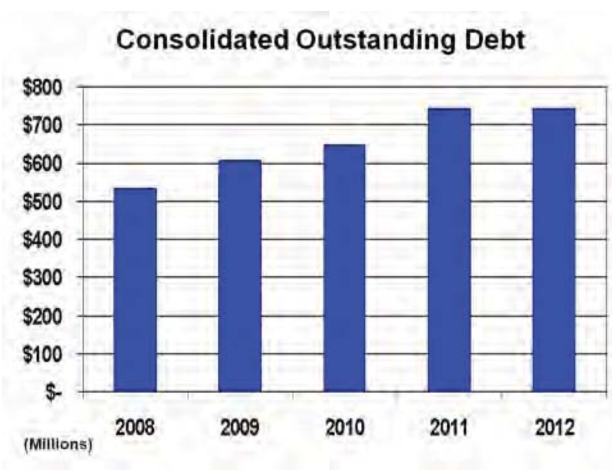
KUB issued $88.9 million in refunding bonds for the purpose of refunding outstanding bonds for all four divisions at lower interest rates. The bonds refunded were issued in 2004. The proceeds of the bonds, when combined with $7.8 million in premiums paid by underwriters, refunded $94.6 million in outstanding bonds and paid all costs of issuance. KUB will realize a total debt service savings of $15.4 million over the life of the bonds.

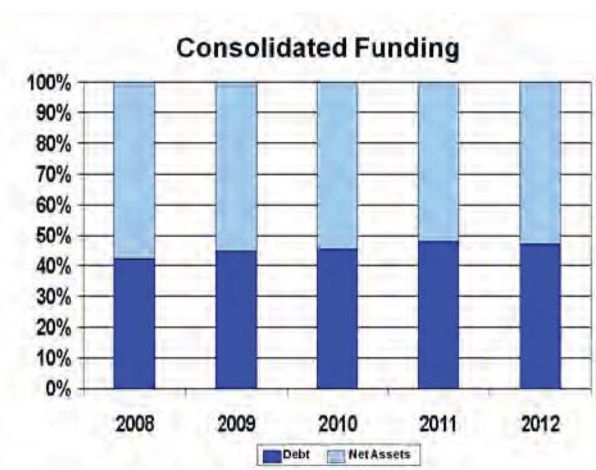
KUB's outstanding debt is rated by Standard & Poor's and Moody's Investors Service. As of June 30, 2012, Standard & Poor's rated the revenue bonds of the Electric, Water, and Wastewater Divisions AA+ and the revenue bonds of the Gas Division AA. Moody's Investors Service rated the bonds of all four divisions Aa2.

The following is a schedule of KUB's outstanding debt as of June 30, 2012.

Outstanding Debt
As of June 30

(in thousands of dollars)	**2012**	**2011**
Revenue bonds	$ 742,210	$ 742,690





Since fiscal year 2008, KUB's outstanding debt has increased from $532 million to its current level of $742.2 million. The majority of the growth is attributed to new debt in the Wastewater Division to fund capital projects to meet the requirements of the Consent Decree.

Impacts on Future Financial Position

KUB anticipates net customer growth of 500 customers over the course of the next fiscal year.

KUB expects to issue $120 million in long-term bonds during the next fiscal year to fund electric, gas, and wastewater system capital projects.

In July 2012, the Gas Division issued a short-term revenue anticipation note (line of credit) for $20 million for the purpose of managing seasonal cash flow during the winter heating season.

A previously adopted one percent electric rate increase, to help fund Century II electric system improvements, will be effective October 1, 2012.

A previously adopted five percent water rate increase, designed to help fund Century II water system improvements, will be effective January 1, 2013.

The KUB Board of Commissioners adopted a 12 percent wastewater rate increase to be effective October 1, 2012. The rate increase will raise the typical residential wastewater customer's monthly bill $5.20.

In fiscal year 2013, KUB will enter into the third year of a three-year smart grid pilot project partially funded by a grant from the Department of Energy. Looking forward to the final year of the project in fiscal year 2013, KUB will deploy conservation voltage reduction equipment on select circuits in and around the core project area. The core project area spans the University of Tennessee and Fort Sanders area. Also, KUB will deploy smart metering technology on its largest commercial and industrial customers through-out the KUB service territory.

No other facts, decisions, or conditions are currently known which would have a significant impact on KUB's financial position or results of operations during fiscal year 2013.

Financial Contact

KUB's financial statements are designed to present users (citizens, customers, investors, and creditors) with a general overview of KUB's financial position and results of operations for the fiscal years ending June 30, 2012 and 2011. If you have questions about the statements or need additional financial information, contact KUB's Chief Financial Officer at 445 South Gay Street, Knoxville, Tennessee 37902.

Knoxville Utilities Board
Consolidated Statements of Net Assets
June 30, 2012 and 2011

	2012	2011
Assets		
Current assets:		
Cash and cash equivalents	$ 69,858,112	$ 124,547,268
Short-term investments	30,500,000	15,000,000
Short-term contingency fund investments	30,795,149	26,845,286
Other current assets	2,775,000	3,641,718
Accrued interest receivable	115,080	61,661
Accounts receivable, less allowance of uncollectible accounts of $955,065 in 2012 and $1,106,488 in 2011	68,491,633	76,343,051
Inventories	7,642,232	5,222,294
Prepaid expenses	745,139	750,090
Prepaid gas purchases	13,789,493	10,836,632
Total current assets	224,711,838	263,248,000
Restricted assets:		
Bond funds	21,354,636	21,481,119
Other funds	23,769	128,582
Unused bond proceeds	13,803,726	47,847,090
Total restricted assets	35,182,131	69,456,791
Plant in service	1,866,937,094	1,772,751,320
Less accumulated depreciation	(647,505,932)	(610,679,323)
	1,219,431,162	1,162,071,997
Retirement in progress	1,305,720	285,292
Construction in progress	146,742,096	107,567,070
Net plant in service	1,367,478,978	1,269,924,359
Other assets:		
Long-term contingency fund investments	41,602,818	42,829,469
TVA conservation program receivable	9,552,209	8,549,048
Unrecovered purchased power cost	17,654,719	15,926,383
Under recovered purchased gas cost	2,825,163	-
Deferred loss on refunding bonds	3,586,800	4,579,121
Supplemental environmental project	-	150,000
Other	3,514,951	4,401,266
Total other assets	78,736,660	76,435,287
Total assets	$ 1,706,109,607	$ 1,679,064,437

Knoxville Utilities Board
Consolidated Statements of Net Assets
June 30, 2012 and 2011

	2012	2011
Capitalization and Liabilities		
Current liabilities:		
Current portion of revenue bonds and revenue notes	$ 21,635,000	$ 19,750,000
Sales tax collections payable	1,145,588	1,107,542
Accounts payable	51,127,955	51,264,087
Accrued expenses	26,741,204	29,246,593
Customer deposits plus accrued interest	14,720,397	13,653,431
Over recovered gas costs	-	1,067,074
Accrued interest on revenue bonds	10,150,676	11,182,299
Total current liabilities	125,520,820	127,271,026
Other liabilities:		
TVA conservation program	9,335,409	8,199,059
Accrued compensated absences	8,237,657	8,219,683
Customer advances for construction	1,283,627	1,451,870
Supplemental environmental project	-	150,000
Other	5,850,719	1,864,017
Total other liabilities	24,707,412	19,884,629
Long-term debt:		
Revenue bonds	720,575,000	722,940,000
Total long-term debt	720,575,000	722,940,000
Total liabilities	870,803,232	870,095,655
Net assets		
Invested in capital assets, net of related debt	621,992,896	529,825,848
Restricted for:		
Debt service	11,203,959	10,298,820
Other	23,768	128,583
Unrestricted	202,085,752	268,715,531
Total net assets	835,306,375	808,968,782
Total liabilities and net assets	$ 1,706,109,607	$ 1,679,064,437

Knoxville Utilities Board
Consolidated Statements of Revenues, Expenses and Changes in Net Assets
June 30, 2012 and 2011

	2012	2011
Operating revenues		
Electric	$ 500,812,890	$ 515,421,181
Gas	85,526,548	105,621,034
Water	37,091,445	36,028,958
Wastewater	70,099,897	65,370,778
Total operating revenues	693,530,780	722,441,951
Operating expenses		
Purchased power	405,767,449	419,672,545
Purchased gas	50,270,966	63,580,197
Treatment	12,624,245	12,999,930
Distribution and collection	53,940,051	56,559,153
Customer service	11,099,777	11,755,170
Administrative and general	31,065,524	31,491,994
Provision for depreciation and amortization	47,613,323	45,602,624
Taxes and tax equivalents	24,552,314	23,950,299
Total operating expenses	636,933,649	665,611,912
Operating income	56,597,131	56,830,039
Non-operating revenues (expenses)		
Contributions in aid of construction	5,729,916	4,807,594
Interest and dividend income	1,503,523	1,875,952
Interest expense	(34,077,313)	(32,244,801)
Write-down of plant for costs recovered through contributions	(5,729,916)	(4,807,594)
Other	(767,199)	(910,633)
Total non-operating revenues (expenses)	(33,340,989)	(31,279,482)
Change in net assets before capital contributions	23,256,142	25,550,557
Capital contributions	3,081,451	2,181,080
Change in net assets	26,337,593	27,731,637
Net assets, beginning of year	808,968,782	781,237,145
Net assets, end of year	$ 835,306,375	$ 808,968,782

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

Knoxville Utilities Board
Consolidated Statements of Cash Flows
June 30, 2012 and 2011

	2012	2011
Cash flows from operating activities:		
Cash receipts from customers	$ 695,320,206	$ 724,421,360
Cash receipts from other operations	16,434,833	(3,563,858)
Cash payments to suppliers of goods or services	(539,558,030)	(559,723,038)
Cash payments to employees for services	(48,822,557)	(38,256,333)
Payment in lieu of taxes	(21,252,243)	(20,469,450)
Cash receipts from collections of TVA conservation loan program participants	2,286,470	2,067,095
Cash payments for TVA Conservation loan program	(2,094,050)	(2,206,781)
Net cash provided by operating activities	102,314,629	102,268,995
Cash flows from capital and related financing activities:		
Net proceeds from bond issuance	24,978,728	111,150,965
Principal paid on revenue bonds and notes payable	(19,750,000)	(16,370,000)
Decrease (increase) in unused bond proceeds	34,004,216	(33,563,208)
Interest paid on revenue bonds and notes payable	(35,108,938)	(30,643,085)
Acquisition and construction of plant	(149,920,294)	(110,952,327)
Changes in bond funds, restricted	126,482	(3,757,829)
Customer advances for construction	(168,243)	363,065
Proceeds received on disposal of plant	73,054	48,870
Cash received from developers and individuals for capital purposes	5,729,917	4,807,594
Net cash used in capital and related financing activities	(140,035,078)	(78,915,955)
Cash flows from investing activities:		
Purchase of investment securities	(19,063,289)	(20,230,052)
Maturities of investment securities	840,078	1,173,778
Interest received	1,503,523	1,875,952
Other property and investments	(249,019)	(916,150)
Net cash (used in) investing activities	(16,968,707)	(18,096,472)
Net (decrease) increase in cash and cash equivalents	(54,689,156)	5,256,569
Cash and cash equivalents, beginning of year	124,547,268	119,290,700
Cash and cash equivalents, end of year	$ 69,858,112	$ 124,547,268
Reconciliation of operating income to net cash provided by operating activities		
Operating income	$ 56,597,131	$ 56,830,039
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation and amortization expenses	49,492,211	47,638,267
Changes in operating assets and liabilities:		
Accounts receivable	7,833,203	(2,992,818)
Inventories	(2,419,939)	1,035,221
Prepaid expenses	(2,947,910)	554,848
TVA conservation program receivable	(1,003,161)	(1,975,025)
Other assets	846,269	(26,746)
Sales tax collections payable	38,046	38,255
Accounts payable and accrued expenses	(2,773,549)	16,675,384
TVA conservation program payable	1,136,351	1,767,193
Unrecovered purchased power cost	(1,728,336)	(15,926,383)
Underrecovered gas costs	(3,892,237)	(2,450,026)
Customer deposits plus accrued interest	1,066,966	1,095,368
Other liabilities	69,584	5,418
Net cash provided by operating activities	$ 102,314,629	$ 102,268,995
Noncash capital activities:		
Acquisition of plant assets through developer contributions	$ 3,081,451	$ 2,181,080

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

1. Description of Business:

Knoxville Utilities Board (KUB), comprised of the Electric Division, Gas Division, Water Division, and Wastewater Division (Divisions), is reported as a component unit enterprise fund in the financial statements of the City of Knoxville. KUB's responsibility is to oversee the purchase, production, distribution, and processing of electricity, water, natural gas, and wastewater services. A seven-member Board of Commissioners governs KUB. The Board has all powers to construct, acquire, expand, or operate the Divisions. It has full control and complete jurisdiction over the management and operation of the Divisions including setting rates. KUB's accounts are maintained in conformity with the Uniform System of Accounts of the Federal Energy Regulatory Commission (FERC), the Uniform System of Accounts of the National Association of Regulatory Utility Commissioners (NARUC), and the Governmental Accounting Standards Board (GASB), as applicable.

2. Significant Accounting Policies:

Basis of Accounting

KUB follows the provisions of Statement No. 34 (Statement 34) of the Governmental Accounting Standards Board *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments.* Statement 34 established standards for external financial reporting for all state and local governmental entities, which includes a statement of net assets; a statement of revenues, expenses and changes in net assets; and a statement of cash flows. It requires the classification of net assets into three components – invested in capital assets, net of related debt; restricted; and unrestricted. These classifications are defined as follows:

- Invested in capital assets, net of related debt – This component of net assets consists of capital assets, including restricted capital assets, net of accumulated depreciation and reduced by the outstanding balances of any bonds, mortgages, notes, or other borrowings that are attributable to the acquisition, construction, or improvement of those assets. If there are significant unspent related debt proceeds at year end, the portion of the debt attributable to the unspent proceeds are not included in the calculation of invested in capital assets, net of related debt. Rather, that portion of the debt is included in the same net assets component as the unspent proceeds.

- Restricted – This component of net assets consists of restrictions placed on net asset use through external constraints imposed by creditors (such as through debt covenants), grantors, contributors, or laws or regulations of other governments or restrictions imposed by law through constitutional provisions or enabling legislation.

- Unrestricted net assets – This component of net assets consists of net assets that do not meet the definition of "restricted" or "invested in capital assets, net of related debt."

Principles of Consolidation

The consolidated financial statements include the accounts of the Electric, Gas, Water and Wastewater Divisions. All significant intercompany balances and transactions have been eliminated in consolidation.

The consolidated financial statements are prepared on the accrual basis of accounting, whereby revenues are recognized when earned and expenses are recognized when incurred. The accounting and financial reporting treatment is determined by measurement focus. The transactions are accounted for on a flow of economic resources measurement focus. With this measurement focus, all assets and all liabilities associated with the operations are included on the consolidated statement of net assets. Net assets (i.e., total assets net of total liabilities) are segregated into invested in capital assets, net of related debt; restricted for capital activity and debt service; and unrestricted components.

As allowed by the Governmental Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, KUB's policy is to apply only those Financial Accounting Standards Board statements, related interpretations, Accounting Principles Board opinions and accounting research bulletins issued on or prior to November 30, 1989 that do not conflict with Governmental Accounting Standards.

KUB issues separate financial reports, which include financial statements and required supplementary information, for the Electric, Gas, Water, and Wastewater Divisions. These reports may be obtained by writing Knoxville Utilities Board, P.O. Box 59017, Knoxville, TN 37950-9017.

Plant

Plant and other property are stated on the basis of original cost. The costs of current repairs and minor replacements are charged to operating expense. The costs of renewals and improvements are capitalized. The original cost of utility plant assets retired or otherwise disposed of and the cost of removal less salvage value is charged to accumulated depreciation. When other property is retired, the related asset and accumulated depreciation are removed from the accounts, and the gain or loss is included in the results of operations.

The provision for depreciation of plants in service is based on the estimated useful lives of the assets, which range from three to sixty-seven years, and is computed using the straight-line method. Pursuant to FERC/NARUC, the caption "Provision for depreciation" in the consolidated statements of revenues, expenses and changes in net assets does not include depreciation for transportation equipment of $1,878,888 in 2012 and $2,035,642 in 2011. Interest costs are expensed as incurred.

Operating Revenue

Operating revenue consists primarily of charges for services provided by the principal operations of KUB. Operating revenue is recorded when the service is rendered, on a cycle basis, and includes an estimate of unbilled revenue. Revenues are reported net of bad debt expense of $1,599,128 in 2012 and $2,958,582 in 2011.

Non-operating Revenue

Non-operating revenue consists of revenues that are related to financing and investing types of activities and result from non-exchange transactions or ancillary activities.

Expense

When an expense is incurred for purposes for which there are both restricted and unrestricted net assets available, it is KUB's policy to apply those expenses to restricted net assets to the extent such are available and then to unrestricted net assets.

Contributions in Aid of Construction and Capital Contributions

Contributions in aid of construction are cash collections from customers or others for a particular purpose, generally the construction of new facilities to serve new customers in excess of the investment KUB is willing to make for a particular incremental revenue source. KUB reduces the plant account balances to which contributions relate by the actual amount of the contribution and recognizes the contributions as non operating revenue in accordance with FAS 71, *"Accounting for the Effects of Certain Types of Regulation"*.

Capital contributions represent contributions of utility plant infrastructure constructed by developers and others in industrial parks and other developments, and transferred to KUB upon completion of construction and the initiation of utility service. In accordance with GASB 33, *"Accounting and Financial Reporting for Nonexchange Transactions"*, such contributions are recognized as revenues and capital assets upon receipt.

Inventories
Inventories, consisting of plant materials and operating supplies, are valued at the lower of average cost or replacement value.

Pension Plan
KUB's employees are participants in the Knoxville Utilities Board Pension Plan as authorized by the Charter of the City of Knoxville §1107(J) (Note 10). KUB's policy is to fund pension cost accrued. As required by GASB Statement No. 27, KUB measures and discloses the annual pension cost on the accrual basis of accounting. At the time the funding method is introduced, there is a liability, which represents the contributions that would have been accumulated if this method of funding had always been used. The excess, if any, of this liability over the actuarial value of the assets held in the fund is the unfunded actuarial accrued liability, which is typically funded over a chosen period in accordance with an amortization schedule.

Investments
Investments are carried at fair value as determined by quoted market prices at the reporting date.

Self-Insurance
KUB has established self-insurance programs covering portions of workers' compensation, employee health, environmental liability, general liability, property and casualty liability, and automobile liability claims. A liability is accrued for claims as they are incurred. When applicable, claims in excess of the self-insured risk are covered by KUB's insurance carriers. Additionally, KUB provides certain lifetime health benefits to eligible retired employees under a self-insurance plan administered by a third party.

Purchased Gas Adjustment
In November 1990, the Division implemented a deferred Purchased Gas (Cost) Adjustment (PGA) mechanism, which 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 KUB's Board of Commissioners. The rate-setting authority vested in the KUB Board by the City Charter meets the "self-regulated" provisions of SFAS No. 71, *"Accounting for the Effects of Certain Types of Regulation,"* and KUB meets the remaining criteria of SFAS No. 71. The PGA is intended to assure 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 PGA is also intended to assure that no excess or deficient cost recovery from KUB's customers occurs.

Under the PGA mechanism, the Division tracks the actual over/under recovered amount in the Over/Under recovered Purchased Gas Costs accounts. These accounts are rolled into the PGA rate adjustment on June 30 of each year thereby assuring that any (under)/over recovered amounts are passed on to the Division's customers. The amount of (under)/over recovered cost was ($2,825,163) at June 30, 2012 and $1,067,074 at June 30, 2011.

Purchased Power Adjustment
In October 2002, the Board adopted a Purchased Power Adjustment (PPA) to address changes in wholesale power costs. The PPA was established in response to an amendment to KUB's power supply contract under which, among other things, TVA relinquished its regulatory authority over KUB retail electric rates. The PPA allows KUB to promptly adjust retail electric rates in response to wholesale rate changes or adjustments, thus ensuring that KUB will recover the costs incurred for purchased power. These changes in electric costs are reflected as adjustments to the base electric rates established by KUB's Board of Commissioners. The rate-setting authority vested in the KUB Board by the City Charter meets the "self-regulated" provisions of SFAS No. 71, *"Accounting for the Effects of Certain Types of Regulation,"* and KUB meets the remaining criteria of SFAS No. 71.

TVA implemented a fuel cost adjustment in October 2006 applied on a quarterly basis to wholesale power rates. TVA's quarterly fuel cost adjustment became a monthly fuel cost adjustment effective October 2009. KUB flows changes to wholesale power rates, from TVA's fuel cost adjustment mechanism, directly through to its retail electric rates via the PPA.

In April 2011, TVA modified its wholesale rate structure to demand & energy billing for its distributors. In response, KUB revised its PPA to include a deferred accounting component to ensure appropriate matching of revenue and expense and cost recovery. KUB will adjust its retail rates on an annual basis to flow any over or under recovery of wholesale power costs through to its customers via the PPA.

Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. These estimates are based on historical experience and various other assumptions that KUB believes are reasonable under the circumstances. However, future events are subject to change and the best estimates and judgments routinely require adjustment. Estimates are used for, but not limited to, inventory valuation, provision for doubtful accounts, depreciable lives of plant assets, unbilled revenue volumes, pension trust valuations, OPEB trust valuations, insurance liability reserves, and potential losses from contingencies and litigation. Actual results could differ from those estimates.

Restricted and Designated Assets

Certain assets are restricted by bond resolutions for the construction of utility plant and debt repayment. Certain additional assets are designated by management for contingency purposes and economic development.

Cash Equivalents

For purposes of the statements of cash flows, KUB considers all unrestricted and undesignated highly liquid investments with an original maturity of three months or less when purchased to be cash equivalents.

Environmental Cleanup Matters

KUB's policy is to accrue environmental cleanup costs when those costs are believed to be probable and can be reasonably estimated. For certain matters, KUB expects to share costs with other parties. KUB does not include anticipated recoveries from insurance carriers in the estimated liability.

Compensated Absences

KUB accrues a liability for earned but unpaid paid-time off (PTO) days.

Subsequent Events

KUB has evaluated events and transactions through October 18, 2012, the date these financial statements were issued, for items that should potentially be recognized or disclosed.

Reclassifications

Certain reclassifications have been made to the 2011 balances to conform to the 2012 presentation.

3. Deposits and Investments

State law authorizes KUB to invest in obligations of the United States Treasury, its agencies and instrumentalities; certificates of deposit; repurchase agreements; money market funds; and the State Treasurer's Investment Pool. All deposits in excess of federal depository insurance limits and investments in other than the State Treasurer's Investment Pool are collateralized with government securities held in KUB's name by third-party custodian bank(s) acting as KUB's agent(s), or through the state of Tennessee's collateral pool. Financial institutions that participate in the collateral pool are subject to special assessment; therefore, the deposits and investments of investors such as KUB are considered insured. Interest income is recorded on an accrual basis.

Information related to the carrying value and bank balances of deposits, and the carrying value and fair value of investments, at June 30, 2012 is as follows:

	Carrying Value	Bank Balance
Deposits		
Deposits in financial institutions	$ 69,881,881	$ 93,832,283
Investments		
Certificates of Deposits	92,121,114	92,121,114
State Treasurer's Investment Pool	3,017,701	3,017,701
Agency Bonds	42,683,415	42,683,415
	$ 207,704,111	$ 231,654,513

Classification of deposits and investments:

Depository Account	Bank Balance
Insured	$ 286,903
Collateralized:	
Collateral held by pledging bank's trust department in KUB's name	42,683,415
Collateral held by pledging bank's trust department not in KUB's name*	188,684,195
Total deposits and investments	$ 231,654,513

* - Funds are collaterlized with the Teneesse State Investment Pool in the name of the pledging bank in accordance with Tennessee Code Annotated, Title 9, Chapter 4, parts 1 and 4.

Classification of deposits and investments per statement of net assets:

		2012
Current assets		
Cash and cash equivalents	$	69,858,112
Short-term investments		30,500,000
Short-term contingency fund investments		30,775,170
Other assets		
Long-term contingency fund investments		41,403,246
Restricted assets		
Unused bond proceeds		13,789,178
Bond fund		21,354,636
Other funds		23,769
	$	207,704,111

The above amounts do not include accrued interest of $234,101.

KUB follows the provisions of Statement No. 40 (Statement 40) of the Governmental Accounting Standards Board *Deposit and Investment Risk Disclosures an amendment of GASB Statement No. 3.* This Statement establishes and modifies disclosure requirements for state and local governments related to deposit and investment risks.

	Deposit and Investment Maturities (in Years)					
		Fair Value		**Less Than 1**		**1-5**
Supersweep NOW and Other Deposits	$	93,832,283	$	93,832,283	$	-
State Treasurer's Investment Pool		3,017,701		3,017,701		-
Agency Bonds		42,683,415		9,100,149		33,583,266
Certificates of Deposits		92,121,114		84,321,115		7,799,999
	$	231,654,513	$	190,271,248	$	41,383,265

Interest Rate Risk. KUB's primary investment objectives, in order, are to place investments in a manner to ensure the preservation of capital, remain sufficiently liquid to meet all operating requirements, and maximize yield of return. KUB minimizes its exposure to interest rate risk by adhering to Tennessee state law requirements for the investment of public funds. This includes types of investments, as described above, and investment maturity. The maximum maturity is four years from the date of investment. KUB also limits its exposure by holding investments to maturity unless cash flow requirements dictate otherwise.

Credit Risk. KUB's investment policy, as required by state law, is to apply the prudent-person rule: Investments are made with judgment and care, under circumstances then prevailing, which persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not for speculation, but for investment, considering the probable income to be derived, as well as the probable safety of their capital. KUB's Agency Bond investments are rated Aaa by Moody's Investors Service.

4. Accounts Receivable

Accounts receivable consists of the following:

	2012	2011
Wholesale and retail customers		
Billed services	$ 37,731,872	$ 43,288,182
Unbilled services	27,180,833	26,058,787
Other	4,533,993	8,102,570
Allowance for uncollectible accounts	(955,065)	(1,106,488)
	$ 68,491,633	$ 76,343,051

5. Accounts Payable and Accruals

Accounts payable and accruals consist of the following:

	2012	2011
Trade accounts	$ 51,127,955	$ 51,264,087
Salaries and wages	871,022	614,703
Advances on pole rental	1,119,017	1,047,294
Self-insurance liabilities	1,827,920	2,175,294
Other current liabilities	22,923,245	25,409,302
	$ 77,869,159	$ 80,510,680

6. Long-Term Obligations

Long-term debt consists of the following:

	Balance June 30, 2011	Additions	Payments	Balance June 30, 2012	Amounts Due Within One Year
Electric					
V-2004 - 2.0 - 4.75%	$ 41,800,000	$ -	$ 40,785,000	$ 1,015,000	$ 1,015,000
W-2005 - 3.0 - 4.5%	38,115,000	-	1,595,000	36,520,000	1,660,000
X-2006 - 4.0 - 5.0%	18,350,000	-	1,500,000	16,850,000	1,550,000
Y-2009 - 2.5 - 5.0%	40,000,000	-	1,300,000	38,700,000	1,350,000
Z-2010 - 1.45 - 6.35%	30,000,000	-	1,030,000	28,970,000	1,245,000
AA-2012 - 3.0 - 5.0%	-	36,815,000	-	36,815,000	100,000
Total debt	$ 168,265,000	$ 36,815,000	$ 46,210,000	$ 158,870,000	$ 6,920,000
Gas					
K-2004 - 2.0 - 4.75%	$ 26,160,000	$ -	$ 26,160,000	$ -	$ -
L-2005 - 3.0 - 4.75%	13,245,000	-	600,000	12,645,000	620,000
M-2006 - 4.0 - 5.0%	19,025,000	-	3,400,000	15,625,000	3,550,000
N-2007 - 4.0 - 5.0%	12,000,000	-	-	12,000,000	-
O-2010 - 2.0 - 3.0%	10,295,000	-	125,000	10,170,000	120,000
P-2010 - 3.3 - 6.2%	12,000,000	-	-	12,000,000	-
Q-2012 - 2.0 - 4.0%	-	24,920,000	-	24,920,000	225,000
Total debt	$ 92,725,000	$ 24,920,000	$ 30,285,000	$ 87,360,000	$ 4,515,000
Water					
Q-2004 - 2.0 - 5.0%	$ 11,990,000	$ -	$ 11,990,000	$ -	$ -
R-2005 - 3.5 - 5.0%	10,000,000	-	-	10,000,000	-
S-2005 - 3.5 - 5.0%	8,345,000	-	380,000	7,965,000	390,000
T-2007 - 4.0 - 5.5%	25,000,000	-	-	25,000,000	-
U-2009 - 3.0 - 4.5%	25,000,000	-	-	25,000,000	-
V-2010 - 2.0 - 2.5%	2,960,000	-	740,000	2,220,000	2,220,000
W-2011 - 2.0 - 4.0%	-	25,000,000	-	25,000,000	550,000
X-2012 - 3.0 - 5.0%	-	10,050,000	-	10,050,000	-
Total debt	$ 83,295,000	$ 35,050,000	$ 13,110,000	$ 105,235,000	$ 3,160,000
Wastewater					
2004 A - 4.0 - 4.75%	$ 18,000,000	$ -	$ 18,000,000	$ -	$ -
2005 A - 4.0 - 5.0%	140,000,000	-	-	140,000,000	-
2005 B - 3.0 - 5.0%	20,170,000	-	730,000	19,440,000	760,000
2007 - 4.0 - 5.0%	75,000,000	-	-	75,000,000	-
2008 - 4.0 - 6.0%	41,800,000	-	3,300,000	38,500,000	3,400,000
2010 - 6.3 - 6.5%	30,000,000	-	-	30,000,000	-
2010B - 2.0 - 3.0%	3,435,000	-	1,700,000	1,735,000	1,735,000
2010C - 1.18 - 6.1%	70,000,000	-	1,000,000	69,000,000	1,075,000
2012A - 2.0 - 4.0%	-	17,070,000	-	17,070,000	70,000
Total debt	$ 398,405,000	$ 17,070,000	$ 24,730,000	$ 390,745,000	$ 7,040,000
Consolidated					
Total Bonds	742,690,000	113,855,000	114,335,000	742,210,000	21,635,000
Total debt	$ 742,690,000	$ 113,855,000	$ 114,335,000	$ 742,210,000	$ 21,635,000

Other liabilities consist of the following:

	Balance June 30, 2011	Increase	Decrease	Balance June 30, 2012	Amounts Due Within One Year
TVA conservation program	$ 8,199,059	$ 3,282,245	$ (2,145,895)	$ 9,335,409	$ 1,500,000
Accrued compensated absences	8,219,683	11,060,994	(11,043,020)	8,237,657	2,600,000
Customer advances for construction	1,451,870	502,381	(670,624)	1,283,627	160,000
Supplemental environmental project	150,000	-	(150,000)	-	-
Other	1,864,017	6,676,954	(2,690,252)	5,850,719	301,000
	$ 19,884,629	$ 21,522,574	$ (16,699,791)	$ 24,707,412	$ 4,561,000

Debt service over remaining term of the debt is as follows:

Fiscal Year	Principal	Interest	Total
2013	$ 21,635,000	$ 32,998,427	$ 54,633,427
2014	21,840,000	32,882,341	54,722,341
2015	22,675,000	32,094,566	54,769,566
2016	23,635,000	31,196,675	54,831,675
2017	24,110,000	30,259,277	54,369,277
2018-2022	136,665,000	135,095,868	271,760,868
2023-2027	151,850,000	102,986,664	254,836,664
2028-2032	128,425,000	70,287,201	198,712,201
2033-2037	89,450,000	44,351,114	133,801,114
2038-2042	91,925,000	21,902,577	113,827,577
2043-2045	30,000,000	3,800,000	33,800,000
Total	$ 742,210,000	$ 537,854,710	$ 1,280,064,710

The Divisions have pledged sufficient revenue, after deduction of all current operating expenses (exclusive of tax equivalents), to meet bond principal and interest payments of revenue bonds when due. Such bond requirements are being met through monthly deposits to the bond funds as required by the bond covenants. As of June 30, 2012 these requirements had been satisfied.

During fiscal year 2004, KUB's Electric Division issued Series V 2004 bonds in part to retire certain existing debt and to fund electric system capital improvements. Concurrent with issuance of these bonds, KUB transferred funds to an irrevocable trust to pay a portion of the Series S 1998 revenue bonds as such amounts mature. During fiscal year 2006, KUB's Electric Division issued Series W 2005 bonds in part to retire certain existing debt and fund electric system capital improvements. Concurrent with the issuance of these bonds, KUB transferred funds to an irrevocable trust to pay a portion of the Series U 2001 bonds, as such amounts mature. KUB's Electric Division also issued Series X 2006 bonds in part to retire certain existing debt and to fund electric system capital improvements. Concurrent with the issuance of these bonds, KUB transferred funds to an irrevocable trust to pay the remaining maturities of principal and interest on the Series S 1998 revenue bonds. During fiscal year 2009, KUB's Electric Division issued Series Y 2009 bonds to fund electric system capital improvements. During fiscal year 2011, KUB's Electric Division issued series Z 2010 bonds to fund electric system capital improvements. The bonds were issued as federally taxable Build America Bonds with a 35 percent interest payment rebate to be received from the United States Government for each interest payment. During fiscal year 2012, KUB's Electric Division issued Series AA 2012 bonds to retire a portion of outstanding Series V 2004 bonds. The outstanding principal balances on defeased bond issues were $106.2 million at June 30, 2012.

During fiscal year 2004, KUB's Gas Division issued Series K 2004 bonds to retire certain existing debt and fund gas system capital improvements. Concurrent with the issuance of these bonds, KUB transferred funds to an irrevocable trust to pay a portion of the Series H 1998 bonds as such amounts mature. During fiscal year 2006, KUB's Gas Division issued Series L 2005 bonds in part to retire certain existing debt. Concurrent with the issuance of these bonds, KUB transferred funds to an irrevocable trust to pay a portion of the Series J 2001 bonds, as such amounts mature. KUB's Gas Division also issued Series M 2006 bonds in part to retire certain existing debt and to fund gas system capital improvements. Concurrent with the issuance of these bonds, KUB transferred funds to an irrevocable trust to pay the remaining maturities of principal and interest on the Series H 1998 bonds. During fiscal year 2008, KUB's Gas Division issued Series N 2007 to fund gas system capital improvements. During fiscal year 2010, KUB's Gas Division issued Series O 2010 bonds to retire Series I 2001 bonds. During fiscal year 2011, KUB's Gas Division issued Series P 2010 bonds to fund gas system capital improvements. The bonds were issued as federally taxable Build America Bonds with a 35 percent interest payment rebate to be received from the United States Government for each interest payment. During fiscal year 2012, KUB's Gas Division issued Series Q 2012 bonds to retire Series K 2004 bonds. The outstanding principal balances on defeased bond issues were $76.1 million at June 30, 2012.

During fiscal year 2004, KUB's Water Division issued Series Q 2004 bonds to retire certain existing debt and fund water system capital improvements. Concurrent with the issuance of these bonds, KUB transferred funds to an irrevocable trust to pay the remaining maturities of principal and interest on the Series N 1998 bonds, as such amounts mature. During fiscal year 2006, KUB's Water Division issued Series R 2005 bonds for the purpose of funding water system capital improvements. KUB's Water Division also issued Series S 2005 bonds to retire certain existing debt and fund water system capital improvements. Concurrent with the issuance of these bonds, KUB transferred funds to an irrevocable trust to pay a portion of the Series P 2001 bonds, as such amounts mature. During fiscal year 2008, KUB's Water Division issued Series T 2007 bonds to fund water system capital improvements. During fiscal year 2010, KUB's Water Division issued Series U 2009 bonds to fund water system capital improvements. KUB's Water Division also issued Series V 2010 bonds to retire Series O 2001 bonds. During fiscal year 2012, KUB's Water Division issued Series W 2011 bonds to fund water system capital improvements. KUB's Water Division also issued Series X 2012 bonds to retire Series Q 2004 bonds. The outstanding principal balances on defeased bond issues were $23 million at June 30, 2012.

During fiscal year 2004, KUB's Wastewater Division issued Series 2004A bonds to fund wastewater system capital improvements. During fiscal year 2006, KUB's Wastewater Division issued Series 2005A bonds for the purpose of funding wastewater system capital improvements and to pay off a previously issued $30 million revenue anticipation note (line of credit), which was used to fund capital improvements to the wastewater system. KUB's Wastewater Division also issued Series 2005B bonds in part to retire certain existing debt and fund wastewater system capital improvements. Concurrent with the issuance of these bonds, KUB transferred funds to an irrevocable trust to pay a portion of the Series 1998 bonds and Series 2001A bonds, as such amounts mature. During fiscal year 2008, KUB's Wastewater Division issued Series 2007 bonds in part to pay off the outstanding balance on a previously issued revenue anticipation note (line of credit), and to fund wastewater system capital improvements. During fiscal year 2009, KUB's Wastewater Division issued Series 2008 bonds to fund wastewater system capital improvements. During fiscal year 2010, KUB's Wastewater Division issued Series 2010 bonds to fund capital improvements. These bonds were issued as federally taxable Build America Bonds with a 35 percent interest payment rebate to be received from the United States Government for each interest payment. KUB's Wastewater Division also issued Series 2010B bonds to retire Series 2001 bonds. During fiscal year 2011, KUB's Wastewater Division issued Series 2010C bonds to fund capital improvements. These bonds were issued as federally taxable Build America Bonds with a 35 percent interest payment rebate to be received from the United States Government for each interest payment. During fiscal year 2012, KUB's Wastewater Division issued Series 2012A bonds to retire Series 2004A bonds. The outstanding principal balances on defeased bond issues were $40.9 million at June 30, 2012.

7. Lease Commitments

KUB has non-cancelable operating lease commitments for office equipment and vehicles, summarized for the following fiscal years:

2013	$	23,524
2014		20,899
2015		26,648
2016		6,917
Total operating minimum lease payments	$	77,988

8. Capital Assets

Capital asset activity for the year ended June 30, 2012, was as follows:

	Beginning 6/30/2011	Increase	Decrease	Ending 6/30/2012
Production Plant (Intakes)	$ 742,503	$ -	$ -	$ 742,503
Pumping and Treatment Plant	209,723,590	17,603,960	(222,765)	227,104,785
Distribution and Collection Plant*				
Mains and metering	684,458,952	25,675,472	(628,660)	709,505,764
Services and meters	136,714,164	3,925,546	(282,679)	140,357,031
Electric station equipment	104,661,003	847,216	(378,197)	105,130,022
Poles, towers and fixtures	103,012,592	7,983,054	(2,859,970)	108,135,676
Overhead conductors	106,129,118	3,066,631	(127,751)	109,067,998
Line transformers	81,312,040	3,291,076	(1,474,718)	83,128,398
Other accounts	223,850,015	29,911,009	(673,134)	253,087,890
Total Distribution & Collection Plant	$ 1,440,137,884	$ 74,700,004	$ (6,425,109)	$ 1,508,412,779
General Plant	122,147,343	12,591,181	(4,061,497)	130,677,027
Total Plant Assets	$ 1,772,751,320	$ 104,895,145	$ (10,709,371)	$ 1,866,937,094
Less Accumulated Depreciation	(610,679,323)	(46,758,259)	9,931,650	(647,505,932)
Net Plant Assets	$ 1,162,071,997	$ 58,136,886	$ (777,721)	$ 1,219,431,162
Work In Progress	107,852,362	141,164,809	(100,969,355)	148,047,816
Total Net Plant	$ 1,269,924,359	$ 199,301,695	$ (101,747,076)	$ 1,367,478,978

*Beginning balances of distribution and collection plant have been re-categorized in order to be consistent with the fiscal year 2012 presentation.

9. Risk Management

KUB is exposed to various risks of loss related to active and retiree medical claims; injuries to workers; theft of, damage to, and destruction of assets; environmental damages; and natural disasters. Claims expenditures and liabilities are reported when it is probable that a loss has occurred and the amount of that loss can be reasonably estimated. These losses include an estimate of claims that have been incurred but not reported.

These liabilities are included in accrued expenses in the Statement of Net Assets. The liability is KUB's best estimate based on available information. At June 30, 2012, the amount of these liabilities was $1,827,919 resulting from the following changes:

	2012	2011
Balance, beginning of year	$ 2,175,294	$ 2,185,831
Current year claims and changes in estimates	14,130,565	22,721,716
Claims payments	(14,477,939)	(22,732,253)
Balance, end of year	$ 1,827,920	$ 2,175,294

10. Pension Plan

Description of Plan

The Plan is a single-employer contributory, defined benefit pension plan established by Resolution No. 980 dated February 18, 1999, effective July 1, 1999, as authorized by the Charter of the City of Knoxville § 1107(J). The Plan is designed to provide retirement, disability and death benefits. The Plan is a governmental plan as defined by the Employee Retirement Income Security Act of 1974 and is not subject to any of the provisions of the Act. The Plan is funded by contributions from KUB, if funding is required, and from Plan A and Plan B employee participants.

At December 31, 2011, the Plan had approximately 652 retirees and beneficiaries currently receiving benefits and 56 terminated employees entitled to benefits but not yet receiving them. Of the approximately 873 current employees in the Plan, 730 were fully vested at December 31, 2011. The Plan issues a financial report, which includes financial statements and required supplementary information. The report may be obtained by writing the Knoxville Utilities Board Retirement System, P.O. Box 59017, Knoxville, TN 37950-9017.

Effective January 1, 2011, KUB has frozen the Plan such that persons employed or re-employed by KUB on or after January 1, 2011, shall not be eligible to participate, but that eligible employees hired prior to January 1, 2011, who have not separated from service, shall continue as Participants and accrue benefits under the Plan.

The Plan provided three different benefit arrangements for KUB participants, retirees, and beneficiaries, as follows:

Career Equity Program (CEP)
CEP is for eligible employees hired on or after January 1, 1999, and for eligible former City System Plan A members who elected CEP coverage as of July 1, 1999. CEP is a closed plan.

All eligible employees became participants on the date of his/her KUB employment. Participants are covered by Social Security. Participation in CEP does not require or permit employee contributions.

Plan A
Plan A benefits are for former City System Plan A active employees, vested terminated employees, retirees, and beneficiaries. Plan A is a closed plan.

All employees participating in the City System Plan A as of June 30, 1999 were eligible to participate in KUB's Plan A or the CEP program. Participants of Plan A are covered by Social Security. Plan A is a closed plan and is not available to KUB employees hired after July 1, 1999. Participation in Plan A requires employee contributions of 3 percent of the first $4,800 of annual earnings and 5 percent of annual earnings in excess of $4,800. Plan A provides for early retirement benefits with 25 years of service and normal retirement benefits at age 62 or older.

Plan B
Plan B benefits are for former City System Plan B active employees, vested terminated employees, retirees, and beneficiaries. Plan B is a closed plan.

All employees participating in the City System Plan B as of June 30, 1999 are eligible to participate in KUB's Plan B. Plan B is now a closed plan and no participants can be added. Participants of Plan B are not covered by Social Security. Participation in Plan B requires employee contributions of 4 percent of annual earnings. Plan B provides for retirement benefits after 25 years of service and the attainment of age 50.

Funding Policy

For the Plan year ended December 31, 2011, a contribution of $3,593,282 is required to be made in the Plan sponsor's fiscal year ending June 30, 2013. The annual required contribution was determined as part of the January 1, 2011 valuation using the Individual Entry Age Normal funding method. The objective under this method is to fund each participant's benefits under the Plan as payments which are level as a percentage of salary, starting on the original participation date (employment date) and continuing until the assumed retirement, termination, disability or death. For the Plan year ended December 31, 2011, the Plan's actuarial funded ratio was 104.5 percent.

At the time the funding method is introduced, there is a liability, which represents the contributions that would have been accumulated if this method of funding had always been used. The excess, if any, of this liability over the actuarial value of the assets held in the fund, is the unfunded actuarial accrued liability, which is typically funded over a chosen period in accordance with an amortization schedule.

Significant actuarial assumptions used in the valuation include (a) rate of return of investments of 8 percent, (b) the RP2000 Mortality Table, (c) annual projected salary increases based on participants' ages ranging from age 25 to age 65 with salary increases from 2.58 percent to 7.92 percent, and (d) cost of living adjustment of 2.8 percent annually. The actuarial value of assets was determined using techniques that smooth the effect of short-term volatility in the market value of equities over a five-year period.

As of the actuarial report for the Plan year ended December 31, 2011, contributions of $3,593,282 and $3,244,057 for 2011 and 2010, respectively, are required to be made during the Plan sponsor's fiscal years ending June 30, 2013 and 2012, respectively.

Subsequent to June 30, 2012, the actuarial report for the Plan year ending December 31, 2012 was completed.

For the Plan year ending December 31, 2012, a contribution of $5,502,677 is required to be made in the Plan sponsor's fiscal year ending June 30, 2014. For the Plan year ending December 31, 2012, the Plan's actuarial funded ratio was 94.1 percent.

11. Defined Contribution Plan

KUB has a defined contribution 401(k) employee retirement savings plan covering eligible KUB employees. Employees hired prior to January 1, 2011 may participate and receive a matching contribution of 50 percent of their own contribution up to a maximum match of 3 percent. Employees hired on or after January 1, 2011 have an enhanced 401(k) Plan due to the closure of the Defined Benefit Pension Plan. They may participate and receive a matching contribution of 50 percent of their own contribution up to a maximum match of 3 percent. They also receive a nonelective KUB contribution of from 3 percent to 6 percent, depending on years of service, whether they contribute or not.

Since July 1, 2000, 401(k) matching contributions for employees eligible to participate in the KUB Pension Plan have been funded by the Pension Plan. These funds are held by the Pension trustee until eligible for distribution. IRS rules permit the funding of 401(k) matching contributions from excess pension assets for employees covered under the Pension Plan. Given the current funding level of the Pension Plan, effective July 1, 2011, KUB began to reimburse the Pension Plan for the current matching contributions. The match and nonelective contributions for employees hired on or after January 1, 2011 are paid directly by KUB.

12. Other Post-Employment Benefits (OPEB)

The Governmental Accounting Standards Board (GASB) established new standards for the measurement, recognition, and reporting of other post-employment benefits (OPEB). OPEB includes post-employment benefits other than pension, which, for KUB, is presently limited to post-employment health care. GASB 45 requires the recognition of the accrued OPEB liability for the respective year, plus the disclosure of the total unfunded liability. GASB 45 was effective for KUB for the fiscal year beginning July 1, 2007.

KUB currently provides post-employment health care benefits to 633 former employees and 647 covered dependents. The cost of coverage is shared with retirees and beneficiaries. KUB recognizes its share of the cost of post-employment health care benefits as an expense as claims are paid.

In anticipation of GASB 45, KUB amended its Group Health Plan in 1999, eliminating post-employment health care benefits for all employees hired on or after July 1, 1999. As of June 30, 2012, 450 active employees were eligible for individual and dependent coverage at separation if the employee meets the Rule of 80 (age plus years of service) with a minimum of 20 years of service.

In May 2006, the state of Tennessee adopted Tennessee Code Annotated, Title 8, Chapter 50, Part 12 authorizing governmental entities to establish Trusts for the purpose of pre-funding their respective OPEB liabilities.

Although GASB 45 does not require pre-funding of the liability, KUB has determined that it is in the long-term economic interest of KUB and its ratepayers to establish a Trust to pre-fund KUB's OPEB liability.

In October 2007, the KUB Board authorized the establishment of an OPEB Trust. The applicable documentation was submitted to the State Funding Board and, in December 2007, the State Funding Board approved the Trust. The Trust was also approved by the Internal Revenue Service in June 2008.

The Trust issues a financial report, which includes financial statements and required supplementary information. The report may be obtained by writing the Knoxville Utilities Board Retirement System, P.O. Box 59017, Knoxville, TN 37950-9017.

The general administration and responsibility for the proper operation of the Trust is governed by a board of trustees, appointed by KUB's President & CEO. The investment of all deposits to the Trust is governed by an Investment Policy, which was adopted by the KUB Board and approved by the State Funding Board.

Total contributions to the OPEB Trust for the fiscal year ended June 30, 2012 were \$8.1 million. The contribution to the Trust exceeded the annual required contribution (ARC), as determined by the Postretirement Benefit Plan's actuarial valuation for the year ended December 31, 2010, which was \$4.6 million. As of June 30, 2012, the employer's net OPEB obligation was \$1.7 million.

The ARC for the fiscal year ending June 30, 2013, as determined by the Plan's actuarial valuation for the year ended December 31, 2011 is \$3.3 million.

The actuarial valuation for the Plan for the year ending December 31, 2012 has been completed. The valuation determined that the Plan's actuarial accrued liability was \$61.6 million. The actuarial value of the Plan's assets was \$37.9 million. As a result, the Plan's unfunded actuarial accrued liability was \$23.7 million. The Plan's actuarial funded ratio was 62 percent. The valuation also determined that the employer's ARC is \$3.3 million for the fiscal year ending June 30, 2014.

13. Related Party Transactions

KUB, in the normal course of operations, is involved in transactions with the City of Knoxville. Such transactions for the years ended June 30, 2012 and 2011 are summarized as follows:

	2012	2011
City of Knoxville		
Amounts billed by KUB for utilities and related services	$ 11,457,145	$ 11,678,173
Payments by KUB in lieu of property tax	13,453,228	12,899,181
Payments by KUB for services provided	1,118,297	1,217,819

With respect to these transactions, accounts receivable from and accounts payable to the City of Knoxville included in the balance sheet at year end were:

	2012	2011
Accounts receivable	$ 726,455	$ 831,191

14. Natural Gas Supply Contract Commitments

For fiscal year 2012 the Gas Division hedged 67 percent of its total gas purchases via gas supply contracts. As of June 30, 2012, the Gas Division had hedged the price on approximately 10 percent of its anticipated gas purchases for fiscal year 2013.

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

Firm obligations related to purchased gas – demand

	2013	2014	2015	2016	2017
Transportation					
Tennessee Gas Pipeline	$ 7,325,892	$ 9,211,524	$ 9,211,524	$ 3,070,508	$ -
East Tennessee Natural Gas	10,066,388	10,066,388	10,066,388	3,355,463	-
Storage					
Tennessee Gas Pipeline	2,076,288	2,076,288	2,076,288	692,096	-
East Tennessee Natural Gas	757,460	757,460	757,460	252,487	-
Saltville Natural Gas	1,545,960	981,900	981,900	981,900	981,900
Demand Total	$ 21,771,988	$ 23,093,560	$ 23,093,560	$ 8,352,454	$ 981,900

Firm obligations related to purchased gas – commodity

	2013	2014	2015	2016	2017
Baseload					
Conoco	$ 1,251,400	$ -	$ -	$ -	$ -
Equitable	-	-	-	-	-
Shell Energy	2,423,970				
CNX	2,286,518	2,286,518	-	-	-
Commodity Total	$ 5,961,888	$ 2,286,518	$ -	$ -	$ -

The total commodity values presented here are based upon firm supply obligations with each individual natural gas supplier. The firm obligations value for Conoco, and Shell Energy are based upon firm supply obligations at locked prices with those suppliers. The firm obligations value for the CNX contract is based upon firm supply obligations and the applicable four month NYMEX strip prices on July 31, 2012.

15. Other Commitments and Contingencies

In the normal course of business, there are various lawsuits pending against KUB. Management has reviewed these lawsuits with counsel, who is vigorously defending KUB's position and is of the opinion that the ultimate disposition of these matters will not have a material adverse effect on KUB's financial position, results of operations or cash flows.

In February 2005, a Consent Decree was entered into federal court regarding the operation of KUB’s wastewater system. Under the terms of the Consent Decree, the remediation of identified sanitary sewer overflows (“SSOs”) on KUB’s wastewater system must be completed by December 31, 2016. KUB anticipates the Division will spend approximately $530 million in capital investments in order to comply with the terms of the Consent Decree related to the collection system. The Consent Decree also required KUB to perform an evaluation of the wet-weather performance and capacity of its wastewater treatment plants.

In July 2007, KUB submitted a Composite Correction Plan (CCP) for its wastewater treatment plants to EPA for review. The development and filing of the CCP was a requirement of the federal order of February 2005. The CCP includes recommended improvements to KUB’s Kuwahee and Fourth Creek treatment plants to address wet weather capacity issues noted in prior assessments. The EPA approved the CCP in January 2009 including a recommended schedule of plant improvements that extends beyond the expiration date of the original Consent Decree. An amendment to the Consent Decree incorporating and establishing this schedule was agreed to by all parties and was entered on June 23, 2009. The purpose of the Amendment is to allow KUB to complete a portion of work outlined in the CCP after the Consent Decree deadline of June 30, 2016. The CCP provides for a biologically enhanced high-rate clarification (the “BEHRC”) secondary treatment system to be installed at the Fourth Creek treatment plant by June 30, 2018, and at the Kuwahee treatment plant by June 30, 2021. The total cost of such improvements is estimated to be approximately $120 million.

KUB anticipates it will invest a total of $650 million in capital improvements to meet the requirements of the Consent Decree.

During fiscal year 2006, KUB launched the Private Lateral Program (PLP), as required by the Consent Decree, under which KUB tests private collection system laterals on its wastewater system over a ten-year period. Defective laterals and improper connections can introduce rainwater overloading the wastewater system and add pollution to area waterways. If a private lateral fails the respective inspection test, then the customer is required to have the lateral repaired/replaced within a specified time period. The $2 million SEP provides funding for lateral repairs/replacements for eligible low-income customers. A $1.7 million liability was accrued in May 2006 for the SEP. During the current and previous fiscal years, KUB funded $1.5 million, thereby reducing the liability to $0.2 million. In fiscal year 2012, KUB completed funding of the SEP.

KUB's funding plan for the Consent Decree through 2016 includes approximately $680 million in bond issues through 2021 plus a series of rate increases phased in over the term of the order. As of June 30, 2012, the Wastewater Division had issued $360 million in bonds to fund system capital improvements since the inception of the Consent Decree. The KUB Board of Commissioners approved two 50 percent rate increases, which went into effect in April 2005 and January 2007, respectively. The Board also approved an 8 percent rate increase, which was effective in September 2008, and a 12 percent rate increase, which was effective in April 2011. The Board also adopted a 12 percent rate increase to be effective October 2012. KUB anticipates additional bond issues and rate increases over the next decade to help fund wastewater capital projects.

16. Segment Information

The following financial information represents identifiable activities for which the revenue bonds and other revenue backed debt are outstanding for the respective divisions:

Condensed Statement of Net Assets

	2012			
	Electric	**Gas**	**Water**	**Wastewater**
Assets				
Current assets	$ 114,299,185	$ 37,206,451	$ 28,096,958	$ 45,109,244
Restricted assets	9,888,399	2,553,160	16,255,225	6,485,347
Net capital assets	376,337,837	208,788,070	207,968,631	574,384,440
Other assets	43,254,862	11,017,247	7,764,451	16,700,100
Total assets	$ 543,780,283	$ 259,564,928	$ 260,085,265	$ 642,679,131
Liabilities				
Current liabilities	$ 84,587,322	$ 15,096,022	$ 8,282,748	$ 17,554,728
Other liabilities	17,452,655	3,303,068	2,087,115	1,864,574
Long-term debt	151,950,000	82,845,000	102,075,000	383,705,000
Total liabilities	$ 253,989,977	$ 101,244,090	$ 112,444,863	$ 403,124,302
Net assets				
Invested in capital assets, net of related debt	$ 214,980,691	$ 120,403,561	$ 102,644,856	$ 183,963,788
Restricted	6,924,697	1,476,723	1,070,263	1,756,045
Unrestricted	67,884,918	36,440,554	43,925,283	53,834,996
Total net assets	$ 289,790,306	$ 158,320,838	$ 147,640,402	$ 239,554,829

Condensed Statement of Revenues, Expenses and Changes in Net Assets

	2012			
	Electric	Gas	Water	Wastewater
Operating revenues	$ 506,053,787	$ 86,760,687	$ 37,475,750	$ 70,502,494
Operating expenses	469,828,063	74,137,204	24,072,128	28,544,871
Provision for depreciation & amortization	20,655,981	8,277,943	5,768,349	12,911,050
Total operating expenses	490,484,044	82,415,147	29,840,477	41,455,921
Operating income	15,569,743	4,345,540	7,635,273	29,046,573
Non-operating expense	(6,738,141)	(3,794,060)	(3,854,058)	(18,954,728)
Change in net assets before capital contributions	8,831,602	551,480	3,781,215	10,091,845
Capital contributions	301,720	-	913,066	1,866,665
Change in net assets	9,133,322	551,480	4,694,281	11,958,510
Net assets				
Beginning of year	280,656,984	157,769,358	142,946,121	227,596,319
End of year	$ 289,790,306	$ 158,320,838	$ 147,640,402	$ 239,554,829

Condensed Statement of Cash Flows

	2012			
	Electric	Gas	Water	Wastewater
Net cash provided by operating activities	$ 38,986,071	$ 5,863,748	$ 13,911,736	$ 43,553,074
Net cash used in capital and related financing activities	(52,878,291)	(25,621,229)	(10,520,596)	(51,014,963)
Net cash provided by investing activities	(9,496,358)	(765,475)	(1,310,486)	(5,396,388)
Net increase (decrease) in cash and cash equivalents	(23,388,578)	(20,522,956)	2,080,654	(12,858,277)
Cash and cash equivalents, beginning of year	50,644,214	30,244,231	15,803,356	27,855,468
Cash and cash equivalents, end of year	$ 27,255,636	$ 9,721,275	$ 17,884,010	$ 14,997,191

Knoxville Utilities Board

Required Supplementary Information - Schedule of Funding Progress
June 30, 2012
(Unaudited)

Pension Plan

Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (b)	Unfunded Actuarial Accrued Liability (UAAL) (b-a)	Funded Ratio (a)/(b)	Annual Covered Payroll (c)	UAAL as a Percentage of Covered Payroll [(b)-(a)]/(c)
January 1, 2009	$ 183,447,296	$ 194,366,597	$ 10,919,301	94.4%	$ 49,602,223	22.01%
January 1, 2010	203,704,898	190,679,453	(13,025,445)	106.8%	48,228,428	(27.01%)
January 1, 2011	195,692,781	187,257,434	(8,435,347)	104.5%	47,405,874	(17.79%)
January 1, 2012	183,980,665	195,536,152	11,555,487	94.1%	48,836,721	23.66%

Other Post-Employment Benefits (OPEB)

Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	Unfunded Actuarial Accrued Liability (UAAL) (b-a)	Funded Ratio (a)/(b)	Covered Payroll (c)	UAAL as a Percentage of Covered Payroll [(b)-(a)]/(c)
January 1, 2008	$ -	$ 108,329,141	$ 108,329,141	0%	$ 31,234,509	346.8%
January 1, 2009	14,593,487	100,726,738	86,133,251	14%	31,846,091	270.5%
January 1, 2010	21,275,643	58,475,364	37,199,721	36%	30,069,028	123.7%
January 1, 2011	40,749,815	64,289,254	23,539,439	63%	28,878,791	81.5%
January 1, 2012	37,907,357	61,603,466	23,696,109	62%	28,269,123	83.8%

Knoxville Utilities Board
Supplemental Information –
Schedule of Expenditures of Federal Awards by Grant
June 30, 2012

Schedule 1

KUB was awarded a grant from the Department of Energy in October 2009, under DOE's Smart Grid Investment Grant Program. The grant, which totals $3.58 million, will be used to help fund a smart grid pilot project in the University of Tennessee and surrounding areas. KUB was also awarded two grants from Tennessee Emergency Management Agency (as a flow through from FEMA) for reimbursement for costs related to storms in 2011. The schedule below shows the expenditures for the current fiscal year.

Program Name	Federal/State Agency	CFDA Number	Contract Number	Beginning Deferred	Cash Receipts	Expenditures	Adjustments	Ending Deferred
ARRA-Electricity Delivery and Energy Reliability, Research, Development and Analysis	Department of Energy	81.122	DE-OE0000405	$ -	$ 2,111,261	$ 2,111,261	$ -	$ -
		Total Program 81.122		$ -	$ 2,111,261	$ 2,111,261	$ -	$ -
U.S. Department of Homeland Security	Tennessee Emergency Management	97.036	34101-0000009205	$ 1,561,320	$ 1,233,221	$ 345,861	$ 132,811	$ 806,771
U.S. Department of Homeland Security	Tennessee Emergency Management	97.036	34101-0000009832	$ 1,267,500	$ 2,950,392	$ 2,666,357	$ -	$ 983,465
		Total Program 97.036		$ 2,828,820	$ 4,183,613	$ 3,012,218	$ 132,811	$ 1,790,236
		Total Federal Awards		$ 2,828,820	$ 6,294,874	$ 5,123,479	$ 132,811	$ 1,790,236

NOTE 1 - BASIS OF PRESENTATION

The accompanying Schedule of Expenditures of Federal Awards includes the federal grant activity of Knoxville Utilities Board and is presented on the accrual basis of accounting. The information in this schedule is presented in accordance with requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the basic financial statements.

Summary of Audit Results

Financial Statements

Type of auditors report issued:	Unqualified	
Internal control over financial reporting:		
Material weakness(es) identified?	___Yes	✓___ No
Significant deficiencies identified that are not considered to be material weakness(es)?	___Yes	✓___ None reported
Noncompliance material to financial statements noted?	___Yes	✓___ No

Federal Awards

Internal control over major programs:		
Material weakness(es) identified?	___Yes	✓___ No
Significant deficiencies identified that are not considered to be material weakness(es)?	___Yes	✓___ None reported
Type of auditor's report issued on compliance for major programs:	Unqualified	
Any audit findings disclosed that are required to be reported in Accordance with Section 510(a) of Circular A-133?	___Yes	✓___ None reported

Major programs:

CFDA Number	Name of Federal Program
81.122	ARRA-Electricity Delivery and Energy Reliability, Research, Development and Analysis
97.036	U.S. Department of Homeland Security

Dollar threshold used to distinguish between type A And type B programs	$300,000	
Auditee qualified as low-risk auditee?	___Yes	✓___ No

Findings – Financial Statements Audit

None

Findings and Questioned Costs – Major Federal Award Programs Audit

None

Crime
Covers losses resulting from employee dishonesty, robbery, burglary, and computer fraud. Limits of coverage - $5,000,000; $250,000 retention.

Directors' and Officers' Liability Insurance
Covers KUB personnel appropriately authorized to make decisions on behalf of KUB (including but not limited to Commissioners, President and CEO, Senior Vice Presidents, Vice Presidents, and Directors) for wrongful acts. Limits of coverage - $20,000,000; $1,000,000 corporate deductible, $0 individual deductible.

Employment Practices Liability
Coverage for costs related to actual or alleged employment practices violations for amounts exceeding specified amount ($500,000). Limits of coverage - $10,000,000.

Fiduciary
Covers losses resulting from wrongful acts related to KUB's Pension, 401(k), and OPEB Trust funds. Limits of coverage - $10,000,000; $150,000 deductible.

Pollution Legal Liability
New conditions coverage for losses exceeding specified amount per occurrence ($1,000,000). Limits of coverage - $20,000,000.

Property Insurance
This coverage provides protection of KUB's property for fire, extended coverage, vandalism and malicious mischief, and coverage on boilers and machinery. Also included are flood and earthquake damage and mechanical failure. Limits of coverage - $250,000,000 per occurrence (subject to certain sublimits); $5,000,000 deductible per occurrence.

Travel Accident
Covers losses related to employees' business travel. Limits of coverage - $1,375,000 aggregate.

Excess Insurance for General Liability
As a government entity, KUB's liability is limited under the Tennessee Governmental Tort Liability Act (TCA §29-20-403). KUB is self-insured for up to the first $700,000 of any accident and has insurance of $1,000,000 above this retention.

Excess Insurance for Workers' Compensation
Covers all losses exceeding specified amount per occurrence ($1,000,000). Limits of coverage - Statutory; stop loss coverage applies for aggregate losses over $5,000,000.

Employee Health Plan Stop Loss Coverage
KUB's employee health plan is self-funded. KUB has purchased stop loss insurance, which covers KUB's exposure to annual expenses in excess of $400,000 per individual participant.

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Report on Internal Control Over Financial Reporting and On Compliance And Other Matters Based On An Audit Of Financial Statements Performed In Accordance With *Government Auditing Standards*

To the Board of Commissioners
Knoxville Utilities Board – Consolidated
Knoxville, Tennessee

We have audited the consolidated financial statements of the Knoxville Utilities Board, (an independent agency and reported as a component unit for financial purposes only by the City of Knoxville), as of and for the year ended June 30, 2012, which collectively comprise the Knoxville Utilities Board's basic financial statements and have issued our report thereon dated October 18, 2012. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

In accordance with *Government Auditing Standards*, the report dated October 18, 2012, has been reissued due to the omission of two federal program contracts on the schedule of expenditures of federal, state and other awards. Since program CFDA 97.036 was considered major, additional audit procedures were performed. The changes to the previously issued report dated October 18, 2012 encompasses the addition of program CFDA 97.036 contract number 34101-0000009205 and contract number 34101-0000009832 to the schedule of expenditures of federal, state and other awards and to the schedule of findings and questioned costs.

Internal Control Over Financial Reporting

Management of the Knoxville Utilities Board is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered Knoxville Utilities Board's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Knoxville Utilities Board's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Knoxville Utilities Board's internal control over financial reporting.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

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

This report is intended solely for the information and use of the Knoxville Utilities Board's audit committee, board of commissioners, and others within the entity, and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Rodefer Moss & Co, PLLC

Knoxville, Tennessee
October 18, 2012
(Except as noted in paragraph 2 above,
as to which the date is October 22, 2013)

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Independent Auditors' Report On Compliance With Requirements That Could Have A Direct And Material Effect On Each Major Program And On Internal Control Over Compliance In Accordance With OMB CIRCULAR A-133

To the Board of Commissioners
Knoxville Utilities Board – Consolidated
Knoxville, Tennessee

Compliance

We have audited the Knoxville Utilities Board's, (an independent agency and reported as a component unit for financial purposes only by the City of Knoxville) compliance with the types of compliance requirements described in the *OMB Circular A-133 Compliance Supplement* that could have a direct and material effect on each of the Knoxville Utilities Board's major federal programs for the year ended June 30, 2012. Knoxville Utilities Board's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of the Knoxville Utilities Board's management. Our responsibility is to express an opinion on the Knoxville Utilities Board's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the Knoxville Utilities Board's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of the Knoxville Utilities Board's compliance with those requirements.

In our opinion, the Knoxville Utilities Board, complied, in all material respects, with the compliance requirements referred to above that could have a direct and material effect on each of its major federal programs for the year ended June 30, 2012.

In accordance with *Government Auditing Standards*, the report dated October 18, 2012, has been reissued due to the omission of two federal program contracts on the schedule of expenditures of federal, state and other awards. Since program CFDA 97.036 was considered major, additional audit procedures were performed. The changes to the previously issued report dated October 18, 2012 encompasses the addition of program CFDA 97.036 contract number 34101-0000009205 and contract number 34101-0000009832 to the schedule of expenditures of federal, state and other awards and to the schedule of findings and questioned costs.

Internal Control over Compliance

Management of the Knoxville Utilities Board is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered the Knoxville Utilities Board's internal control over compliance with the requirements that could have a direct and material effect on a major federal program to determine the auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the Knoxville Utilities Board's internal control over compliance.

A *deficiency in internal control over compliance* exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a type of compliance requirement of a federal program on a timely basis. A *material weakness in internal control over compliance* is a deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over compliance that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses, as defined above.

This report is intended solely for the information and use of the Knoxville Utilities Board's audit committee, board of commissioners, others within the entity, federal awarding agencies, and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Rodefer Moss & Co, PLLC

Knoxville, Tennessee
October 18, 2012
(Except as noted in paragraph 4 above,
as to which the date is October 22, 2013)