LUNA INNOVATIONS INC
Form 10-Q
August 16, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2010

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from ______ to ______

COMMISSION FILE NUMBER 000-52008

LUNA INNOVATIONS INCORPORATED

(Exact name of registrant as specified in its charter)

Delaware	**54-1560050**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification Number)**

One Riverside Circle, Suite 400

Roanoke, VA 24016

(Address of Principal Executive Offices)

(540) 769-8400

(Registrant s Telephone Number, Including Area Code)

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

x Yes ¨ No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

¨ Yes ¨ No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer	¨	Accelerated filer	¨
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

¨ Yes x No

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court.

x Yes ¨ No

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: As of August 11, 2010, there were 13,119,866 shares of the registrant s common stock outstanding.

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CAUTIONARY NOTE REGARDING FORWARD LOOKING STATEMENTS

This Quarterly Report on Form 10-Q, including the sections entitled Management s Discussion and Analysis of Financial Condition and Results of Operations and Quantitative and Qualitative Disclosure About Market Risk under Items 2 and 3, respectively, of Part I of this report, and the sections entitled Legal Proceedings, Risk Factors, and Unregistered Sales of Equity Securities and Use of Proceeds under Items 1, 1A and 2, respectively, of Part II of this report, may contain forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended. All statements other than statements of historical fact are forward-looking statements for purposes of these statutes, including those relating to future events or our future financial performance. In some cases, you can identify these forward looking statements by words such as intends, will, plans, anticipates, expects, may, might, estimates, believes, should, projects, predicts, potential or continue, or the negative of those words and other comparable words, and other words or terms of similar meaning in connection with any discussion of future operating or financial performance. Similarly, statements that describe our management transition, business strategy, goals, prospects, opportunities, outlook, objectives, plans or intentions are also forward-looking statements. These statements are only predictions and may relate to, but are not limited to, expectations of future operating results or financial performance, capital expenditures, introduction of new products, regulatory compliance and plans for growth and future operations, as well as assumptions relating to the foregoing.

These statements are based on current expectations and assumptions regarding future events and business performance and involve known and unknown risks, uncertainties and other factors that may cause actual events or results to be materially different from any future events or results expressed or implied by these statements. These factors include those set forth in the following discussion and within Item 1A Risk Factors of this Quarterly Report on Form 10-Q and elsewhere within this report.

You should not place undue reliance on these forward-looking statements, which apply only as of the date of this Quarterly Report on Form 10-Q. You should carefully review the risk factors described in other documents that we file from time to time with the U.S. Securities and Exchange Commission, or SEC. Except as required by applicable law, including the rules and regulations of the SEC, we do not plan to publicly update or revise any forward-looking statements, whether as a result of any new information, future events or otherwise, other than through the filing of periodic reports in accordance with the Securities Exchange Act of 1934, as amended.

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LUNA INNOVATIONS INCORPORATED

QUARTERLY REPORT ON FORM 10-Q

FOR THE QUARTER ENDED JUNE 30, 2010

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Luna Innovations Incorporated

Condensed Consolidated Balance Sheets

	June 30, 2010 (unaudited)	December 31, 2009
Assets		
Current assets		
Cash and cash equivalents	$ 6,267,969	$ 5,228,802
Accounts receivable, net	8,044,870	7,203,203
Inventory, net	2,971,791	2,890,364
Prepaid expenses	576,095	560,964
Other current assets	45,530	729,532
Total current assets	17,906,255	16,612,865
Property and equipment, net	3,678,257	4,129,015
Intangible assets, net	557,829	580,785
Other assets	362,007	435,259
Total assets	$ 22,504,348	$ 21,757,924
Liabilities and stockholders equity (deficit)		
Liabilities not subject to compromise:		
Current Liabilities:		
Revolving line of credit	2,500,000	
Current portion of long term-debt obligation	1,296,867	
Accounts payable	2,187,396	1,142,267
Accrued liabilities	3,278,705	3,386,849
Deferred credits	1,453,460	1,027,016
Total current liabilities	10,716,428	5,556,132
Long-term debt obligation	3,271,696	
Liabilities subject to compromise		19,062,000
Total liabilities	13,988,124	24,618,132
Commitments and contingencies		
Stockholders equity (deficit):		
Preferred stock, par value $0.001, 1,321,514 shares authorized, issued and outstanding at June 30, 2010	1,322	
Common stock, par value $0.001, 100,000,000 shares authorized, 13,119,866 and 11,351,967 shares issued and outstanding at June 30, 2010 and December 31, 2009, respectively	13,156	11,352
Additional paid-in capital	54,590,810	41,228,698
Accumulated deficit	(46,089,064)	(44,100,258)

Total stockholders equity (deficit)	8,516,224	(2,860,208)
Total liabilities and stockholders equity (deficit)	$ 22,504,348	$ 21,757,924

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

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Luna Innovations Incorporated

Condensed Consolidated Statements of Operations

	Three Months Ended June 30, 2010 (unaudited)	Three Months Ended June 30, 2009 (unaudited)	Six Months Ended June 30, 2010 (unaudited)	Six Months Ended June 30, 2009 (unaudited)
Revenues:				
Technology development revenues	$ 6,091,503	$ 6,446,971	$ 11,902,597	$ 13,329,343
Product and license revenues	2,907,139	2,214,808	4,981,836	3,825,991
Total revenues	8,998,642	8,661,779	16,884,433	17,155,334
Cost of revenues:				
Technology development costs	4,192,920	4,271,252	8,025,260	9,169,008
Product and license costs	1,499,861	1,048,249	2,719,102	1,926,850
Total cost of revenues	5,692,781	5,319,501	10,744,362	11,095,858
Gross Profit	3,305,861	3,342,278	6,140,071	6,059,476
Operating expense:				
Selling, general and administrative	3,350,524	4,907,564	6,765,036	9,142,073
Research, development, and engineering	430,181	684,755	946,809	1,681,475
Litigation reserve				36,303,643
Impairment of intangible assets				1,310,598
Total operating expense	3,780,705	5,592,319	7,711,845	48,437,789
Operating loss	(474,844)	(2,250,041)	(1,571,774)	(42,378,313)
Other expense				
Other expense		17,244	14,872	18,167
Interest expense	143,485	139,875	227,526	298,864
Total other expense	143,485	157,119	242,398	317,031
Loss before income taxes	(618,329)	(2,407,160)	(1,814,172)	(42,695,344)
Income tax expense				600,000
Net loss	(618,329)	(2,407,160)	(1,814 ,172)	(43,295,344)
Preferred stock dividend	93,000		174,633	
Net loss attributible to common stockholders	$ (711,329)	$ (2,407,160)	$ (1,988,805)	$ (43,295,344)
Net loss per share:				
Basic and Diluted	$ (0.05)	$ (0.21)	$ (0.16)	$ (3.87)
Weighted average shares:				

Basic and Diluted	12,946,802	11,207,021	12,739,201	11,184,348

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

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Luna Innovations Incorporated

Condensed Consolidated Statements of Cash Flows

	Six months ended June 30, 2010	Six months ended June 30, 2009
	(unaudited)	
Cash flows used in operating activities		
Net loss	$ (1,814,172)	$ (43,295,344)
Adjustments to reconcile net loss to net cash used in operating activities		
Depreciation and amortization	641,979	1,142,846
Impairment of intangible assets		1,310,598
Share-based compensation	1,763,015	1,569,043
Deferred tax expense		600,000
Change in assets and liabilities:		
Accounts receivable	(1,007,451)	452,114
Inventory	(127,163)	(22,590)
Other current assets	668,871	
Other assets	31,024	(60,071)
Accounts payable and accrued expenses	(2,264,121)	(559,125)
Litigation reserve		36,303,643
Deferred credits	426,444	11,967
Net cash used in operating activities	(1,681,574)	(2,546,919)
Cash flows used in investing activities		
Acquisition of property and equipment	(39,146)	(41,445)
Intangible property costs	(88,712)	(121,132)
Net cash used in investing activities	(127,858)	(162,577)
Cash flows provided by (used in) financing activities		
Payments on capital lease obligations	(2,684)	(5,614)
Proceeds from debt obligations	2,500,000	
Payment of debt obligations	(265,657)	(714,285)
Proceeds from the exercise of options and warrants	616,940	20,693
Net cash provided by (used in) financing activities	2,848,599	(699,206)
Net change in cash	1,039,167	(3,408,702)
Cash and cash equivalents beginning of period	5,228,802	15,518,960
Cash and cash equivalents end of period	$ 6,267,969	$ 12,110,258
Supplemental disclosure of cash flow information		
Cash paid for interest	$ 145,000	$ 149,472
Common stock issued in litigation settlement (1,247,330 shares)	$ 4,565,227	
Installment note issued in litigation settlement	$ 5,000,000	

Preferred stock issued in exchange of notes (1,321,514 shares)	$ 4,836,742
Warrants issued in exchange of notes payable (356,000 warrants)	$ 1,261,879
Common stock issued in settlement of other claims (25,000 shares)	$ 91,500
Dividend on preferred stock, 37,223 shares of common stock issuable	$ 174,633

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

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Luna Innovations Incorporated

Notes to Unaudited Condensed Consolidated Financial Statements

1. Basis of Presentation and Significant Accounting Policies

Nature of Operations

Luna Innovations Incorporated (Luna Innovations) was incorporated in the Commonwealth of Virginia in 1990 and subsequently reincorporated in the State of Delaware in April 2003. We are engaged in the research, development and commercialization of innovative technologies in the areas of test & measurement, sensing, and instrumentation products and health care products. We are organized into two main groups, which work closely together to turn ideas into products: our Technology Development Group, and our Product and License Group. We have a disciplined and integrated business model that is designed to accelerate the process of bringing new and innovative technologies to market. We identify technology that can fulfill identified market needs. We then take these solutions from the applied research stage through commercialization.

Unaudited Interim Financial Information

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (US GAAP) and with the instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities Exchange Act of 1934. Accordingly, they do not include all of the information and footnotes required by US GAAP for audited financial statements. The unaudited consolidated financial statements have been prepared on the same basis as the annual financial statements and in the opinion of management reflect all adjustments, consisting of only normal recurring accruals considered necessary to present fairly our financial position at June 30, 2010 and results of operations and cash flows for the three and six months ended June 30, 2010 and 2009. The results of operations for the six months ended June 30, 2010 are not necessarily indicative of the results that may be expected for the year ending December 31, 2010.

The consolidated interim financial statements, including our significant accounting policies, should be read in conjunction with the audited Consolidated Financial Statements and the notes thereto for the year ended December 31, 2009, included in the Company s Annual Report on Form 10-K as filed with the Securities and Exchange Commission on March 26, 2010. As used herein, the terms Luna , Company , we , our and mean Luna Innovations Incorporated and its consolidated subsidiaries.

Consolidation Policy

Our consolidated financial statements are prepared in accordance with US GAAP and include the accounts of the Company, our wholly owned subsidiaries and other entities in which we have a controlling financial interest. We eliminate from our financial results all significant inter-company transactions. We do not have any investments in entities we believe are variable interest entities for which we are the primary beneficiary.

Fair Value Measurements

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market in an orderly transaction between marketplace participants. Various valuation approaches can be used to determine fair value, each requiring different valuation inputs. The following hierarchy classifies the inputs used to determine fair value into three levels:

Level 1 Quoted prices for identical instruments in active markets

Level 2 Quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets

Level 3 Valuations derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable
The Company s financial instruments include cash and cash equivalents, accounts receivable, accounts payable, and debt. As of June 30, 2010 and December 31, 2009, the carrying value of all financial instruments approximated their fair value.

Certain nonfinancial assets and liabilities are measured at fair value on a nonrecurring basis in accordance with applicable U.S. GAAP. This includes items such as nonfinancial assets and liabilities initially measured at fair value in a business combination and nonfinancial long-lived asset groups measured at fair value for an impairment assessment. In general, nonfinancial assets including goodwill, other intangible assets and property and equipment are measured at fair value when there is an indication of impairment and are recorded at fair value only when any impairment is recognized.

Emergence from Chapter 11 Reorganization

On July 17, 2009, Luna Innovations, along with Luna Technologies, Inc., which together included all of the operations of the consolidated Company, filed a voluntary petition for relief in order to reorganize under Chapter 11 of the United States Bankruptcy Code, including a proposed plan of reorganization, in the United States Bankruptcy Court for the Western District of Virginia (the Bankruptcy Court). During the period from July 17, 2009 through January 12, 2010, the Company continued to operate its business in the ordinary course as a Debtor-in-Possession. On January 12, 2010, the Bankruptcy Court approved our plan of reorganization, and the Company successfully emerged from Chapter 11 reorganization.

Upon our emergence and in connection with our litigation settlement, we issued approximately 1.2 million shares of common stock to Hansen Medical, Inc., as described below. Other outstanding shares of common stock were not directly affected by our plan of reorganization. Because the shareholders immediately prior to our emergence from Chapter 11 continue to own more than 50% of the total outstanding common stock immediately following our emergence from Chapter 11 reorganization, we did not adopt the fresh-start reporting principles of Accounting Standards Codification (ASC) 852-10-45 Financial Reporting during Reorganization.

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Settlement of Hansen Litigation

In June 2007, Hansen Medical, Inc. (Hansen), a company for which we had conducted certain research and performed certain services, filed a lawsuit against us for using allegedly misappropriated trade secrets from Hansen in connection with our work with Intuitive Surgical, Inc. (Intuitive), or otherwise. On April 21, 2009, a jury found in favor of Hansen and awarded a verdict for $36.3 million against us. As a result of this jury verdict, we filed for Chapter 11 reorganization in July 2009, as described above under Emergence from Chapter 11 Reorganization.

On December 11, 2009, we and our wholly owned subsidiary Luna Technologies, Inc., entered into a settlement agreement with Hansen to settle all claims arising out of the litigation. As a result of the settlement our accrual of $36.3 million recorded during the quarter ended March 31, 2009 was adjusted to $9.7 million at December 31, 2009. On January 12, 2010, as part of our reorganization plan, we entered into a series of agreements with Hansen and Intuitive that were contemplated by the settlement agreement. The following is a summary of the material terms of these agreements.

License Agreement with Hansen (the Hansen License)

Under the Hansen License, we granted Hansen (i) a co-exclusive (with Intuitive), royalty-free, fully paid, perpetual and irrevocable license to our fiber optic shape sensing/localization technology within the medical robotics field. The license can only be sublicensed by Hansen in connection with Hansen products, except that Hansen can grant full sublicenses to third parties for single degree of freedom robotic medical devices; (ii) an exclusive (and fully sublicenseable) royalty-free, fully paid, perpetual and irrevocable license to our fiber optic shape sensing/localization technology for non-robotic medical devices within the orthopedics, vascular, and endoluminal fields; and (iii) a co-exclusive (with us) royalty-free, fully paid, perpetual and irrevocable license to our fiber optic shape sensing/localization technology for non-robotic medical devices in other medical fields (including colonoscopies but not including devices described in clause (ii) above). After five years, the exclusive license in the non-robotic endoluminal field may be converted to a co-exclusive (with us) license in certain circumstances in connection with certain supply provisions applicable to that field under the Development and Supply Agreement described below.

The Hansen License provides that Hansen and Intuitive have the right to enforce the intellectual property licensed by us within the medical robotics field. Hansen has the sole right to enforce such intellectual property for non-robotic devices in the orthopedics field, the vascular field and the endoluminal field. We have the right to enforce such intellectual property in other non-robotic medical fields.

In addition, Hansen granted us a nonexclusive, sublicenseable, royalty-free, fully paid, perpetual and irrevocable license to certain Hansen fiber optic shape sensing/localization technology in all fields outside of the medical robotics field and the orthopedics, vascular and endoluminal fields. Furthermore, we confirmed Hansen s ownership of certain intellectual property developed in whole or in part by us under a prior agreement between us and Hansen.

Development and Supply Agreement with Hansen

In connection with the settlement agreement, we also entered into a development and supply agreement with Hansen. Under the terms of this agreement, we will perform product development services with respect to fiber optic shape sensing at Hansen s request and provide Luna shape sensing products to Hansen. Revenues earned for product development will be determined in a manner consistent with our contract development services in our Technology Development business segment and will be payable monthly to us. Each quarter, to the extent such revenues exceed the installment payment owed by us to Hansen under the Hansen Note described below, then such excess will not be payable in cash and instead will be credited against the outstanding principal balance of the Hansen Note. Revenue is recognized under the development and supply agreement as time and expenses are incurred based upon contractual billing rates. Under the agreement, 30% of the costs incurred under the contract are not billable until specified milestones are met. Additionally, such amounts may be reduced if such milestones are not met within the timetable specified in the agreement. Since the holdback portion is not fixed and determinable as of June 30, 2010, we have deferred such amounts, approximately $168,000, until the milestone is achieved. We achieved this milestone during the third quarter of 2010.

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Luna Securities Issued to Hansen

In connection with the settlement agreement, on January 12, 2010, we issued 1,247,330 shares of common stock to Hansen, representing 9.9% of our common stock then outstanding. In addition, we issued to Hansen a warrant entitling Hansen to purchase, until January 12, 2013, a number of shares of our common stock as necessary for Hansen to maintain a 9.9% ownership interest in our common stock, at an exercise price of $0.01 per share. On June 22, 2010, Hansen exercised the warrant to acquire 20,628 shares of our common stock based upon our outstanding shares of common stock as of March 31, 2010, the amount of which was included in operating expenses at March 31.

Note Payable to Hansen (the Hansen Note)

In connection with the settlement agreement, we issued a promissory note to Hansen in the principal amount of $5.0 million, payable in 16 quarterly installments beginning in April 2010. The Hansen Note bears interest at a fixed rate of 8.5% and is secured by substantially all of our assets. The Hansen Note is subordinated to our primary bank credit facility.

Preferred Stock Issued to Carilion Clinic

In January 2010, we entered into a transaction with Carilion Clinic (Carilion), in which Carilion agreed to exchange all of its Senior Convertible Promissory Notes in the principal amount of $5.0 million plus all accrued but unpaid interest, totaling $1.2 million, for (i) 1,321,514 shares of our newly designated Series A Convertible Preferred Stock and (ii) an additional warrant to purchase 356,000 shares of our common stock at an exercise price of $2.50 per share. This warrant is exercisable beginning February 1, 2013, and continuing until December 31, 2020. We also agreed to reduce the exercise price of Carilion s prior common stock warrant from $7.98 to $2.50 per share and to extend its expiration date to December 31, 2020. The Series A Convertible Preferred Stock carries a dividend of 6% payable in shares of common stock and maintains a liquidation preference up to $6.2 million. As of June 30, 2010, 37,223 shares of common stock were issuable to Carilion as dividends and have been recorded in the statement of stockholders equity. Each share of Series A Convertible Preferred Stock may be converted into one share of our common stock at the option of the holder. We recorded the fair value of the Series A Convertible Preferred Stock, determined based upon the conversion value immediately prior to the exchange, the fair value of the new warrant issued, determined using the Black-Scholes valuation model, and the incremental fair value of the prior warrant due to the re-pricing and extension of maturity to stockholders equity.

Going Concern

The accompanying consolidated financial statements have been prepared assuming that we will continue as a going concern, which contemplates the realization of assets and the liquidation of liabilities in the normal course of business. We have a history of net losses from 2005 through the six months ended June 30, 2010, attributable to our operations and other charges. We experienced continued negative cash flow from operations in the six months ended June 30, 2010. We have historically managed our liquidity through cost reduction initiatives, debt financings, and capital markets transactions.

Since the second half of 2008, the increased turmoil in the U.S. and global capital markets and a global slowdown of economic growth created a substantially more difficult business environment. Our ability to access the capital markets is expected to be extremely limited. The deteriorating economic and market conditions may not improve significantly during 2010, may continue past 2010, and could get worse.

Although there can be no guarantees, we believe that our current cash balance in addition to the funds available to us under the Credit Facility described below provide adequate liquidity for us to meet our working capital needs through 2010.

Use of Estimates

The preparation of our consolidated financial statements in accordance with US GAAP requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and the disclosure of contingent assets and liabilities in our consolidated financial statements and accompanying notes. Although these estimates are based on our knowledge of current events and actions we may undertake in the future, actual results may differ from such estimates and assumptions.

Net Loss Per Share

We compute net loss per share in accordance with ASC 260-10-45, Earnings Per Share. Basic per share data is computed by dividing loss available to common stockholders by the weighted average number of shares outstanding during the period. Diluted per share data is computed by dividing loss available to common stockholders by the weighted average shares outstanding during the period increased to include, if dilutive, the number of

additional common share equivalents that would have been outstanding if potential common shares had been issued using the treasury stock method. Diluted per share data would also include the potential common share equivalents relating to convertible securities by application of the if-converted method.

The effect of 6,724,111 and 4,936,856 common stock equivalents (which include conversion of preferred stock, outstanding warrants and stock options) are not included for the three months and six months ended June 30, 2010 and 2009, respectively, as they are anti-dilutive to earnings per share.

Stock-Based Compensation

We recognize stock-based compensation expense based upon the fair value of the underlying equity award on the date of the grant. The Company has elected to use the Black-Scholes option pricing model to value any awards granted. We amortize stock-based compensation for such awards on a straight-line basis over the related service period of the awards taking into account the effects of the employees expected exercise and post-vesting employment termination behavior. To compute the volatility used in this model we use the lifetime volatility of our common stock. The risk-free interest rate is based on US Treasury interest rates, the terms of which are consistent with the expected life of the stock options. The expected life and estimated post employment termination behavior is based upon historical experience of homogeneous groups within our company.

The fair value of each option granted is estimated as of the grant date using the Black-Scholes option pricing model with the following assumptions:

	Six months ended June 30, 2010	Six months ended June 30, 2009
Risk-free interest rate	2.87 3.22%	2.91 3.17%
Expected life of options (in years)	7.5	7.5
Expected stock price volatility	117%	83.00 88.59%

A summary of the activity for our 2003 Stock Plan and 2006 Equity Incentive Plan is presented below for the periods indicated:

	Options Outstanding				Options Exercisable		
	Number of Shares	Price per Share Range	Weighted Average	Aggregate Intrinsic Value (1)	Number of Shares	Weighted Average	Aggregate Intrinsic Value (1)
Balance, December 31, 2009	4,727,360	$ 0.35 - $8.20	$ 2.43	$ 3,545,705	2,987,955	$ 1.72	$ 2,734,841
Granted	563,667	$ 3.45 - 4.43	$ 4.21				
Exercised	(210,104)	$ 0.35 - 2.11	$ 1.49				
Canceled	(24,277)	$ 1.77 - $5.73	$ 4.03				
Balance, March 31, 2010	5,056,646	$ 0.35 - $8.20	$ 2.66	$ 3,866,520	2,924,567	$ 2.10	$ 2,980,196
Granted	174,981	$ 2.32 - 2.35	$ 2.32				
Exercised	(261,408)	$ 0.35 - 2.11	$ 1.16				
Canceled	(5,150)	$ 1.70 - 6.00	$ 2.36				
Balance, June 30, 2010	4,965,069	$ 0.35 - $8.20	$ 2.72	$ 3,328,505	2,951,700	$ 2.30	$ 2,530,921

(1) The intrinsic value of an option represents the amount by which the market value of the stock exceeds the exercise price of the option of in-the-money options only. The aggregate intrinsic value is based on the price of $2.20, which was the closing price of the Company s Common Stock on the NASDAQ Capital Market on June 30, 2010.

At June 30, 2010, our approximately 5.0 million outstanding stock options had a weighted average remaining contractual term of 6.9 years, and our approximately 3.0 million outstanding and exercisable stock options had a weighted average remaining contractual term of 5.7 years.

For the three months ended June 30, 2010 and 2009, we recognized $875,675 and $779,518 in share-based payment expense, respectively and for the six months ended June 30, 2010 and 2009, we recognized $1,763,015 and $1,569,029 in share-based payment expense, respectively. We expect to recognize approximately $5.4 million in stock-based compensation expense over the remaining requisite service period of five years for stock options outstanding as of June 30, 2010.

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Income Taxes

We have not recorded an income tax benefit during the current period as we have determined that it is not more likely than not that such amount will be recovered.

Intangible Assets and Other Long Lived Assets

Long-lived assets and certain identifiable intangibles are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset might not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds the fair market value of the asset. Assets to be disposed of are reported at the lower of the carrying amount or fair market value, less cost to sell.

Inventory

Inventory consists of finished goods, work-in-process and parts valued at the lower of cost (determined on the first-in, first-out basis) or market. We provide reserves for estimated obsolescence or unmarketable inventory equal to the difference between the cost of the inventory and the estimated market value based upon assumptions about future demand and market conditions. Inventory reserves at June 30, 2010 and December 31, 2009 were approximately $84,000 and $48,000, respectively.

Recent Accounting Pronouncements

There have been no additional accounting pronouncements or changes in accounting pronouncements during the six months ended June 30, 2010, as compared to the recent accounting pronouncements described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009, that are material, or potentially material, to the Company s financial statements.

2. Debt

Silicon Valley Bank Facility

On February 18, 2010, we entered into a Loan and Security Agreement (the Credit Facility) with Silicon Valley Bank (the Bank). The Credit Facility is a revolving credit facility that provides the Company with borrowing capacity of up to $5 million, subject to a percentage of our outstanding eligible accounts receivable, at a floating annual interest rate equal to the greater of (a) 6% or (b) the Bank s prime rate then in effect plus 2%. The Credit Facility matures on February 17, 2011, unless earlier terminated, and any amounts due under the Credit Facility will be secured by substantially all of the Company s assets, including our intellectual property, personal property and bank accounts. Outstanding borrowings under the facility were $2.5 million as of June 30, 2010, accruing interest at an annual rate of 6%.

The Credit Facility includes a fee of one-half of one percent (0.50%) per annum based on the average unused portion of the Credit Facility from time to time.

The Credit Facility requires the Company to observe a number of financial and operational covenants, including maintenance of a specified liquidity ratio, achievement of certain adjusted EBITDA targets (as defined in the agreement), protection and registration of intellectual property rights, and certain customary negative covenants. If the Company draws on the Credit Facility, we may use the proceeds of the loans for any variety of purposes, including working capital and general corporate purposes. As of June 30, 2010, we were in compliance with all covenants.

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In addition, the Credit Facility contains customary events of default, including nonpayment of principal, interest or other amounts, violation of covenants, material adverse change, an event of default under any subordinated debt documents, incorrectness of representations and warranties in any material respect, bankruptcy, judgments in excess of a threshold amount, and violations of other agreements in excess of a threshold. If any event of default occurs the Bank may declare due immediately all borrowings under the Credit Facility and foreclose on the collateral. Furthermore, an event of default under the Credit Facility would result in an increase in the interest rate on any amounts outstanding.

Hansen Note

As described in Note 1, we issued the Hansen Note in the principal amount of $5 million in January 2010. Hansen agreed to subordinate its right to payment under the Hansen Note in favor of the Bank s right to payment under the Credit Facility, subject to certain terms and conditions.

Issuance of Preferred Stock in exchange for Carilion Promissory Note

In 2005, we issued $5.0 million in principal amount of convertible promissory notes to Carilion that were convertible into shares of our Common Stock at a fixed price of $4.69 per share. The notes accrued simple interest at a rate of 6.0% per year and were originally scheduled to mature on December 30, 2009. In May 2008, we amended the terms of the notes to extend their due date to December 31, 2012 and to subordinate them to our credit facility with Silicon Valley Bank. We also issued warrants to purchase 10,000 shares of Common Stock at a price of $7.98 per share in connection with the amended terms. We valued the warrants using the Black-Scholes option pricing model, and we were amortizing the value as a deferred financing cost over the life of the promissory notes.

On January 12, 2010, we exchanged the convertible notes for 1,321,514 shares of convertible preferred stock in full satisfaction of the $5.0 million principal amount due under the convertible notes and $1.2 million in accrued but unpaid interest under the notes. In addition, the warrants issued in May 2008 to purchase 10,000 shares of Common Stock were amended to reduce their strike price to $2.50 per share. As part of the exchange, the company also issued additional warrants to Carilion to purchase an aggregate of 356,000 shares of Common Stock with a strike price of $2.50. The warrants are exercisable beginning December 31, 2012 and February 1, 2013, respectively, and continuing until December 31, 2020. Please see Note 1 for discussion of accounting recognition.

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3. Capital Stock and Additional Paid-in Capital

During the six months ended June 30, 2010, we issued shares of capital stock as follows:

	Preferred Stock		Common Stock		Additional Paid-in Capital
	Shares	$	Shares	$	$
Balances, December 31, 2009		$	11,351,967	$ 11,352	$ 41,228,698
Exercise of stock options			161,598	162	226,596
Share-based compensation					887,340
Issuance of Common Stock, Hansen Settlement			1,247,330	1247	4,563,980
Stock dividends to Carilion (1)				17	81,616
Issuance of Warrants, Other					1,264,946
Issuance of Common Stock, Other (2)			25,000	25	91,475
Issuance of Preferred Stock, in exchange of Carilion notes	1,321,514	1,322			4,835,420
Balances, March 31, 2010	1,321,514	1,322	12,785,895	12,803	53,180,071
Exercise of stock options and warrants			330,542	331	437,086
Share-based compensation					875,675
Stock dividends to Carilion (1)				20	92,980
Issuance of Common Stock, Other			2,293	2	4,998
Balances, June 30, 2010	**1,321,514**	**1,322**	**13,118,730**	**13,156**	**54,590,810**

(1) The stock dividends payable in connection with Carilion s Series A Preferred Stock will be issued subsequent to June 30, 2010.

(2) In January 2010 we settled a complaint filed by a former employee in exchange for the payment of $13,000 in cash and the issuance of 25,000 shares of our common stock. The settlement was included as an accrued liability on our December 31, 2009 consolidated balance sheet.

See Note 1 for a description of the securities issued to Hansen and Note 2 for a description of the issuance of preferred stock to Carilion.

4. Operating Segments

Our operations are divided into two operating segments Technology Development and Product and Licensing.

The Technology Development segment provides applied research to customers in our areas of focus. Our engineers and scientists collaborate with our network of government, academic and industry experts to identify technologies and ideas with promising market potential. We then compete to win fee-for-service contracts from government agencies and industrial customers who seek innovative solutions to practical problems that require new technology. The Technology Development segment derives its revenue primarily from services.

The Product and Licensing segment develops and sells products or licenses technologies based on commercially viable concepts developed by the Technology Development segment. The Product and Licensing segment derives its revenue from product sales, funded product development and technology licenses.

Through June 30, 2010, our acting President and our Chief Executive Officer and their direct reports collectively represented our chief operating decision makers, and they evaluate segment performance based primarily on revenue and operating income or loss. The accounting policies of our segments are the same as those described in the summary of significant accounting policies (see Note 1 to our Financial Statements, Organization and Summary of Significant Accounting Policies, presented in our Annual Report on Form 10-K as filed with the Securities and Exchange Commission on March 26, 2010).

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The table below presents revenues and operating loss for reportable segments:

	Three Months Ended June 30, 2010	2009	Six Months Ended June 30, 2010	2009
	(unaudited)		(unaudited)	
Revenues :				
Technology development revenues	$ 6,091,503	$ 6,446,971	$ 11,902,597	$ 13,329,343
Product and license revenues	2,907,139	2,214,808	4,981,836	3,825,991
Total revenues	$ 8,998,642	$ 8,661,779	$ 16,884,433	$ 17,155,334
Technology Development operating loss	(406,434)	(1,215,110)	(710,655)	(1,956,757)
Product and License operating loss	$ (68,410)	$ (1,034,931)	$ (861,120)	$ (40,421,556)
Total operating loss	$ (474,844)	$ (2,250,041)	$ (1,571,774)	$ (42,378,313)
Depreciation, Technology Development	177,834	248 ,958	377,597	539,480
Depreciation, Product and License	84,870	85,527	158,043	154,850
Amortization, Technology Development	34,061	140,354	74,963	348,486
Amortization, Product and License	16,255	48,217	31,376	100,028

Additional segment information is as follows:

The table below presents assets for reportable segments:

	June 30, 2010	December 31, 2009
Total segment assets:		
Technology Development	$ 15,233,999	$ 15,937,039
Product and License	7,270,349	5,820,885
Total	$ 22,504,348	$ 21,757,924
Property plant and equipment, and intangible assets, Technology Development	$ 2,867,558	$ 3,449,790
Property plant and equipment, and intangible assets, Product and License	$ 1,368,528	$ 1,260,010

There are no material inter-segment revenues for any period presented.

The United States Government accounted for approximately 65% and 77% of total consolidated revenues for the three months ended June 30, 2010 and 2009, respectively and 70% and 80% of revenues for the six months ending June 30, 2010 and 2009, respectively.

International revenues (customers outside of the United States) accounted for approximately 10% and 8% of total revenues for the three months ended June 30, 2010 and 2009, respectively and 10% and 7% of total revenues for the six months ended June 30, 2010 and 2009, respectively.

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5. Contingencies and Guarantees

We are from time to time involved in certain legal proceedings in the ordinary course of conducting our business. While the ultimate liability pursuant to these actions cannot currently be determined, we believe these legal proceedings will not have a material adverse effect on our financial position or results of operations.

We have an outstanding letter of credit as of June 30, 2010, in the amount of $239,832 in favor of the Industrial Development Authority of Montgomery County, Virginia, to support a lease of office space. This letter of credit expires in June 2012.

In September 2008, our Luna Technologies Division executed a non-cancelable $2.0 million purchase order for multiple shipments of tunable lasers to be delivered over an 18-month period beginning in September 2008. As of June 30, 2010, approximately $0.3 million of this commitment remained. The delivery of the remaining lasers has been extended through September 2010.

We have entered into indemnification agreements with our officers and directors, to the extent permitted by law, pursuant to which we have agreed to reimburse the officers and directors for legal expenses in the event of litigation and regulatory matters. The terms of these indemnification agreements provide for no limitation to the maximum potential future payments. We have a directors and officers insurance policy that may, in certain instances, mitigate the potential liability and payments.

ITEM 2. ***MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS***

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and the related notes to those statements included elsewhere in this report. In addition to historical financial information, the following discussion and analysis contains forward-looking statements that involve risks, uncertainties and assumptions. Our actual results and timing of selected events may differ materially from those anticipated in these forward-looking statements as a result of many factors, including those discussed under Risk factors and elsewhere in this report.

Overview

We research, develop and commercialize innovative technologies in two primary areas of focus: instrumentation, test & measurement and sensing products, and healthcare products. We have a disciplined and integrated business model that is designed to accelerate the process of bringing new and innovative products to market. We identify technologies that can fulfill large and unmet market needs and then take these technologies from the applied research stage through commercialization. Although revenues from product sales currently represent less than one half of our total revenues, we continue to invest in product development and commercialization, which we anticipate will lead to increased product sales growth. In the future, we expect that revenues from product sales will represent a larger proportion of our total revenues. In addition, we anticipate that these revenues will reflect a broader and more diversified mix of products as we develop and commercialize new products.

We have developed a disciplined and integrated process to accelerate the development and commercialization of innovative technologies. Our business model employs a market-driven approach and provides the infrastructure, resources and know-how throughout the process of developing and commercializing new products. To manage a diverse set of products effectively across a range of development stages, we are organized into two main groups: our Technology Development Division and our Products and License Division. These groups work together through all product development stages, including:

- Searching for emerging technologies based on market needs;
- Conducting applied research;
- Developing and commercializing innovative products; and

Applying proven technologies and products to new market opportunities.

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Our total revenues were $9.0 million and $8.7 million during the three months ended June 30, 2010 and 2009, respectively, and we had net losses attributable to common stockholders of $0.7 million and $2.4 million for the same periods, respectively.

We generate revenues through technology development services provided under contractual arrangements, product sales and license fees. Historically, our technology development revenues have accounted for a large and growing proportion of our total revenues, and we expect that they will continue to represent a significant portion of our total revenues for the foreseeable future. The rate at which we have received new research contract awards declined significantly during the period of our reorganization in 2009 and early 2010, and this resulted in a decline in our technology development revenues for the three months ended June 30, 2010, as compared to the three months ended June 30, 2009. We regularly have a backlog of contracts for which work has been scheduled, but for which a specified portion of work has not yet been completed. We define backlog as the dollar amount of obligations payable to us under negotiated contracts upon completion of a specified portion of work that has not yet been completed, exclusive of revenues previously recognized for work already performed under these contracts, if any. Total backlog includes funded backlog (the amount for which money has been directly authorized by the U.S. Congress or for which a purchase order has been received by a commercial customer) and unfunded backlog (firm orders for which funding has not been appropriated). Indefinite delivery and quantity contracts and unexercised options are not reported in total backlog. The recent slowing in the rate of our receipt of new research contract awards described above has led to a decline in our backlog, and the approximate value of our backlog was $26.4 million as of June 30, 2010, as compared to $27.9 million of backlog as of June 30, 2009. We may continue to experience year over year declines in revenue for this segment of our business unless and until we are able to increase the rate at which we receive new research contract awards and restore our backlog to prior levels.

Revenues from product sales currently represent a smaller proportion of our total revenues, and, historically, we have derived most of these revenues from the sales of our sensing systems and products that make use of light-transmitting optical fibers, or fiber optics. Although we have been successful in licensing certain technology in past years, we do not expect license revenues to represent a significant portion of future revenues; however, over time we do intend to gradually increase such revenues. In the near term, we expect revenues from product sales to increase primarily in areas associated with our fiber optic instrumentation and test and measurement platforms. We also expect to continue our efforts in product development and commercialization, which we anticipate will lead to increased product sales growth. In the future, we expect that revenues from product sales will represent a larger proportion of our total revenues and that as we develop and commercialize new products, these revenues will reflect a broader and more diversified mix of products.

We do expect to continue to incur significant expenses as we expand our business, including increased expenses for research and development, sales and marketing, and manufacturing capability, which could result in losses. We may also grow our business in part through acquisitions of additional companies and complementary technologies, which could cause us to incur transaction expenses, amortization or write-offs of intangible assets and other acquisition-related expenses. As a result, we expect that we may likely continue to incur losses in 2010 and for the foreseeable future, and these losses could be substantial.

There was a rapid softening of the economy and tightening of the financial markets in the second half of 2008 that continued throughout 2009 and into 2010. This slowing of the economy has in some instances reduced the financial capacity of our customers and possibly our potential customers, thereby slowing spending on the products and services we provide. The outlook for the economy for the remainder of 2010 remains uncertain.

Description of Our Revenues, Costs and Expenses

Revenues

We generate revenues from technology development, product sales and commercial product development and licensing activities. We derive technology development revenues from providing research and development services to third parties, including government entities, academic institutions and corporations, and from achieving milestones established by some of these contracts and in collaboration agreements. In general, we complete contracted research over periods ranging from six months to three years, and recognize these revenues over the life of the contract as costs are incurred or upon the achievement of certain milestones built into the contracts. Our product revenues reflect amounts that we receive from sales of our products or development of products for third parties and represented approximately 32% and 30% of our total revenues for the three- and six- month periods ended June 30, 2010, respectively. Our license revenues are composed of fees paid to us in connection with licenses or sublicenses of certain patents and other intellectual property.

Cost of Revenues

Cost of revenues associated with technology development revenues consists of costs associated with performing the related research activities, including direct labor, amounts paid to subcontractors and overhead allocated to technology development activities.

Cost of revenues associated with product sales and license revenues consists of license fees for use of certain technologies; product manufacturing costs including all direct material and direct labor costs; amounts paid to our contract manufacturers; shipping and handling; provisions for product warranty; inventory obsolescence; and overhead costs related to these activities.

Operating Expense

Operating expense consists of selling, general and administrative expenses, as well as expenses related to research and development, depreciation of fixed assets and amortization of intangible assets. These expenses also include compensation for employees in executive and operational functions, including certain non-cash charges related to expenses from option grants; facilities costs; professional fees; salaries, commissions, travel expense and related benefits of personnel engaged in sales, product management and marketing activities; costs of marketing programs and promotional materials; salaries, bonuses and related benefits of personnel engaged in our own research and development beyond the scope and activities of our Technology Development Division; product development activities not provided under contracts with third parties; and overhead costs related to these activities.

Our operating expenses include stock-based compensation charges. We recorded stock-based compensation charges of approximately $0.9 million, including the expense of warrants issued to a third party, for the three months ended June 30, 2010. We also expect to recognize aggregate stock-based compensation expenses of $5.4 million in future periods through 2014 relating to stock options outstanding as of June 30, 2010.

Litigation Reserve

In the first quarter of 2009, we established a litigation reserve of $36.3 million in connection with the Hansen litigation, equal to the original jury verdict against us, pending final resolution of the matter. In January 2010, we settled our litigation with Hansen and issued to Hansen a secured promissory note in the principal amount of $5.0 million as well as 1,247,330 shares of our common stock with a fair value of approximately $4.7 million, based on the closing price of our common stock on January 11, 2010. Therefore, in the fourth quarter of 2009, we adjusted the prior litigation reserve downward to $9.7 million. This adjustment was recorded on our statement of operations as a reduction of operating expenses during the fourth quarter of 2009.

Interest Income/Expense

Interest expense includes interest accrued on our outstanding bank credit facilities, our 6% senior convertible notes issued to Carilion that were outstanding until January 2010 and our promissory note issued to Hansen in January 2010, which we refer to in this report as the Hansen Note, as well as interest incurred with respect to our capital lease obligations. From January 1, 2009 through July 15, 2009, we had borrowed $5.0 million under a term loan with Silicon Valley Bank. On July 15, 2009, we repaid the outstanding balance of our term loan with Silicon Valley Bank and terminated the credit facility. In February 2010, we entered into a new revolving line of credit with Silicon Valley Bank for up to $5.0 million, of which $2.5 million was outstanding as of June 30, 2010. In addition, as of June 30, 2010 we also had a $4.7 million principal balance outstanding on the Hansen Note. During the year ended December 31, 2009, we also had the full $5.0 million principal balance outstanding under the senior convertible notes issued to Carilion. During January 2010, the principal balance and accrued interest under the senior convertible notes was converted in full into shares of our Series A Preferred Stock and no amounts were outstanding under these notes as of June 30, 2010. The interest expense for the six months ended June 30, 2010 primarily includes approximately $190,000 on the Hansen Note and approximately $40,000 on the revolving line of credit with Silicon Valley Bank. The interest expense for the same period of 2009 is primarily attributable to approximately $150,000 on the prior term loan with Silicon Valley Bank and approximately $150,000 on the convertible notes issued to Carilion.

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Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with US GAAP. The preparation of these financial statements requires us to make estimates, assumptions and judgments that affect the amounts reported in our financial statements and the accompanying notes. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or judgments. Our critical accounting policies are described in the Management s Discussion and Analysis section and the notes to our audited consolidated financial statements previously included in our Annual Report on Form 10-K for the period ended December 31, 2009, as filed with the Securities and Exchange Commission on March 26, 2010. There have been no material changes to the descriptions therein.

Results of Operations

Three Months Ended June 30, 2010 Compared to Three Months Ended June 30, 2009

Revenues

Total revenues increased 3.9% to $9.0 million for the three months ended June 30, 2010 from $8.7 million for the three months ended June 30, 2009. Revenues within our Technology Development Division decreased 5.5% from the corresponding period in 2009, while revenues in our Product and License Division increased by 31.3%. Technology development revenues decreased to $6.1 million for the three months ended June 30, 2010 from $6.4 million for the corresponding 2009 period, due primarily to a decline in direct labor hours and other direct costs associated with a reduction or slowing in awards for new long-term development projects during our reorganization in the latter half of 2009. We generated approximately $2.9 million in product and license revenues in the second quarter of 2010 as compared with $2.2 million for the corresponding 2009 period, primarily reflecting increased demand for fiber optic test and measurement equipment during the quarter.

Cost of Revenues

Cost of revenues increased 7.0%, to $5.7 million for the three months ended June 30, 2010 from $5.3 million for the corresponding 2009 period, primarily corresponding to increased revenue in our Product and License Division business segment. The Technology Development Division cost of sales decreased by approximately 1.8%, from $4.3 million to $4.2 million, due primarily to the decline in direct labor hours described above. Product and license cost of sales increased by $0.5 million, or 43.1%, from $1.0 million to $1.5 million, reflecting the growth in our product sales during the second quarter of 2010.

Our resulting gross profit was $3.3 million for each of the quarters ended June 30, 2010 and 2009. The growth in our Product and License segment offset the gross profit impact of lower revenues from our Technology Development segment. Revenues from our Products and License Division business segment typically carry a higher gross margin percentage than revenues from our Technology Development Division business segment.

Operating Expense

Operating expense decreased to $3.8 million for the three months ended June 30, 2010 from $5.6 million for the corresponding quarter in 2009. The improvement in operating expenses is primarily attributable to a reduction in legal expenses related to our filing for bankruptcy in July of 2009 and our litigation with Hansen, which totaled approximately $1.5 million in the second quarter of 2009, but which were insignificant in the second quarter of 2010.

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Other Income (Expense)

Net interest expense for the three months ended June 30, 2010 was approximately $143,000 compared to a net interest expense of approximately $140,000 during the same period in 2009. At June 30, 2009 we had a $5.0 million term loan facility with Silicon Valley Bank, or SVB, in addition to the promissory note of $5.0 million to Carilion. During the quarter ending June 30, 2010 we had a line of credit with SVB with an average outstanding balance of $2.5 million and $4.6 million balance on our promissory note to Hansen.

Six Months Ended June 30, 2010 Compared to Six Months Ended June 30, 2009

Revenues

Total revenues decreased 1.6% to $16.9 million for the six months ended June 30, 2010 from $17.2 million for the six months ended June 30, 2009. Revenues within our Technology Development Division decreased 10.7% from the corresponding period in 2009, while revenues in our Product and License Division increased by 30.2%. Technology development revenues decreased to $11.9 million for the six months ended June 30, 2010 from $13.3 million for the corresponding 2009 period, due primarily to decline in direct labor hours and other direct costs associated with a reduction or slowing in awards for new long-term development projects during our reorganization in the latter half of 2009. We generated approximately $5.0 million in product and license revenues in the six months ended June 30, 2010 as compared with $3.8 million for the corresponding 2009 period, primarily reflecting increased shipments of our OVA and OBR products, which increased by 81% compared to the first six months of 2009.

Cost of Revenues

Cost of revenues decreased 3.2%, to $10.7 million for the six months ended June 30, 2010 from $11.1 million for the corresponding 2009 period, primarily corresponding to the larger share of our consolidated revenue being provided by our Product and License Division and its greater gross profit. The Technology Development Division cost of sales decreased by approximately 12.5%, from $9.2 million to $8.0 million, reflecting the 10.7% decrease in Technology Development Division revenues. Product and license cost of sales increased by 41.1%, from $1.9 million to $2.7 million, reflecting the growth in our product sales and increased costs associated with product development contracts. Additionally, Product and License Division cost of sales includes the costs associated with certain product development activities for which approximately $168,000 was deferred until the achievement of certain milestones and, accordingly, this revenue has been deferred as of June 30, 2010.

Our resulting gross profit was essentially flat at $6.1 million for each period, or 36.4% of revenue for the six months ended June 30, 2010 and 35.3% of revenue, for the six months ended June 30, 2009.

Operating Expense

Operating expense decreased to $7.7 million for the six months ended June 30, 2010 from $48.4 million for the corresponding period in 2009. This decrease is primarily due to the $36.3 million Hansen litigation reserve recorded in the first half of 2009 and the associated impairment of goodwill and other intangible assets totaling $1.3 million in our Products and License Division business segment. Excluding those charges, operating expenses were $10.8 million for the six months ending June 30, 2009. Operating expenses in the first half of 2009 also included approximately $1.6 million of professional fees associated with the Hansen litigation and our preparation for filing for Chapter 11 reorganization on July 17, 2009, which costs did not continue materially into 2010. The remainder of the improvement in operating expenses is primarily attributable to our expense reduction initiatives undertaken after the first quarter of 2009 and carrying into the first half of 2010.

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Other Income (Expense)

Net interest expense for the six months ended June 30, 2010 was approximately $228,000 compared to a net interest expense of approximately $299,000 during the same period in 2009. During the six months ended June 30, 2010, we expensed approximately $42,000 in interest for the SVB line of credit under which borrowings commenced in 2010 and approximately $192,000 for the Hansen note issued in January 2010. During the first six months of 2009, we recognized approximately $150,000 of interest expense on our then outstanding $5.0 million notes to Carilion and approximately $127,000 on our prior term loan with SVB of $5.0 million.

Liquidity and Capital Resources

At June 30, 2010, our total cash and cash equivalents were approximately $6.3 million. We expect the settlement of our litigation with Hansen and our emergence from bankruptcy in January 2010 will improve our cash flows in future periods.

On February 18, 2010, we entered into a line of credit facility with Silicon Valley Bank, or SVB, under which we have a borrowing capacity of up to $5 million at a floating annual interest rate equal to the greater of (a) 6% or (b) SVB s prime rate then in effect plus 2%. The facility matures on February 17, 2011, unless earlier terminated, and any amounts due under the facility are secured by substantially all of our assets, including our intellectual property, personal property and bank accounts. Amounts due to Hansen under our January 2010 promissory note to Hansen are subordinated to amounts due to SVB under the line of credit, subject to certain terms and conditions. On March 30, 2010, we borrowed $2.5 million under the line of credit with SVB, and $2.5 million remains available under the facility as of the date of this report. The line of credit includes a fee of one-half of one percent (0.50%) per annum based on the average unused portion of the facility from time to time.

The SVB facility requires us to observe a number of financial and operational covenants, including maintenance of a specified liquidity ratio, achievement of certain adjusted EBITDA targets (as defined in the agreement), protection and registration of intellectual property rights, and certain customary negative covenants. We may use the proceeds of borrowings for any variety of purposes, including working capital and general corporate purposes. At June 30, 2010 we were in compliance with the required covenants.

The line of credit with SVB contains customary events of default, including nonpayment of principal, interest or other amounts, violation of covenants, material adverse change, an event of default under any subordinated debt documents, incorrectness of representations and warranties in any material respect, bankruptcy, judgments in excess of a threshold amount, and violations of other agreements in excess of a threshold. If any event of default occurs, SVB may declare due immediately all borrowings and foreclose on the collateral. Furthermore, an event of default under the line of credit would result in an increase in the interest rate on any amounts outstanding.

We believe that our current cash balance, in addition to the funds available to us under the line of credit with SVB, provide adequate liquidity for us to meet our working capital needs during 2010.

Discussion of Cash Flows

Recent Activity

We used approximately $1.7 million net cash in our operating activities during the six months ended June 30, 2010, as compared to $2.5 million used during the six months ended June 30, 2009. The difference was primarily due to our lower net loss of $1.8 million for the six months ended June 30, 2010, as compared to $5.7 million during the six months ended June 30, 2009, excluding our litigation reserve and related impairment charge for certain of our intangible assets. This improvement in cash flows was offset by a net cash outflow of $2.3 million from changes in working capital during the six months ended June 30, 2010, as compared to a net cash outflow of $0.2 million from changes in working capital during the six months ended June 30, 2009. During the six months ended June 30, 2010, we paid approximately $1.9 million for prepetition debts and legal fees related to our Chapter 11 reorganization that were included in our accounts payable and accrued expenses as of December 31, 2009. We also incurred $0.6 million in non-cash deferred tax expense during the six months ended June 30, 2009 as compared to no such expense during 2010.

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Our cash flows from investing activities, consisting of purchases of equipment and costs associated with certain intangible assets, were not material during the six months ended June 30, 2010 or 2009. Net cash provided to us by financing activities during the six months ended June 30, 2010 was $2.8 million, which was the result of borrowing $2.5 million under our line of credit with SVB, and $0.6 million received upon the exercise of warrants and employee stock options, offset by paying down $0.3 million on the Hansen Note . During the six months ended June 30, 2009, our only material financial activities were net repayments of $0.7 million under our term loan with SVB in place at that time.

Summary of Contractual Obligations

We lease our facilities in Blacksburg, Charlottesville, Danville and Roanoke, Virginia under operating leases that expire on various dates through December 2017 or under a month-to-month arrangement. Upon expiration of the leases, we may exercise certain renewal options as specified in the leases.

We also lease certain computer equipment and software under capital lease agreements that expire through September 2013. The assets subject to these obligations are included in property and equipment on our consolidated balance sheet.

In September 2008, our Luna Technologies division executed a non-cancelable $2.0 million purchase order for multiple shipments of tunable lasers to be delivered over an 18-month period beginning in September 2008. As of June 30, 2010, approximately $0.3 million of this commitment remained. The delivery of the remaining lasers has been extended through September 2010.

The Hansen Note is payable in quarterly installments through April 2014. As of June 30, 2010, $4.6 million of principal was outstanding under the Hansen Note.

We have licensed certain third-party technologies from vendors for which we owe minimum royalties aggregating $2.0 million payable over the remaining patent terms of the underlying technology.

Off-Balance Sheet Arrangements

We have no material off-balance sheet arrangements as defined in Regulation S-K Item 303(a) (4) (ii).

ITEM 3. ***QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK***

Market risk represents the risk of loss that may impact our financial position due to adverse changes in financial market prices and rates. We do not hold or issue financial instruments for trading purposes or have any derivative financial instruments. Our exposure to market risk is limited to interest rate fluctuations due to changes in the general level of United States interest rates.

Interest Rate Risk

We do not use derivative financial instruments as a hedge against interest rate fluctuations, and, as a result, interest income earned on our cash and cash equivalents and short-term investments is subject to changes in interest rates. However, we believe that the impact of these fluctuations does not have a material effect on our financial position due to the immediately available liquidity or short-term nature of these financial instruments. As of June 30, 2010 we had $6.3 million deposited in cash and cash equivalents.

We are exposed to interest rate fluctuations as a result of our $5.0 million revolving line of credit with SVB, which has a variable rate. We do not currently use derivative instruments to alter the interest rate characteristics of any of our debt. As of June 30, 2010, the revolving debt facility interest rate was 6%. For the principal amount of $2.5 million outstanding under the line of credit as of June 30, 2010, a change in the interest rate by one percentage point for one year would result in a change in our annual interest expense of approximately $25,000.

Although we believe that these measures are indicative of our sensitivity to interest rate changes, they do not adjust for potential changes in our credit quality, composition of our balance sheet and other business developments that could affect our interest rate exposure. Accordingly, no assurances can be given that actual results would not differ materially from the potential outcome simulated by this estimate.

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Foreign Currency Exchange Rate Risk

As of June 30, 2010, all payments made under our research contracts have been denominated in United States dollars. Our product sales to foreign customers are also denominated in U.S. dollars, and we do not receive payments in foreign currency. As such, we are not directly exposed to currency gains or losses resulting from fluctuations in foreign exchange rates.

ITEM 4. ***CONTROLS AND PROCEDURES***

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures, as defined in Rules 13-15(e) and led-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act), which are controls and other procedures that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company s management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure.

Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. In addition, the design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with policies or procedures may deteriorate. Because of the inherent limitations in a control system, misstatements due to error or fraud may occur and not be detected.

Under the supervision and with the participation of our management, including our interim President and Chief Operating Officer and our interim Chief Financial Officer, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report. Based on this evaluation, our interim President and Chief Operating Officer and interim Chief Financial Officer have concluded that, as of June 30, 2010, our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Control over Financial Reporting

No change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the quarter ended June 30, 2010 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. ***LEGAL PROCEEDINGS***

None.

ITEM 1A. ***RISK FACTORS***

You should carefully consider the risks described below before deciding whether to invest in our common stock. The risks described below are not the only ones we face. Additional risks not presently known to us or that we currently believe are immaterial may also impair our business operations and financial results. If any of the following risks actually occurs, our business, financial condition or results of operations could be adversely affected. In such case, the trading price of our common stock could decline and you could lose all or part of your investment. Our filings with the Securities and Exchange Commission also contain forward-looking statements that involve risks or uncertainties. Our actual results could differ materially from those anticipated or contemplated by these forward-looking statements as a result of a number of factors, including the risks we face described below, as well as other variables that could affect our operating results. Past financial performance should *not be considered to be a reliable indicator of future performance, and investors should not use historical trends to anticipate results or trends in future periods.*

RISKS RELATING TO OUR BUSINESS GENERALLY

Our recently announced senior management changes and our search for a new chief executive officer could cause disruption in our business and may not be successful.

On August 10, 2010, as part of our previously announced transition plan for the company s leadership, Dr. Kent Murphy, our founder, resigned from his position as our chief executive officer to assume the role of senior strategic and technology advisor to the company in a consulting capacity. Dr. Murphy remains a member of the board of directors, serving in the new role as the vice chairman. We have formally initiated a search for a new chief executive officer to replace Dr. Murphy. At the time of Dr. Murphy s resignation, we also announced a number of other senior management changes. Jonathan Cool, who had been serving as our acting president and chief operating officer since May 2010, returned to his position on the board and as chairman of the board s strategy committee, where he can focus on strategic direction of the company. Dale Messick, our former chief financial officer, assumed the roles of interim president and interim chief operating officer, and Scott Graeff, our chief commercialization officer and treasurer, assumed the additional role of interim chief financial officer. We currently expect that Messrs. Messick and Graeff will serve in their newly designated interim capacities until we hire a new chief executive officer, at which time Mr. Messick will return to being chief financial officer.

Implementation of these senior management transitions has just recently begun, and there can be no guarantee that any of these transitions will be successful. During this period of transition, there may be operational inefficiencies as Mr. Messick, as interim president and interim chief operating officer, assumes responsibility for our corporate operations, and there can be no guarantee that the transition of operational responsibilities from Mr. Cool to Mr. Messick will be successful. Similarly, as Mr. Graeff assumes responsibility for the financial and accounting functions, there can be no guarantee that the transition of these responsibilities will be successful.

Moreover, there can be no guarantee that the our efforts to identify and recruit a permanent chief executive officer will be successful, or that a transition to a new chief executive officer will be smooth or successful. Leadership transitions can be inherently difficult to manage and may cause uncertainty or a disruption to our business or may increase the likelihood of turnover in key officers and employees.

Competition for qualified personnel, particularly those with the significant skills and expertise of many of Luna s officers and employees, remains intense. Any loss of key personnel could have a material adverse effect on our ability to meet key operational objectives, such as timely and effective project milestones and product introductions, which could adversely affect our business, results of operations and financial condition. Also, the uncertainty inherent in our senior management transitions could lead to concerns from current and potential customers, suppliers and other third parties with whom we do business, any of which could have a material adverse impact on our operations. Finally, we have certain contractual obligations to adequately staff certain development projects, and a loss of key personnel could lead to our inability to meet these obligations, which in turn could expose us to claims for significant damages under any such agreement.

Our business could suffer as a result of our filing for reorganization under Chapter 11 of the U.S. Bankruptcy Code in 2009.

As described elsewhere in this report, in July 2009, we filed a voluntary petition for relief in order to reorganize under Chapter 11 of the United States Bankruptcy Code, including a proposed plan of reorganization, under Chapter 11 of the U.S. Bankruptcy Code. In January 2010, the bankruptcy court approved our reorganization plan and we emerged from bankruptcy on that date. Even though our plan of reorganization has been implemented, operating results may be adversely affected by the possible reluctance of prospective customers, suppliers and lenders to do business with a company that recently emerged from bankruptcy proceedings. For example, the rate at which we received new research contract awards declined significantly during the period of our reorganization in 2009 and early 2010, which has resulted in a decline in our technology development revenues and may continue to do so in the future. In addition, our emergence from bankruptcy may result in reputational risks that make it difficult to attract and retain employees and work with customers and suppliers.

We have recently experienced a decline in government research contract awards, upon which we have historically relied for a significant portion of our revenues. If we continue to experience a decline in our receipt of these awards, or if there is any decline in government funding of existing or future government research contracts, including Small Business Innovation Research (SBIR) contracts, it could adversely affect our revenues, our cash flows and our ability to fund our growth.

Technology development revenue, which consists primarily of government-funded research, accounted for approximately 70% of our consolidated total revenues for the six months ended June 30, 2010 and 78% for the same period in 2009. As a result, we are vulnerable to adverse changes in our revenues and cash flows if a significant number of our research contracts and subcontracts were to be simultaneously delayed or canceled for budgetary, performance or other reasons. The U.S. government, for example, may cancel these contracts at any time without cause and without penalty or may change its requirements, programs or contract budget, any of which could reduce our revenues and cash flows from U.S. government research contracts. Our revenues and cash flows from U.S. government research contracts and subcontracts could also be reduced by declines or other changes in U.S. defense, homeland security and other federal agency budgets. In addition, we compete as a small business for some of these contracts, and in order to maintain our eligibility to compete as a small business, we, together with any affiliates, must continue to meet size and revenue limitations established by the U.S. government.

Our contract research customer base includes government agencies, corporations and academic institutions. Our customers are not obligated to extend their agreements with us and may elect not to do so. Also, our customers priorities regarding funding for certain projects may change, and funding resources may no longer be available at previous levels.

In addition, we may not be successful in securing future contracts. For example, the rate at which we received new research contract awards declined significantly during the period of our reorganization in 2009 and early 2010, which has resulted in a decline in our technology development revenues and a decline in our backlog. If we are unable to increase the rate at which we receive new research contract awards, we may continue to experience year over year declines in revenue for this portion of our business, which could have a significant adverse impact on our results of operations, cash flows and financial condition.

In addition to contract cancellations and changes in agency budgets, our future financial results may be adversely affected by curtailment of the U.S. government s use of contract research providers, including curtailment due to government budget reductions and related fiscal matters. These or other factors could cause U.S. defense and other federal agencies to conduct research internally rather than through commercial research organizations, to reduce their overall contract research requirements or to exercise their rights to terminate contracts. Alternatively, the U.S. government may discontinue the SBIR program or its funding altogether. Any of these actions could limit our ability to obtain new contract awards and adversely affect our revenues and cash flows and our ability to fund our growth.

We rely and will continue to rely on contracts and grants awarded under the SBIR program for a significant portion of our revenues. A finding by the U.S. Small Business Administration, or SBA, that we no longer qualify to receive SBIR funding could adversely affect our business.

We compete as a small business for some of our government contracts. As described above our revenues under the SBIR program account for a significant portion of our consolidated total revenues, and contract research, including SBIR contracts, will remain a significant portion of our consolidated total revenues for the foreseeable future.

We may not continue to qualify to participate in the SBIR program or to receive new SBIR awards from federal agencies. In order to qualify for SBIR contracts and grants, we must meet certain size and revenue eligibility criteria. These eligibility criteria are applied as of the time of the award of a contract or grant. We believe that we are currently in compliance with the SBIR eligibility criteria, but we cannot assure you that the U.S. Small Business Administration, or SBA, the federal agency that administers the SBIR program, will interpret its regulations in our favor. As we grow our business, it is foreseeable that we will eventually exceed the SBIR eligibility limitations, in which case we may be required to seek alternative sources of revenues or capital.

In order to be eligible for SBIR contracts and grants, the number of our employees, including those of any entities that are considered to be affiliated with us, cannot exceed 500. In determining whether we are affiliated with any other entity, the SBA analyzes whether another entity controls or has the power to control us. As of June 30, 2010, we had approximately 198 employees. Our largest institutional stockholder, Carilion, beneficially owns approximately 31% of our common stock, including shares issuable upon conversion of non-voting preferred stock, as well as shares of common stock underlying warrants. If the SBA were to make a determination that we are affiliated with Carilion, we could exceed the size limitations, as Carilion has over 500 employees. In that case, we could lose eligibility for new SBA contracts, public contracts, grants and other awards that are set aside for small businesses, including SBIR grants.

In order to be eligible for SBIR contracts and grants, we must also be 51% owned and controlled by individuals who are U.S. citizens or permanent resident aliens. In the event our institutional ownership significantly increases, either because of increased buying by institutions or selling by individuals, we could lose eligibility for new SBIR contracts, public contracts, grants and other awards that are set aside for small businesses, including SBIR grants.

The results of our operations could be adversely affected by economic and political conditions and the effects of these conditions on our customers businesses and level of business activity.

Global economic and political conditions affect our customers businesses and the markets they serve. A severe and/or prolonged economic downturn or a negative or uncertain political climate could adversely affect our customers financial condition and the timing or levels of business activity of our customers and the industries we serve. This may reduce the demand for our products or depress pricing for our products and have a material adverse effect on our results of operations. Changes in global economic conditions could also shift demand to products or services for which we do not have competitive advantages, and this could negatively affect the amount of business that we are able to obtain. In addition, if we are unable to successfully anticipate changing economic and political conditions, we may be unable to effectively plan for and respond to those changes, and our business could be negatively affected.

There was a rapid softening of the economy and tightening of the financial markets in the second half of 2008 that continued throughout 2009. This slowing of the economy has reduced the financial capacity of our customers and possibly our potential customers, thereby slowing spending on the products and services we provide. The outlook for the economy for the remainder of 2010 remains uncertain, and until there is a sustained economic recovery our revenues and results of operations could be negatively impacted.

Our failure to attract, train and retain skilled employees or members of our senior management would adversely affect our business and operating results.

The availability of highly trained and skilled technical and professional personnel is critical to our future growth and profitability. Competition for scientists, engineers, technicians and professional personnel is intense and competitors aggressively recruit key employees. In the past, we have experienced difficulties in recruiting and hiring these personnel as a result of the tight labor market in certain fields. Any such difficulty, combined with our growth strategy and future needs for additional experienced personnel, particularly in highly specialized areas such as nanomaterial manufacturing and fiber optic sensing technologies, may make it more difficult to meet all of our needs for these employees in a timely manner. Although we intend to continue to devote significant resources to recruit, train and retain qualified employees, we may not be able to attract and retain these employees, especially in technical fields where the supply of experienced qualified candidates is limited. Any failure to do so would have an adverse effect on our business.

In addition, our future success depends in a large part upon the continued service of key members of our senior management team. We do not maintain any key-person life insurance policies on our officers. The loss of any members of our management team or other key personnel could seriously harm our business.

We have a history of losses, and because our strategy for expansion may be costly to implement, we may experience continuing losses and we may never achieve or maintain profitability or positive cash flow.

We incurred consolidated net losses attributable to common stockholders of approximately $2.0 million and $43.3 million for the six months ended June 30, 2010 and 2009, respectively. As of June 30, 2010, our accumulated deficit totaled $46.1 million. While the magnitude of our net loss during the first six months of 2009 exceeded our historical losses due to expenses associated with litigation, which was resolved in December 2009, we expect to continue to incur significant expenses as we expand our operations, including increased expenses for research and development, sales and marketing, manufacturing, finance and accounting personnel and expenses associated with being a public company. We may also grow our business in part through acquisitions of additional companies and complementary technologies which could cause us to incur greater than anticipated transaction expenses, amortization or write-offs of intangible assets and other acquisition-related expenses. As a result, we expect that we may likely continue to incur losses for the foreseeable future, and these losses could be substantial.

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Because of the numerous risks and uncertainties associated with our business, we are unable to predict when or if we will be able to achieve profitability again. If our revenues do not increase, or if our expenses increase at a greater rate than our revenues, we will continue to experience losses. Even if we do achieve profitability, we may not be able to sustain or increase our profitability on a quarterly or annual basis.

We might require additional capital to support and expand our business, and this capital might not be available on favorable terms, if at all.

We intend to continue to make investments to support our business growth, including the development of new products and the enhancement of our existing products, obtaining important regulatory approvals, enhancing our operating infrastructure, completing our development activities and building our commercial scale manufacturing facilities. To the extent that we are unable to become or remain profitable and to finance our activities from our continuing operations, we may require additional funds to support these initiatives and to grow our business.

If we are successful in raising additional funds through issuances of equity or convertible debt securities, our existing stockholders could suffer significant dilution, including as the result of warrants in connection with the financing, and any new equity securities we issue could have rights, preferences and privileges superior to those of holders of our existing common stock. Furthermore, such financings may jeopardize our ability to apply for SBIR grants or qualify for SBIR contracts or grants, and our dependence on SBIR grants may restrict our ability to raise additional outside capital. If we raise additional funds through debt financings, these financings may involve significant cash payment obligations and covenants that restrict our ability to operate our business and make distributions to our stockholders.

As part of the settlement of our litigation with Hansen Medical, Inc., or Hansen, we issued to Hansen a warrant for additional shares of our common stock in an amount such that Hansen may maintain ownership of 9.9% of our total outstanding common stock for a period of three years at a price of one cent per common share. In the event that we raise capital through the issuance of common stock, stockholders will experience further dilution to the extent that Hansen exercises this warrant, which may make it more difficult to raise equity capital or adversely impact the price at which we are able to raise equity capital.

If we are unable to obtain adequate financing or financing terms satisfactory to us, when we require it, our ability to continue to support our business growth and to respond to business challenges could be significantly limited.

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Our settlement agreement and related agreements with Hansen could result in our making substantial future cash payments.

As part of the settlement of our litigation with Hansen, we issued a promissory note payable to Hansen in the principal amount of $5.0 million. The note bears interest at a rate of 8.5% and is payable in quarterly installments commencing April 2010 and continuing through January 2014. Additionally, we entered into a Development and Supply Agreement with Hansen under which we will develop certain fiber optic shape sensing technologies or products for Hansen. Hansen is required to pay us for the development services provided. In the event that the amounts owed by Hansen under the Development and Supply Agreement exceed the quarterly installment payment under Hansen s promissory note, then the excess amount will not be payable in cash by Hansen but will reduce the outstanding principal balance on the note to Hansen. Additionally, Hansen may terminate the Development and Supply Agreement at any time without further obligation, while we would remain liable for the payments due under the note, which would have a material adverse effect on our cash flows. The Development and Supply Agreement also provides for substantial liquidated damages in the event that we are deemed not to have complied in a commercially reasonable good faith manner with respect to our technology development obligations under the agreement. We cannot assure you that there will be no disagreements with Hansen as to whether we are complying with our obligations under the Development and Supply Agreement. In the event that we are required to make substantial payments to Hansen under the Development and Supply Agreement, it would adversely affect our results of operations and cash flows.

If we cannot successfully transition our revenue mix from contract research revenues to product sales and license revenues, we may not be able to fully execute our business model or grow our business.

Our business model and future growth depend on our ability to transition to a revenues mix that contains significantly larger product sales and license revenues components. Product sales and license revenues potentially offer greater scalability than services-based contract research revenues. Our current plan is to increase our portfolio of commercial products and, accordingly, we expect that our future product sales and license revenues will represent a larger percentage of total revenues. However, if we are unable to develop and grow our product sales and license revenues to augment our contract research revenues, our ability to execute our business model or grow our business could suffer.

If we are unable to manage growth effectively, our revenue and net loss could be adversely affected.

While historically we have developed and commercialized only a few products at a time, we plan to grow our revenues by developing and commercializing multiple products concurrently across many industries, technologies and markets. Our ability to expand our business by developing and commercializing multiple products simultaneously requires that we manage a diverse range of projects, and expand our personnel resources. Our inability to do any of these could prevent us from successfully implementing our growth strategy, and our revenues and profits could be adversely affected.

To advance the development of multiple promising potential products concurrently, we need to manage effectively the logistics of maintaining the requisite corporate, operational, administrative and financing functions for each of these product opportunities. Potentially expanding our operations into new geographic areas and relying on multiple facilities to develop and manufacture different products concurrently pose additional challenges. We have little experience in managing these functions simultaneously for multiple projects in development or in building new infrastructure and integrating the operations of various facilities. If we cannot manage this process successfully, we may be subject to operating difficulties, additional expenditures and limited revenue growth.

We may need to expand our personnel resources to grow our business effectively. We believe that sustained growth at a higher rate will place a strain on our management, as well as on our other human resources. To manage this growth, we must continue to attract and retain qualified management, professional, scientific and technical and operating personnel. If we are unable to recruit a sufficient number of qualified personnel, we may be unable to staff and manage projects adequately; this may slow the rate of growth of our contract research revenue or our product development efforts.

We may not be successful in identifying market needs for new technologies and developing new products to meet those needs.

The success of our business model depends on our ability to identify correctly market needs for new technologies. We intend to identify new market needs, but we may not always have success in doing so, in part, because our contract research largely centers on identification and development of unproven technologies, often for new or emerging markets. Furthermore, we must identify the most promising technologies from a sizable pool of projects. If our commercialization strategy process fails to identify projects with commercial potential or if management does not ensure that such projects advance to the commercialization stage, we may not successfully commercialize new products and grow our revenues.

Our growth strategy requires that we not only identify new technologies that meet market needs, but that we also develop successful commercial products that address those needs. We face several challenges in developing successful new products. Many of our existing products and those currently under development, including our Trimetasphere® carbon nanomaterials, are technologically innovative and require significant and lengthy product development efforts. These efforts include planning, designing, developing and testing at the technological, product and manufacturing-process levels. These activities require us to make significant investments. Although there are many potential applications for our technologies, our resource constraints require us to focus on specific products and to forgo other opportunities. We expect that one or more of the potential products we choose to develop will not be technologically feasible or will not achieve commercial acceptance, and we cannot predict which, if any, of our products we will successfully develop or commercialize. The technologies we research and develop are new and steadily changing and advancing. The products that are derived from these technologies may not be applicable or compatible with the state of technology or demands in existing markets. Our existing products and technologies may become uncompetitive or obsolete if our competitors adapt more quickly than we do to new technologies and changes in customers requirements. Furthermore, we may not be able to identify if and when new markets will open for our products given that future applications of any given product may not be readily determinable, and we cannot reasonably estimate the size of any markets that may develop. If we are not able to successfully develop new products, we may be unable to increase our product revenues.

We depend on third-party vendors for specialized components in our manufacturing operations, making us vulnerable to supply shortages and price fluctuations that could harm our business.

We primarily rely on third-party vendors for the manufacture of the specialized components used in our products. The highly specialized nature of our supply requirements poses risks that we may not be able to locate additional sources of the specialized components required in our business. For example, there are few manufacturers who produce the special lasers used in our optical test equipment. Our reliance on these vendors subjects us to a number of risks that could negatively affect our ability to manufacture our products and harm our business, including interruption of supply. Although we are now manufacturing tunable lasers in low-rate initial production, we expect our overall reliance on third-party vendors to continue.

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Any significant delay or interruption in the supply of components, or our inability to obtain substitute components or materials from alternate sources at acceptable prices in a timely manner, could impair our ability to meet the demand of our customers and harm our business.

If we are unable to secure third-party reimbursement for our medical products, our revenue and net loss could be adversely affected.

In both the United States and foreign markets where we intend to sell our medical products, third-party payers such as the government and health insurance companies are generally responsible for hospital and doctor reimbursement for medical products and services. Governments and insurance companies carefully review and may challenge the prices charged for medical products and services. Reimbursement rates from private insurance companies vary depending on the procedure performed, the third party involved, the insurance plan involved, and other factors. In the United States, reimbursement for medical procedures under the Medicare and Medicaid programs is administered by Centers for Medicare & Medicaid Services. Medicare reimburses both hospitals and physicians a pre-determined, fixed amount based on the procedure performed. This fixed amount is paid regardless of the actual costs incurred by the hospital or physician in furnishing the care and is often unrelated to the specific devices used in that procedure. Thus, any reimbursements that hospitals or physicians obtain for using our medical products will generally have to cover any additional costs that hospitals incur in purchasing such products.

Hospitals and medical centers to which we intend to sell our medical products typically bill the services performed with our products to various third-party payers, such as Medicare, Medicaid and other government programs and private insurance plans. If hospitals do not obtain sufficient reimbursement from third-party payers for procedures performed with our products, or if governmental and private payors policies do not permit reimbursement for services performed using our products, demand for our product may be negatively impacted.

In countries outside the United States, reimbursement is obtained from various sources, including governmental authorities, private health insurance plans and labor unions. To sell our product in foreign markets, we may need to seek international reimbursement approvals. We cannot be certain whether such required approvals will be obtained in a timely manner or at all.

Furthermore, any regulatory or legislative developments in domestic or foreign markets that eliminate or reduce reimbursement rates for procedures performed with our products could harm our ability to sell our products or cause downward pressure on the prices of our products, either of which would have a negative effect on our product revenue and net loss.

We face and will face substantial competition in several different markets that may adversely affect our results of operations.

We face or will face substantial competition from a variety of companies in several different markets. Our competitors in contract research include, but are not limited to, companies such as General Dynamics Corporation, Lockheed Martin Corporation, SAIC, Inc. and SRA International, Inc. In the instrumentation and test and measurement products market, our competitors include, but are not limited to, large companies such as Agilent Technologies, Inc., Analog Devices, Inc., Freescale Semiconductor, Inc., JDS Uniphase Corp., Robert Bosch GmbH and Silicon Sensing, as well as emerging companies. In addition, in the MRI contrast agent market our competitors include Amersham Plc, Berlex Laboratories, Inc., Bracco Diagnostics, Inc., and Mallinckrodt Inc.

The products that we have developed or are currently developing will compete with other technologically innovative products as well as products incorporating conventional materials and technologies. We expect that our products will face competition in a wide range of industries, including telecommunications, industrial instrumentation, healthcare, military and security applications.

Many of our competitors have longer operating histories, greater name recognition, larger customer bases and significantly greater financial, sales and marketing, manufacturing, distribution, technical and other resources than we do. These competitors may be able to adapt more quickly to new or emerging technologies and changes in customer requirements. In addition, current and potential competitors have established or may establish financial or strategic relationships among themselves or with existing or potential customers or other third parties. Accordingly, new competitors or alliances among competitors could emerge and rapidly acquire significant market share. We cannot assure you that we will be able to compete successfully against current or new competitors, in which case our net revenues may fail to increase or may decline.

We have limited experience manufacturing our products in commercial quantities in a cost-effective manner, which could adversely impact our business.

In the past, we produced most of our products on a custom order basis rather than pursuant to large contracts that require production on a large volume basis. Accordingly, other than the commercial manufacture of products by our Luna Technologies division, we have no experience manufacturing products in large volume. Because our experience in large scale manufacturing is limited, we may encounter unforeseen difficulties in our efforts to manufacture other products or materials in commercial quantities or have to rely on third party contractors over which we may not have direct control to manufacture our products. For example, we may need to develop or in-license Trimetasphere® nanomaterial purification and isolation technology, which would result in manufacturing delays or shortfalls. We may also encounter difficulties and delays in manufacturing our products for any of the following reasons:

- we may need to expand our manufacturing operations, and our production processes may have to change to accommodate this growth;

- to increase our manufacturing output significantly, we will have to attract and retain qualified employees, who are in short supply, for the assembly and testing operations;

- we might have to sub-contract to outside manufacturers which might limit our control of costs and processes; and

- our manufacturing operations may have to comply with government specifications.

If we are unable to keep up with demand for our products, our revenues could be impaired, market acceptance for our products could be adversely affected and our customers might instead purchase our competitors products. Moreover, failure to develop and maintain a U.S. market for goods developed with U.S. government-licensed technology may result in the cancellation of the relevant U.S. government licenses. Our inability to manufacture our products successfully would have a material adverse effect on our revenues.

Even if we are able to manufacture our products on a commercial scale, the cost of manufacturing our products may be higher than we expect. If the costs associated with manufacturing are not significantly less than the prices at which we can sell our products, we may not be able to operate at a profit.

Our nanotechnology-enabled products are new and may be, or may be perceived as being, harmful to human health or the environment.

While we believe that none of our current products contain chemicals known by us to be hazardous or subject to environmental regulation, it is possible our current or future products, particularly carbon-based nanomaterials, may become subject to environmental or other regulation. We intend to develop and sell carbon-based nanomaterials as well as nanotechnology-enabled products, which are products that include nanomaterials as a component to enhance those products performance. Nanomaterials and nanotechnology-enabled products have a limited historical safety record. Because of their size or shape or because they may contain harmful elements, such as gadolinium and other rare-earth metals, our products could pose a safety risk to human health or the environment. These characteristics may also cause countries to adopt regulations in the future prohibiting or limiting the manufacture, distribution or use of nanomaterials or nanotechnology-enabled products. Such regulations may inhibit our ability to sell some products containing those materials and thereby harm our business or impair our ability to develop commercially viable products.

The subject of nanotechnology has received negative publicity and has aroused public debate. Government authorities could, for social or other purposes, prohibit or regulate the use of nanotechnology. Ethical and other concerns about nanotechnology could adversely affect acceptance of our potential products or lead to government regulation of nanotechnology-enabled products.

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We face risks associated with our international business.

We currently conduct business internationally and we might considerably expand our international activities in the future. Our international business operations are subject to a variety of risks associated with conducting business internationally, including:

- having to comply with U.S. export control regulations and policies that restrict our ability to communicate with non-U.S. employees and supply foreign affiliates and customers;
- changes in or interpretations of foreign regulations that may adversely affect our ability to sell our products, perform services or repatriate profits to the United States;
- the imposition of tariffs;
- hyperinflation or economic or political instability in foreign countries;
- imposition of limitations on or increase of withholding and other taxes on remittances and other payments by foreign subsidiaries or joint ventures;
- conducting business in places where business practices and customs are unfamiliar and unknown;
- the imposition of restrictive trade policies;
- the imposition of inconsistent laws or regulations;
- the imposition or increase of investment and other restrictions or requirements by foreign governments;
- uncertainties relating to foreign laws and legal proceedings;
- having to comply with a variety of U.S. laws, including the Foreign Corrupt Practices Act; and
- having to comply with licensing requirements.

We do not know the impact that these regulatory, geopolitical and other factors may have on our international business in the future.

RISKS RELATING TO OUR REGULATORY ENVIRONMENT

As a provider of contract research to the U.S. government, we are subject to federal rules, regulations, audits and investigations, the violation or failure of which could adversely affect our business.

We must comply with and are affected by laws and regulations relating to the award, administration and performance of U.S. government contracts. Government contract laws and regulations affect how we do business with our government customers and, in some instances, impose added costs on our business. A violation of specific laws and regulations could result in the imposition of fines and penalties or the termination of our contracts or debarment from bidding on contracts. In some instances, these laws and regulations impose terms or rights that are more favorable to the government than those typically available to commercial parties in negotiated transactions. For example, the U.S. government may terminate any of our government contracts and, in general, subcontracts, at their convenience, as well as for default based on performance.

In addition, U.S. government agencies, including the Defense Contract Audit Agency and the Department of Labor, routinely audit and investigate government contractors. These agencies review a contractor s performance under its contracts, cost structure and compliance with applicable laws, regulations and standards. The U.S. government also may review the adequacy of, and a contractor s compliance with, its internal control systems and policies, including the contractor s purchasing, property, estimating, compensation and management information systems. Any costs found to be improperly allocated to a specific contract will not be reimbursed, while such costs already reimbursed must be refunded. If an audit uncovers improper or illegal activities, we may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeiture of profits, suspension of payments, fines and suspension or prohibition from doing business with the U.S. government. In addition, our reputation could suffer serious harm if allegations of impropriety were made against us.

In addition to the risk of government audits and investigations, U.S. government contracts and grants impose requirements on contractors and grantees relating to ethics and business practices, which carry civil and criminal penalties including monetary fines, assessments, loss of the ability to do business with the U.S. government and certain other criminal penalties.

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We may also be prohibited from commercially selling certain products that we develop under our Technology Development division or related products based on the same core technologies if the U.S. government determines that the commercial availability of those products could pose a risk to national security. For example, certain of our wireless technologies have been classified as secret by the U.S. government and as a result we cannot sell them commercially. Any of these determinations would limit our ability to generate product sales and license revenues.

Our operations are subject to domestic and foreign laws, regulations and restrictions, and noncompliance with these laws, regulations and restrictions could expose us to fines, penalties, suspension or debarment, which could have a material adverse effect on our profitability and overall financial position.

Our international sales subject us to numerous U.S. and foreign laws and regulations, including, without limitation, regulations relating to imports, exports (including the Export Administration Regulations and the International Traffic in Arms Regulations), technology transfer restrictions, anti-boycott provisions, economic sanctions and the Foreign Corrupt Practices Act. Failure by us or our sales representatives or consultants to comply with these laws and regulations could result in administrative, civil, or criminal liabilities and could result in suspension of our export privileges, which could have a material adverse effect on our business. Changes in regulation or political environment may affect our ability to conduct business in foreign markets including investment, procurement, and repatriation of earnings.

Our health care and medical products are subject to a lengthy and uncertain domestic regulatory approval process. If we do not obtain and maintain the necessary domestic regulatory approvals or clearances, we will not be able to market and sell our products for clinical use in the United States.

Certain of our current and potential products will require regulatory clearances or approvals prior to commercialization. In particular, our Trimetasphere® nanomaterial-based MRI contrast agent will be considered a drug under the Federal Food, Drug and Cosmetic Act, or FDC Act, and our EDAC® ultrasound diagnostic devices for measuring certain medical conditions will be considered medical devices under the FDC Act. Drugs and some medical devices are subject to rigorous preclinical testing and other approval requirements by the U.S. Food and Drug Administration, or FDA, pursuant to the FDC Act, and regulations under the FDC Act, as well as by similar health authorities in foreign countries.

Various federal statutes and regulations also govern or influence the testing, manufacturing, safety, labeling, packaging, advertising, storage, registration, listing and recordkeeping related to marketing of pharmaceuticals. The process of obtaining these clearances or approvals and the subsequent compliance with appropriate federal statutes and regulations require the expenditure of substantial resources, which we may not be able to obtain on favorable terms, if at all. We cannot be certain that any required FDA or other regulatory approval will be granted or, if granted, will not be withdrawn. Our failure to obtain the necessary regulatory approvals, or our failure to obtain them in a timely manner, will prevent or delay our commercialization of new products and our business or our stock price could be adversely affected.

In general, the FDA regulates the research, testing, manufacturing, safety, labeling, storage, record keeping, promotion, distribution and production of medical devices in the United States to ensure that medical products distributed domestically are safe and effective for their intended uses. In order for us to market medical devices for clinical use in the United States, we generally must first obtain clearance from the FDA pursuant to Section 510(k) of the FDC Act, which has occurred in the case of the EDAC® product. Clearance under Section 510(k) requires demonstration that a new device is substantially equivalent to another device with 510(k) clearance or is eligible for grandfather status. If we significantly modify our products after they receive FDA clearance, the FDA may require us to submit a separate 510(k) or premarket approval application, or PMA, for the modified product before we are permitted to market the products in the United States. In addition, if we develop products in the future that are not considered to be substantially equivalent to a device with 510(k) clearance or are eligible for grandfather status, we will be required to obtain FDA approval by submitting a PMA.

The FDA may not act favorably or quickly in its review of our 510(k) or PMA submissions, or we may encounter significant difficulties and costs in our efforts to obtain FDA clearance or approval, all of which could delay or preclude sale of new products for clinical use in the United States. Furthermore, the FDA may request additional data or require us to conduct further testing, or compile more data, including clinical data and clinical

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studies, in support of a 510(k) submission. The FDA may also, instead of accepting a 510(k) submission, require us to submit a PMA, which is typically a much more complex and burdensome application than a 510(k). To support a PMA, the FDA would likely require that we conduct one or more clinical studies to demonstrate that the device is safe and effective. We may not be able to meet the requirements to obtain 510(k) clearance or PMA approval, or the FDA may not grant any necessary clearances or approvals. In addition, the FDA may place significant limitations upon the intended use of our products as a condition to a 510(k) clearance or PMA approval. Product applications can also be denied or withdrawn due to failure to comply with regulatory requirements or the occurrence of unforeseen problems following clearance or approval. Any delays or failure to obtain FDA clearance or approvals of new products we develop, any limitations imposed by the FDA on new product use, or the costs of obtaining FDA clearance or approvals could have a material adverse effect on our business, financial condition and results of operations.

Complying with FDA regulations is an expensive and time-consuming process. Our failure to comply fully with such regulations could subject us to enforcement actions.

Our commercially distributed medical device products will be subject to numerous post-market regulatory requirements, including the following:

- Quality System Regulation, or QSR, which requires manufacturers to follow elaborate design, testing, control, documentation and other quality assurance procedures during the manufacturing process;

- labeling regulations;

- the FDA s general prohibition against false or misleading statements in the labeling or promotion of products for unapproved or off-label uses;

- the Reports of Corrections and Removals regulation, which requires that manufacturers report to the FDA recalls and field corrective actions taken to reduce a risk to health or to remedy a violation of the FDC Act that may pose a risk to health; and

- the Medical Device Reporting regulation, which requires that manufacturers report to the FDA if their device may have caused or contributed to a death or serious injury or malfunctioned in a way that would likely cause or contribute to a death or serious injury if it were to recur.

We will also become subject to inspection and marketing surveillance by the FDA to determine our compliance with regulatory requirements. If the FDA finds that we have failed to comply, it can institute a wide variety of enforcement actions, ranging from a regulatory letter to a public warning letter to more severe civil and criminal sanctions. Our failure to comply with applicable requirements could lead to an enforcement action that may have an adverse effect on our financial condition and results of operations.

If our manufacturing facilities do not meet Federal, state or foreign country manufacturing standards, we may be required to temporarily cease all or part of our manufacturing operations, which would result in product delivery delays and negatively impact revenue.

Our manufacturing facilities are subject to periodic inspection by regulatory authorities and our operations will continue to be regulated by the FDA for compliance with Good Manufacturing Practice requirements contained in the QSRs. We are also required to comply with International Organization for Standardization, or ISO, quality system standards in order to produce products for sale in Europe. If we fail to continue to comply with Good Manufacturing Practice requirements or ISO standards, we may be required to cease all or part of our operations until we comply with these regulations. Obtaining and maintaining such compliance is difficult and costly. We cannot be certain that our facilities will be found to comply with Good Manufacturing Practice requirements or ISO standards in future inspections and audits by regulatory authorities.

Our medical products are subject to various international regulatory processes and approval requirements. If we do not obtain and maintain the necessary international regulatory approvals, we may not be able to market and sell our medical products in foreign countries.

To be able to market and sell our products in other countries, we must obtain regulatory approvals and comply with the regulations of those countries. These regulations, including the requirements for approvals and the

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time required for regulatory review, vary from country to country. Obtaining and maintaining foreign regulatory approvals are expensive, and we cannot be certain that we will receive regulatory approvals in any foreign country in which we plan to market our products. If we fail to obtain regulatory approval in any foreign country in which we plan to market our products, our ability to generate revenue will be harmed.

The European Union requires that manufacturers of medical products obtain the right to affix the CE mark to their products before selling them in member countries of the European Union. The CE mark is an international symbol of adherence to quality assurance standards and compliance with applicable European medical device directives. In order to obtain the right to affix the CE mark to products, a manufacturer must obtain certification that its processes meet certain European quality standards.

We have not yet received permission to affix the CE mark to our medical products. We do not know whether we will be able to obtain permission to affix the CE mark for new or modified products. If we are unable to obtain permission to affix the CE mark to our products, we will not be able to sell our products in member countries of the European Union.

We are subject to additional significant foreign and domestic government regulations, including environmental and health and safety regulations, and failure to comply with these regulations could harm our business.

Our facilities and current and proposed activities involve the use of a broad range of materials that are considered hazardous under applicable laws and regulations. Accordingly, we are subject to a number of foreign, federal, state, and local laws and regulations relating to health and safety, protection of the environment, and the storage, use, disposal of, and exposure to, hazardous materials and wastes. We could incur costs, fines and civil and criminal penalties, personal injury and third party property damage claims, or could be required to incur substantial investigation or remediation costs if we were to violate or become liable under environmental, health and safety laws. Moreover, a failure to comply with environmental laws could result in fines and the revocation of environmental permits, which could prevent us from conducting our business. Liability under environmental laws can be joint and several and without regard to fault. There can be no assurance that violations of environmental health and safety laws will not occur in the future as a result of the inability to obtain permits, human error, equipment failure or other causes. Environmental laws could become more stringent over time, imposing greater compliance costs and increasing risks and penalties associated with violations, which could harm our business. Accordingly, violations of present and future environmental laws could restrict our ability to expand facilities, pursue certain technologies, and could require us to acquire costly equipment, or to incur potentially significant costs to comply with environmental regulations.

The European Union Directive 2002/96/EC on Waste Electrical and Electronic Equipment, known as the WEEE Directive, requires producers of certain electrical and electronic equipment, including monitoring instruments, to be financially responsible for specified collection, recycling, treatment and disposal of past and present covered products placed on the market in the European Union. As a manufacturer of covered products, we may be required to register as a producer in some European Union countries, and we may incur some financial responsibility for the collection, recycling, treatment and disposal of both new product sold, and product already sold prior to the WEEE Directive s enforcement date, including the products of other manufacturers where these are replaced by our own products. European Union Directive 2002/95/EC on the Restriction of the use of Hazardous Substances in electrical and electronic equipment, known as the RoHS Directive, restricts the use of certain hazardous substances, including mercury, lead and cadmium in specified covered products; however, the RoHS Directive currently exempts monitoring instruments from its requirements. If the European Commission were to remove this exemption in the future, we would be required to change our manufacturing processes and redesign products regulated under the RoHS Directive in order to be able to continue to offer them for sale within the European Union. For some products, substituting certain components containing regulated hazardous substances may be difficult, costly or result in production delays. We will continue to review the applicability and impact of both directives on the sale of our products within the European Union, and although we cannot currently estimate the extent of such impact, they are likely to result in additional costs and could require us to redesign or change how we manufacture our products, any of which could adversely affect our operating results. Failure to comply with the directives could result in the imposition of fines and penalties, inability to sell covered products in the European Union and loss of revenues.

Compliance with foreign, federal, state and local environmental laws and regulations represents a small part of our present budget. If we fail to comply with any such laws or regulations, however, a government entity

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may levy a fine on us or require us to take costly measures to ensure compliance. Any such fine or expenditure may adversely affect our development. We are committed to complying with and, to our knowledge, are in compliance with, all governmental regulations. We cannot predict the extent to which future legislation and regulation could cause us to incur additional operating expenses, capital expenditures, or restrictions and delays in the development of our products and properties.

RISKS RELATING TO OUR INTELLECTUAL PROPERTY

Our proprietary rights may not adequately protect our technologies.

Our commercial success will depend in part on our obtaining and maintaining patent, trade secret, copyright and trademark protection of our technologies in the United States and other jurisdictions as well as successfully enforcing this intellectual property and defending this intellectual property against third-party challenges. We will only be able to protect our technologies from unauthorized use by third parties to the extent that valid and enforceable intellectual property protections, such as patents or trade secrets, cover them. In particular, we place considerable emphasis on obtaining patent and trade secret protection for significant new technologies, products and processes. Furthermore, the degree of future protection of our proprietary rights is uncertain because legal means afford only limited protection and may not adequately protect our rights or permit us to gain or keep our competitive advantage. The degree of future protection of our proprietary rights is also uncertain for products that are currently in the early stages of development such as the Trimetasphere® carbon nanomaterials products because we cannot predict which of these products will ultimately reach the commercial market or whether the commercial versions of these products will incorporate proprietary technologies.

Our patent position is highly uncertain and involves complex legal and factual questions. Accordingly, we cannot predict the breadth of claims that may be allowed or enforced in our patents or in third-party patents. For example:

- we or our licensors might not have been the first to make the inventions covered by each of our pending patent applications and issued patents;
- we or our licensors might not have been the first to file patent applications for these inventions;
- others may independently develop similar or alternative technologies or duplicate any of our technologies;
- it is possible that none of our pending patent applications or the pending patent applications of our licensors will result in issued patents;
- patents may issue to third parties that cover how we might practice our technology;
- our issued patents and issued patents of our licensors may not provide a basis for commercially viable technologies, may not provide us with any competitive advantages, or may be challenged and invalidated by third parties; and
- we may not develop additional proprietary technologies that are patentable.

Patents may not be issued for any pending or future pending patent applications owned by or licensed to us, and claims allowed under any issued patent or future issued patent owned or licensed by us may not be valid or sufficiently broad to protect our technologies. Moreover, protection of certain of our intellectual property may be unavailable or limited in the United States or in foreign countries, and certain of our products including our Trimetasphere® carbon nanomaterials products do not have foreign patent protection. Any issued patents owned by or licensed to us now or in the future may be challenged, invalidated, or circumvented, and the rights under such patents may not provide us with competitive advantages. In addition, competitors may design around our technology or develop competing technologies. Intellectual property rights may also be unavailable or limited in some foreign countries, and in the case of certain products no foreign patents were filed or can be filed. This could make it easier for competitors to capture or increase their market share with respect to related technologies. We could incur substantial costs to bring suits in which we may assert our patent rights against others or defend ourselves in suits brought against us. An unfavorable outcome of any litigation, such as our litigation with Hansen, could have a material adverse effect on our business and results of operations.

We also rely on trade secrets to protect our technology, especially where we believe patent protection is not appropriate or obtainable. However, trade secrets are difficult to protect. We regularly attempt to obtain confidentiality agreements and contractual provisions with our collaborators, employees, and consultants to protect our trade secrets and proprietary know-how. These agreements may be breached and or may not have adequate remedies for such breach. While we use reasonable efforts to protect our trade secrets, our employees, consultants, contractors or scientific and other advisors, or those of our strategic partners, may unintentionally or willfully disclose our information to competitors. If we were to enforce a claim that a third party had illegally obtained and was using our trade secrets, our enforcement efforts would be expensive and time consuming, and the outcome would be unpredictable. In addition, courts outside the United States are sometimes unwilling to protect trade secrets. Moreover, if our competitors independently develop equivalent knowledge, methods and know-how, it will be more difficult for us to enforce our rights and our business could be harmed.

If we are not able to defend the patent or trade secret protection position of our technologies, then we will not be able to exclude competitors from developing or marketing competing technologies, and we may not generate enough revenues from product sales to justify the cost of development of our technologies and to achieve or maintain profitability.

We also rely on trademarks to establish a market identity for our company and our products. To maintain the value of our trademarks, we might have to file lawsuits against third parties to prevent them from using trademarks confusingly similar to or dilutive of our registered or unregistered trademarks. Also, we might not obtain registrations for our pending trademark applications, and might have to defend our registered trademark and pending trademark applications from challenge by third parties. Enforcing or defending our registered and unregistered trademarks might result in significant litigation costs and damages, including the inability to continue using certain trademarks.

Third parties may claim that we infringe their intellectual property, and we could suffer significant litigation or licensing expense as a result.

Various U.S. and foreign issued patents and pending patent applications, which are owned by third parties, exist in our technology areas. Such third parties may claim that we infringe their patents. Because patent applications can take several years to result in a patent issuance, there may be currently pending applications, unknown to us, which may later result in issued patents that our technologies may infringe. For example, we are aware of competitors with patents in technology areas applicable to our optical test equipment products. Such competitors may allege that we infringe these patents. There could also be existing patents of which we are not aware that our technologies may inadvertently infringe. If third parties assert claims against us alleging that we infringe their patents or other intellectual property rights including third parties that have asserted claims against businesses that we have acquired prior to our acquisition of these businesses we could incur substantial costs and diversion of management resources in defending these claims, and the defense of these claims could have a material adverse effect on our business, financial condition, and results of operations. In addition, if third parties assert claims against us and we are unsuccessful in defending against these claims, these third parties may be awarded substantial damages, as well as injunctive or other equitable relief against us, which could effectively block our ability to make, use, sell, distribute, or market our products and services in the United States or abroad.

Commercial application of nanotechnologies in particular, or technologies involving nanomaterials, is new and the scope and breadth of patent protection is uncertain. Consequently, the patent positions of companies involved in nanotechnologies have not been tested and complex legal and factual questions for which important legal principles will be developed or may remain unresolved. In addition, it is not clear whether such patents will be subject to interpretations or legal doctrines that differ from conventional patent law principles. Changes in either the patent laws or in interpretations of patent laws in the United States and other countries may diminish the value of our nanotechnology-related intellectual property. Accordingly, we cannot predict the breadth of claims that may be allowed or enforced in our nanotechnology-related patents or in third party patents.

In the event that a claim relating to intellectual property is asserted against us, or third parties not affiliated with us hold pending or issued patents that relate to our products or technology, we may seek licenses to such intellectual property or challenge those patents. However, we may be unable to obtain these licenses on commercially reasonable terms, if at all, and our challenge of the patents may be unsuccessful. Our failure to obtain the necessary licenses or other rights could prevent the sale, manufacture, or distribution of our products and, therefore, could have a material adverse effect on our business, financial condition, and results of operations.

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A substantial portion of our technology is subject to retained rights of our licensors, and we may not be able to prevent the loss of those rights or the grant of similar rights to third parties.

A substantial portion of our technology is licensed from academic institutions, corporations and government agencies. Under these licensing arrangements, a licensor may obtain rights over the technology, including the right to require us to grant a license to one or more third parties selected by the licensor or that we provide licensed technology or material to third parties for non-commercial research. The grant of a license for any of our core technologies to a third party could have a material and adverse effect on our business. In addition, some of our licensors retain certain rights under the licenses, including the right to grant additional licenses to a substantial portion of our core technology to third parties for noncommercial academic and research use. It is difficult to monitor and enforce such noncommercial academic and research uses, and we cannot predict whether the third party licensees would comply with the use restrictions of such licenses. We have incurred and could incur substantial expenses to enforce our rights against them. We also may not fully control the ability to assert or defend those patents or other intellectual property which we have licensed from other entities, or which we have licensed to other entities.

In addition, some of our licenses with academic institutions give us the right to use certain technology previously developed by researchers at these institutions. In certain cases we also have the right to practice improvements on the licensed technology to the extent they are encompassed by the licensed patents and within our field of use. Our licensors may currently own and may in the future obtain additional patents and patent applications that are necessary for the development, manufacture and commercial sale of our anticipated products. We may be unable to agree with one or more academic institutions from which we have obtained licenses that certain intellectual property developed by researchers at these academic institutions is covered by our existing licenses. In the event that the new intellectual property is not covered by our existing licenses, we would be required to negotiate a new license agreement. We may not be able to reach agreement with current or future licensors on commercially reasonable terms, if at all, or the terms may not permit us to sell our products at a profit after payment of royalties, which could harm our business.

Some of our patents may cover inventions that were conceived or first reduced to practice under, or in connection with, U.S. government contracts or other federal funding agreements. With respect to inventions conceived or first reduced to practice under a federal funding agreement, the U.S. government may retain a nonexclusive, non-transferable, irrevocable, paid-up license to practice or have practiced for or on behalf of the United States the invention throughout the world. We may not be successful or succeed in our efforts to retain title in patents, maintain ownership of intellectual property or in limiting the U.S. government s rights in our proprietary technologies and intellectual property whether such intellectual property was developed in the performance of a federal funding agreement or developed at private expense.

RISKS RELATING TO OUR COMMON STOCK

We may not be able to comply with all applicable listing requirements or standards of the NASDAQ Capital Market and NASDAQ could delist our common stock.

Our common stock is listed on the NASDAQ Capital Market. In order to maintain that listing, we must satisfy minimum financial and other continued listing requirements and standards. There can be no assurances that we will be able to comply with applicable listing standards. In the event that our common stock is not eligible for quotation on another market or exchange, trading of our common stock could be conducted in the over-the-counter market or on an electronic bulletin board established for unlisted securities such as the Pink Sheets or the OTC Bulletin Board. In such event, it could become more difficult to dispose of, or obtain accurate quotations for the price of our common stock, and there would likely also be a reduction in our coverage by security analysts and the news media, which could cause the price of our common stock to decline further. Also in such event, it may be difficult for us to raise additional capital if we are not listed on a major exchange.

Our common stock price has been volatile and we expect that the price of our common stock will fluctuate substantially in the future, which could cause you to lose all or a substantial part of your investment.

The public trading price for our common stock is volatile and may fluctuate significantly and will continue to be affected by a number of factors, many of which we cannot control For example, since January 1, 2008, our

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common stock has traded between a high of $8.49 per share and a low of $0.30 per share. Among the factors that could cause material fluctuations in the market price for our common stock include:

- changes in earnings estimates, investors perceptions, recommendations by securities analysts or our failure to achieve analysts earnings estimates;
- changes in our status as an entity eligible to receive SBIR contracts and grants;
- quarterly variations in our or our competitors results of operations;
- general market conditions and other factors unrelated to our operating performance or the operating performance of our competitors;
- announcements by us, or our competitors, of acquisitions, new products, significant contracts, commercial relationships or capital commitments;
- litigation, such as our recently settled litigation with Hansen;
- any major change in our board of directors or management, including in connection with our recently announced management transition initiatives;
- changes in governmental regulations or in the status of our regulatory approvals;
- announcements related to patents issued to us or our competitors;
- a lack of, limited or negative industry or security analyst coverage;
- discussions of our company or our stock price by the financial and scientific press and online investor communities such as chat rooms; and
- general developments in our industry.

In addition, the stock prices of many technology companies have experienced wide fluctuations that have often been unrelated to the operating performance of those companies. These factors may materially and adversely affect the market price of our common stock.

If there are substantial sales of our common stock, or the perception that such sales may occur, our stock price could decline.

If any of our stockholders were to sell substantial amounts of our common stock, the market price of our common stock may decline, which might make it more difficult for us to sell equity or equity-related securities in the future at a time and price that we deem appropriate. Substantial sales of our common stock, or the perception that such sales may occur, may have a material adverse effect on the prevailing market price of our common stock.

Carilion, Dr. Kent Murphy and certain other stockholders have rights to require us, subject to certain conditions, to file one or more registration statements providing for the sale of up to an aggregate of approximately 6.4 million shares of our common stock, which number includes approximately 1.3 million shares of common stock issuable to Carilion upon conversion of shares Series A Preferred Stock it currently holds, or to include their shares in registration statements that we may file for ourselves or other stockholders. Once we register the issuance of these shares, they can generally be freely sold in the public market.

Dr. Murphy currently owns approximately 2.8 million shares of our common stock. In connection with Dr. Murphy s resignation as our chief executive officer, he has agreed that, subject to certain conditions, he may only request the registration of up to 800,000 shares of common stock through December 31, 2011, and he will not make any open market sales of his common stock pursuant to the exemption from registration provided by Rule 144 under the Securities Act during this period. However, these restrictions expire at the end of 2011, after which time Dr. Murphy will once again have the contractual ability to cause us to register all remaining shares that he owns at that time and sell under Rule 144.

In addition, certain of our employees, including some of our executive officers, have entered into agreements with us that restrict their ability to sell shares of our common stock beyond specified amounts through December 31, 2010. These employees currently beneficially own approximately 5% of our outstanding common stock, including shares issuable upon exercise of stock options. We have the right to waive any of these sale restrictions for employees and management at our discretion, and in such instance, the shares would become freely tradable.

We cannot assure you that Carilion, Dr. Murphy or any of our other significant stockholders will not seek to sell their shares once the contractual restrictions on their ability to do so have lapsed, or at any other time that could have an adverse effect on the market price of our stock.

If our internal controls over financial reporting are found not to be effective or if we make disclosure of existing or potential significant deficiencies or material weaknesses in those controls, investors could lose confidence in our financial reports, and our stock price may be adversely affected.

Section 404 of the Sarbanes-Oxley Act of 2002 requires us to include an internal control report with our Annual Report on Form 10-K. That report must include management s assessment of the effectiveness of our internal control over financial reporting as of the end of the fiscal year. We evaluate our existing internal control over financial reporting against the standards adopted by Committee of Sponsoring Organizations of the Treadway Commission. During the course of our ongoing evaluation of the internal controls, we may identify areas requiring improvement, and may have to design enhanced processes and controls to address issues identified through this review. Remedying any deficiencies, significant deficiencies or material weaknesses that we or our independent registered public accounting firm may identify, may require us to

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incur significant costs and expend significant time and management resources. We cannot assure you that any of the measures we implement to remedy any such deficiencies will effectively mitigate or remedy such deficiencies. Investors could lose confidence in our financial reports, and our stock price may be adversely affected, if our internal controls over financial reporting are found not to be effective by management or by an independent registered public accounting firm or if we make disclosure of existing or potential significant deficiencies or material weaknesses in those controls.

Our directors and executive officers collectively control approximately 50% of our outstanding common stock and if they choose to act together, they can significantly influence our management and operations in a manner that may be in their best interests and not in the best interests of other stockholders.

As of the date of this report, our directors and executive officers, together with their affiliates, collectively own an aggregate of approximately 50% of our outstanding common stock, determined on an as-converted basis. As a result, these stockholders, if they were to act together, will be able to significantly influence our management and affairs and all matters requiring stockholder approval, including the election of directors and approval of mergers or other significant corporate transactions. You and other stockholders will have minimal influence over these actions. The interests of this group of stockholders may not always coincide with our interests or the interests of other stockholders, and this group may act in a manner that advances their best interests and not necessarily those of other stockholders. This concentration of ownership may also have the effect of delaying or preventing a change in control of our company and might adversely affect the market price of our common stock.

Anti-takeover provisions in our amended and restated certificate of incorporation and bylaws and Delaware law could discourage or prevent a change in control, even if an acquisition would be beneficial to our stockholders, which could affect our stock price adversely and prevent attempts by our stockholders to replace or remove our current management.

Our amended and restated certificate of incorporation and bylaws and Delaware law contain provisions that might delay or prevent a change in control, discourage bids at a premium over the market price of our common stock and adversely affect the market price of our common stock and the voting and other rights of the holders of our common stock. These provisions include:

- a classified board of directors serving staggered terms;
- advance notice requirements to stockholders for matters to be brought at stockholder meetings;
- a supermajority stockholder vote requirement for amending certain provisions of our amended and restated certificate of incorporation and bylaws; and
- the right to issue preferred stock without stockholder approval, which could be used to dilute the stock ownership of a potential hostile acquirer.

We are also subject to provisions of the Delaware corporation law that, in general, prohibit any business combination with a beneficial owner of 15% or more of our common stock for five years unless the holder s acquisition of our stock was approved in advance by our board of directors.

The existence of these provisions could adversely affect the voting power of holders of common stock and limit the price that investors might be willing to pay in the future for shares of our common stock.

We may become involved in securities class action litigation that could divert management s attention and harm our business and our insurance coverage may not be sufficient to cover all costs and damages.

The stock market has from time to time experienced significant price and volume fluctuations that have affected the market prices for the common stock of technology companies. These broad market fluctuations may cause the market price of our common stock to decline. In the past, following periods of volatility in the market price of a particular company s securities, securities class action litigation has often been brought against that company. We may become involved in this type of litigation in the future. Litigation often is expensive and diverts management s attention and resources, which could adversely affect our business.

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ITEM 2. ***UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS***

(a) Unregistered Sales of Equity Securities during the Three-Month Period Ended June 30, 2010

Shares Issued Upon Exercise of Warrants

During the three months ended June 30, 2010, the Company issued 20,628 shares of common stock upon exercise of warrants held by Hansen for gross proceeds of $206.28. The issuance of these shares was deemed to be exempt from registration under the Securities Act in reliance on Section 4(2) of that statute.

Common Stock Dividend Payable to Carilion

As described in the Company s Current Report on Form 8-K filed on January 15, 2010, the Company issued 1,321,514 shares of Series A Preferred Stock, par value $0.001 per share, to Carilion Clinic in January 2010. The Series A Preferred Stock accrues dividends at the rate of approximately $0.2815 per share per annum, payable quarterly in arrears. Accrued dividends are payable in shares of the Company s common stock, with the number of shares being equal to the quotient of (i) the cumulative aggregate balance of accrued but unpaid dividends on each share of Series A Preferred Stock divided by (ii) the conversion price of the Series A Preferred Stock, which is currently $4.69159 per share. For the period from January 12, 2010, the original issue date of the Series A Preferred Stock, through June 30, 2010, the Series A Preferred Stock issued to Carilion has accrued approximately $175,000 in dividends. The accrued dividend as of June 30, 2010 will be paid by the issuance of 37,223 shares of the Company s common stock, which the Company will issue subsequent to June 30, 2010. The shares of common stock will be issued under exemptions from registration pursuant to Sections 3(a) (9) and 4(2) of the Securities Act.

(b) Use of Proceeds from Sale of Registered Equity Securities

In 2006, we completed the initial public offering of 3,500,000 shares of our common stock at a price to the public of $6.00 per share and received net proceeds of approximately $17.9 million, after deducting underwriters discounts and commissions and additional offering-related expenses.

We are using, or expect to use, the net proceeds of the offering principally to fund further development and expansion of our products and product candidates, in particular our nanomaterial and ultrasound-related medical product candidates, and for general working capital purposes. We may also use a portion of the net proceeds for the acquisition of, or investment in, companies, technologies, products or assets that complement our business. We have no present commitments or binding agreements to enter into any acquisitions or investments. Pending these uses, we intend to continue to invest the net proceeds of our initial public offering in short-term, investment-grade interest-bearing securities or guaranteed obligations of the U.S. government.

(c) Purchases of Equity Securities by the Issuer and Affiliated Purchasers

None.

ITEM 3. ***DEFAULTS UPON SENIOR SECURITIES***

None.

ITEM 4. ***RESERVED***

ITEM 5. ***OTHER INFORMATION***

None.

ITEM 6. ***EXHIBITS***

The exhibits listed on the Exhibit Index hereto are filed or incorporated by reference (as stated therein) as part of this Quarterly Report on Form 10-Q.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Luna Innovations Incorporated

Date: August 16, 2010

By: /s/ Scott A. Graeff
Scott A. Graeff
Interim Chief Financial Officer

(principal financial and accounting officer

and duly authorized officer)

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EXHIBIT INDEX

Exhibit Number	**Description**
10.1(1)*	Development and Supply Agreement, effective January 12, 2010, by and among Luna Innovations Incorporated, Luna Technologies, Inc. and Hansen Medical, Inc., as amended on February 17, 2010 and April 2, 2010 (Exhibit 10.7)
10.2(1)*	Amendment to Development and Supply Agreement, effective January 12, 2010 and April 27, 2010, by and between Luna Innovations Incorporated and Intuitive Surgical, Inc. (Exhibit 10.9)
10.3(1)	Lease for Riverside Center, dated December 30, 2005, by and between Carilion Medical Center and Luna Innovations Incorporated, as amended by an Amended Lease dated July 20, 2006, a Second Amendment dated on or about October 5, 2007 and a Third Amendment effective as of April 1, 2010 (Exhibit 10.15)
10.4	Lease Agreement Extension dated June 17, 2010, by and between the Industrial Development Authority of Danville, Virginia, and Luna Innovations Incorporated
10.5	Third Amendment to Commercial Lease dated June 21, 2010, by and between Canvasback Real Estate & Investments, LLC, and Luna Innovations Incorporated
31.1	Certification of the Principal Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of the Principal Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

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32.1**	Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2**	Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(1) Incorporated by reference to the exhibits to the Registrant s Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on May 17, 2010 (File No. 000-52008). The number in parentheses indicates the corresponding exhibit number in such Form 10-Q.

* Confidential treatment has been requested with respect to portions of this exhibit, indicated by asterisks, which have been filed separately with the Securities and Exchange Commission.

** These certifications are being furnished solely to accompany this quarterly report pursuant to 18 U.S.C. Section 1350, and are not being filed for purposes of Section 18 of the Securities Exchange Act of 1934 and are not to be incorporated by reference into any filing of the registrant, whether made before or after the date hereof, regardless of any general incorporation language in such filing.

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)

(69,883
)
Cash and cash equivalents at beginning of period
31,020

93,576

Cash and cash equivalents at end of period
$
7,567

$
23,693

Supplementary cash flow information

Interest paid (net of amount capitalized)
$
39,120

$
40,320

Income taxes (refunded) paid, net
$
(45,789
)

$
13

Supplementary non-cash investing and financing activities

Accrued additions to property, plant, and equipment
$
13,096

$
13,921

Non-cash additions to property, plant, and equipment, net
$
1,280

$
7,105

Issuance of common stock – ESPP
$
160

$
86

The accompanying notes are an integral part of the Condensed Consolidated Financial Statements.

CLECO CORPORATION

Condensed Consolidated Statements of Changes in Common Shareholders' Equity (Unaudited)

(THOUSANDS, EXCEPT SHARE AMOUNTS)	COMMON STOCK SHARES	COMMON STOCK AMOUNT	TREASURY STOCK SHARES	TREASURY STOCK COST	PREMIUM ON COMMON STOCK	RETAINED EARNINGS	ACCUMULATED OTHER COMPREHENSIVE LOSS	TOTAL SHAREHOLDERS' EQUITY
Balances, Dec. 31, 2011	60,702,342	$60,702	(410,403)	$(13,215)	$409,904	$990,605	$ (28,139)	$ 1,419,857
Common stock issued for compensatory plans	246,738	247	3,561	122	3,944	—	—	4,313
Repurchase of common stock	—	—	(200,000)	(8,007)	—	—	—	(8,007)
Dividends on common stock, $0.625 per share	—	—	—	—	—	(38,163)	—	(38,163)
Net income	—	—	—	—	—	76,718	—	76,718
Other comprehensive income, net of tax	—	—	—	—	—	—	1,549	1,549
Balances, June 30, 2012	60,949,080	$60,949	(606,842)	$(21,100)	$413,848	$1,029,160	$ (26,590)	$ 1,456,267
Balances, Dec. 31, 2012	60,961,570	$60,962	(606,025)	$(21,072)	$416,619	$1,075,074	$ (32,370)	$ 1,499,213
Common stock issued for compensatory plans	85,436	85	8,233	286	2,703	—	—	3,074
Dividends on common stock, $0.70 per share	—	—	—	—	—	(42,614)	—	(42,614)
Net income	—	—	—	—	—	69,166	—	69,166
Other comprehensive income, net of tax	—	—	—	—	—	—	2,495	2,495
Balances, June 30, 2013	61,047,006	$61,047	(597,792)	$(20,786)	$419,322	$1,101,626	$ (29,875)	$ 1,531,334

The accompanying notes are an integral part of the Condensed Consolidated Financial Statements.

PART I — FINANCIAL INFORMATION
ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Cleco Power
These unaudited Condensed Consolidated Financial Statements should be read in conjunction with Cleco Power's Consolidated Financial Statements and Notes included in the Registrants' Combined Annual Report on Form 10-K for the fiscal year ended December 31, 2012. For more information on the basis of presentation, see "Notes to the Unaudited Condensed Consolidated Financial Statements — Note 1 — Summary of Significant Accounting Policies — Basis of Presentation."

CLECO POWER

Condensed Consolidated Statements of Income (Unaudited)

(THOUSANDS, EXCEPT SHARE AND PER SHARE AMOUNTS)	FOR THE THREE MONTHS ENDED JUNE 30, 2013	2012
Operating revenue		
Electric operations	$252,765	$228,293
Other operations	11,027	11,613
Affiliate revenue	335	342
Gross operating revenue	264,127	240,248
Electric customer credits	(402)	(281)
Operating revenue, net	263,725	239,967
Operating expenses		
Fuel used for electric generation	72,611	54,695
Power purchased for utility customers	23,247	22,367
Other operations	29,540	27,243
Maintenance	23,585	19,630
Depreciation	32,959	30,559
Taxes other than income taxes	9,204	8,682
Gain on sale of assets	—	(1)
Total operating expenses	191,146	163,175
Operating income	72,579	76,792
Interest income	255	(6)
Allowance for other funds used during construction	413	1,399
Other income	1,268	1,228
Other expense	(1,208)	(823)
Interest charges		
Interest charges, including amortization of debt expense and premium, net	21,007	21,283
Allowance for borrowed funds used during construction	(129)	(478)
Total interest charges	20,878	20,805
Income before income taxes	52,429	57,785
Federal and state income tax expense	17,965	20,501
Net income	$34,464	$37,284

The accompanying notes are an integral part of the Condensed Consolidated Financial Statements.

CLECO POWER

Condensed Consolidated Statements of Comprehensive Income (Unaudited)

(THOUSANDS)	FOR THE THREE MONTHS ENDED JUNE 30, 2013	2012
Net income	$34,464	$37,284
Other comprehensive income (loss), net of tax:		
Amortization of postretirement benefits (net of tax expense of $168 in 2013 and $89 in 2012)	269	226
Net gain (loss) on cash flow hedges (net of tax expense of $23 in 2013 and tax benefit of $2,360 in 2012)	36	(3,774)
Total other comprehensive income (loss), net of tax	305	(3,548)
Comprehensive income, net of tax	$34,769	$33,736

The accompanying notes are an integral part of the Condensed Consolidated Financial Statements.

CLECO POWER

Condensed Consolidated Statements of Income (Unaudited)

	FOR THE SIX MONTHS ENDED JUNE 30,	
(THOUSANDS)	2013	2012
Operating revenue		
Electric operations	$482,191	$437,883
Other operations	22,064	22,062
Affiliate revenue	670	687
Gross operating revenue	504,925	460,632
Electric customer credits	(424)	1,955
Operating revenue, net	504,501	462,587
Operating expenses		
Fuel used for electric generation	157,976	127,759
Power purchased for utility customers	32,940	32,239
Other operations	54,912	53,585
Maintenance	38,379	35,644
Depreciation	65,288	60,648
Taxes other than income taxes	20,662	17,614
Gain on sale of assets	—	(1)
Total operating expenses	370,157	327,488
Operating income	134,344	135,099
Interest income	453	23
Allowance for other funds used during construction	1,577	2,416
Other income	1,965	2,323
Other expense	(1,652)	(1,473)
Interest charges		
Interest charges, including amortization of debt expense and premium, net	42,731	40,113
Allowance for borrowed funds used during construction	(504)	(822)
Total interest charges	42,227	39,291
Income before income taxes	94,460	99,097
Federal and state income tax expense	32,203	35,008
Net income	$62,257	$64,089

The accompanying notes are an integral part of the Condensed Consolidated Financial Statements.

CLECO POWER

Condensed Consolidated Statements of Comprehensive Income (Unaudited)

	FOR THE SIX MONTHS ENDED JUNE 30,	
(THOUSANDS)	2013	2012
Net income	$62,257	$64,089
Other comprehensive income, net of tax:		
Amortization of postretirement benefits (net of tax expense of $325 in 2013 and $163 in 2012)	520	431
Net gain on cash flow hedges (net of tax expense of $859 in 2013 and $413 in 2012)	1,373	661
Total other comprehensive income, net of tax	1,893	1,092
Comprehensive income, net of tax	$64,150	$65,181

The accompanying notes are an integral part of the Condensed Consolidated Financial Statements.

CLECO POWER

Condensed Consolidated Balance Sheets (Unaudited)

(THOUSANDS)	AT JUNE 30, 2013	AT DEC. 31, 2012
Assets		
Utility plant and equipment		
Property, plant, and equipment	$3,964,491	$3,871,940
Accumulated depreciation	(1,262,963)	(1,227,078)
Net property, plant, and equipment	2,701,528	2,644,862
Construction work in progress	152,568	176,584
Total utility plant, net	2,854,096	2,821,446
Current assets		
Cash and cash equivalents	2,743	23,368
Restricted cash and cash equivalents	8,067	8,781
Customer accounts receivable (less allowance for doubtful accounts of $862 in 2013 and $1,105 in 2012)	48,732	39,293
Accounts receivable - affiliate	796	2,991
Other accounts receivable	40,186	37,562
Unbilled revenue	36,012	28,662
Fuel inventory, at average cost	53,220	46,867
Material and supplies inventory, at average cost	58,877	55,472
Accumulated deferred federal and state income taxes, net	53,061	87,286
Accumulated deferred fuel	9,593	7,833
Cash surrender value of company-owned life insurance policies	21,040	20,842
Prepayments	4,592	4,415
Regulatory assets - other	7,803	11,095
Other current assets	—	371
Total current assets	344,722	374,838
Equity investment in investee	14,532	14,532
Prepayments	4,143	4,261
Restricted cash and cash equivalents	4,327	5,343
Restricted investments	12,548	10,852
Regulatory assets - deferred taxes, net	213,061	210,445
Regulatory assets - other	290,764	289,570
Intangible asset	113,720	120,545
Other deferred charges	19,949	19,897
Total assets	$3,871,862	$3,871,729

The accompanying notes are an integral part of the Condensed Consolidated Financial Statements.

(Continued on next page)

CLECO POWER

Condensed Consolidated Balance Sheets (Unaudited)

(THOUSANDS)	AT JUNE 30, 2013	AT DEC. 31, 2012
Liabilities and member's equity		
Member's equity	$1,359,069	$1,319,919
Long-term debt, net	1,298,765	1,232,258
Total capitalization	2,657,834	2,552,177
Current liabilities		
Short-term debt	$3,000	$—
Long-term debt due within one year	16,658	91,140
Accounts payable	86,527	89,782
Accounts payable - affiliate	11,373	10,097
Customer deposits	47,546	45,553
Provision for rate refund	4,589	4,165
Taxes payable	16,770	1,328
Interest accrued	13,583	13,893
Interest rate risk management liability	—	2,627
Regulatory liabilities - other	—	8,255
Other current liabilities	11,582	11,746
Total current liabilities	211,628	278,586
Commitments and Contingencies (Note 11)		
Deferred credits		
Accumulated deferred federal and state income taxes, net	850,423	845,769
Accumulated deferred investment tax credits	5,698	6,252
Postretirement benefit obligations	105,642	137,637
Restricted storm reserve	16,952	16,285
Uncertain tax positions	222	222
Other deferred credits	23,463	34,801
Total deferred credits	1,002,400	1,040,966
Total liabilities and member's equity	$3,871,862	$3,871,729

The accompanying notes are an integral part of the Condensed Consolidated Financial Statements.

CLECO POWER

Condensed Consolidated Statements of Cash Flows (Unaudited)

	FOR THE SIX MONTHS ENDED JUNE 30,	
(THOUSANDS)	2013	2012
Operating activities		
Net income	$62,257	$64,089
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	70,893	66,482
Allowance for other funds used during construction	(1,577)	(2,416)
Net deferred income taxes	33,802	19,830
Deferred fuel costs	(478)	(4,670)
Changes in assets and liabilities:		
Accounts receivable	(9,147)	(2,468)
Accounts and notes receivable, affiliate	2,361	(1,439)
Unbilled revenue	(7,350)	(5,704)
Fuel, materials and supplies inventory	(9,758)	(9,926)
Accounts payable	(15,924)	(36,382)
Accounts and notes payable, affiliate	575	1,351
Customer deposits	6,316	5,860
Postretirement benefit obligations	(31,959)	3,103
Regulatory assets and liabilities, net	(11,842)	(8,207)
Other deferred accounts	(11,187)	(10,363)
Taxes accrued	15,442	17,972
Interest accrued	(309)	(3,191)
Other operating	93	(409)
Net cash provided by operating activities	92,208	93,512
Investing activities		
Additions to property, plant, and equipment	(81,436)	(99,392)
Allowance for other funds used during construction	1,577	2,416
Property, plant, and equipment grants	729	4,603
Transfer of cash from restricted accounts	1,730	192
Purchase of restricted investments	(4,334)	—
Maturity of restricted investments	2,559	—
Other investing	515	597
Net cash used in investing activities	(78,660)	(91,584)
Financing activities		
Issuance of short-term debt	3,000	—
Draws on credit facility	140,000	—
Payments on credit facility	(140,000)	—
Issuance of long-term debt	160,000	50,000
Retirement of long-term debt	(107,129)	(67,957)
Repurchase of long-term debt	(60,000)	—
Settlement of interest rate swap	(3,269)	—
Distribution to parent	(25,000)	(40,000)
Other financing	(1,775)	(1,193)
Net cash used in financing activities	(34,173)	(59,150)

Net decrease in cash and cash equivalents	(20,625)	(57,222)
Cash and cash equivalents at beginning of period	23,368	67,458
Cash and cash equivalents at end of period	$2,743	$10,236
Supplementary cash flow information		
Interest paid (net of amount capitalized)	$38,966	$40,248
Income taxes refunded, net	$(456)	$—
Supplementary non-cash investing and financing activities		
Accrued additions to property, plant, and equipment	$13,026	$13,714
Non-cash additions to property, plant, and equipment, net	$1,280	$7,105

The accompanying notes are an integral part of the Condensed Consolidated Financial Statements.

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CLECO POWER

Condensed Consolidated Statements of Changes in Member's Equity (Unaudited)

(THOUSANDS)	RETAINED EARNINGS	ACCUMULATED OTHER COMPREHENSIVE LOSS	TOTAL MEMBER'S EQUITY
Balances, Dec. 31, 2011	$ 1,251,492	$ (20,630)	$ 1,230,862
Other comprehensive income, net of tax	—	1,092	1,092
Distribution to parent	(40,000)	—	(40,000)
Net income	64,089	—	64,089
Balances, June 30, 2012	$ 1,275,581	$ (19,538)	$ 1,256,043
Balances, Dec. 31, 2012	$ 1,340,340	$ (20,421)	$ 1,319,919
Other comprehensive income, net of tax	—	1,893	1,893
Distribution to parent	(25,000)	—	(25,000)
Net income	62,257	—	62,257
Balances, June 30, 2013	$ 1,377,597	$ (18,528)	$ 1,359,069

The accompanying notes are an integral part of the Condensed Consolidated Financial Statements.

Index to Applicable Notes to the Unaudited Condensed Consolidated Financial Statements of Registrants

Notes to the Unaudited Condensed Consolidated Financial Statements

Note 1 — Summary of Significant Accounting Policies

Principles of Consolidation
The accompanying Condensed Consolidated Financial Statements of Cleco include the accounts of Cleco and its majority-owned subsidiaries after elimination of intercompany accounts and transactions.

Basis of Presentation
The Condensed Consolidated Financial Statements of Cleco Corporation and Cleco Power have been prepared in accordance with GAAP for interim financial information and with the instructions to Form 10-Q and Regulation S-X. Accordingly, these Condensed Consolidated Financial Statements do not include all of the information and notes required by GAAP for annual financial statements. The year-end Condensed Consolidated Balance Sheet data was derived from audited financial statements. Because the interim Condensed Consolidated Financial Statements and the accompanying notes do not include all of the information and notes required by GAAP for annual financial statements, the Condensed Consolidated Financial Statements and other information included in this quarterly report should be read in conjunction with the consolidated financial statements and accompanying notes in the Registrants' Combined Annual Report on Form 10-K for the year ended December 31, 2012.

These Condensed Consolidated Financial Statements, in the opinion of management, reflect all normal recurring adjustments that are necessary to fairly present the financial position and results of operations of Cleco. Amounts reported in Cleco's interim financial statements are not necessarily indicative of amounts expected for the annual periods due to the effects of seasonal temperature variations on energy consumption, regulatory rulings, the timing of maintenance on electric generating units, changes in mark-to-market valuations, changing commodity prices, and other factors.

In preparing financial statements that conform to GAAP, management must make estimates and assumptions that affect the reported amounts of assets and liabilities, the

reported amounts of revenues and expenses, and the disclosure of contingent assets and liabilities at the date of the financial statements. Actual results could differ from those estimates. For more information on recent authoritative guidance and its effect on financial results, see Note 2 — "Recent Authoritative Guidance."

Property, Plant, and Equipment

Property, plant, and equipment consists primarily of regulated utility generation and energy transmission assets. Regulated assets, utilized primarily for retail operations and electric transmission and distribution, are stated at the cost of construction, which includes certain materials, labor, payroll taxes and benefits, administrative and general costs, and the estimated cost of funds used during construction. Jointly owned assets are reflected in property, plant, and equipment at Cleco Power's share of the cost to construct or purchase the assets. Cleco's property, plant, and equipment consisted of:

(THOUSANDS)	AT JUNE 30, 2013		AT DEC. 31, 2012	
Regulated utility plants	$3,964,491		$3,871,940	
Other	269,500		268,254	
Total property, plant, and equipment	4,233,991		4,140,194	
Accumulated depreciation	(1,350,533	)	(1,311,273	)
Net property, plant, and equipment	$2,883,458		$2,828,921	

Restricted Cash and Cash Equivalents

Various agreements to which Cleco is subject contain covenants that restrict its use of cash. As certain provisions under these agreements are met, cash is transferred out of related escrow accounts and becomes available for its intended purposes and/or general corporate purposes. Cleco's restricted cash and cash equivalents consisted of:

(THOUSANDS)	AT JUNE 30, 2013	AT DEC. 31, 2012
Diversified Lands' mitigation escrow	$97	$97
Cleco Katrina/Rita's storm recovery bonds	8,067	8,781
Cleco Power's future storm restoration costs	4,326	5,343
Total restricted cash and cash equivalents	$12,490	$14,221

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Cleco Katrina/Rita has the right to bill and collect storm restoration costs from Cleco Power's customers. As cash is collected, it is restricted for payment of operating expenses, interest, and principal on storm recovery bonds. During the six months ended June 30, 2013, Cleco Katrina/Rita collected $9.7 million net of operating expenses. In March 2013, Cleco Katrina/Rita used $7.1 million for scheduled storm recovery bond principal payments and $3.3 million for related interest.

Fair Value Measurements and Disclosures

Various accounting pronouncements require certain assets and liabilities to be measured at their fair values. Some assets and liabilities are required to be measured at their fair value each reporting period, while others are required to be measured only one time, generally the date of acquisition or debt issuance. Cleco and Cleco Power are required to disclose the fair value of certain assets and liabilities by one of three levels when required for recognition purposes under GAAP. For more information about fair value levels, see Note 4 — "Fair Value Accounting."

Risk Management

Market risk inherent in Cleco's market risk-sensitive instruments and positions includes potential changes arising from changes in interest rates and the commodity market prices of power and natural gas on different energy exchanges. Cleco's Energy Market Risk Management Policy authorizes the use of various derivative instruments, including exchange traded futures and option contracts, forward purchase and sales contracts, and swap transactions to reduce exposure to fluctuations in the price of power and natural gas. Cleco applies the authoritative guidance as it relates to derivatives and hedging to determine whether the market risk-sensitive instruments and positions are required to be marked-to-market. Generally, Cleco Power's market risk-sensitive instruments and positions qualify for the normal-purchase, normal-sale exception to mark-to-market accounting because Cleco Power takes physical delivery and the instruments and positions are used to satisfy customer requirements.

Cleco Power may enter into positions to mitigate the volatility in customer fuel costs. These positions are marked-to-market with the resulting gain or loss recorded on the balance sheet as a component of energy risk management assets or liabilities. Such gain or loss is deferred as a component of deferred fuel assets or liabilities in accordance with regulatory policy. When these positions close, actual gains or losses will be included in the FAC and reflected on customers' bills as a component of the fuel cost adjustment. There were no open positions at June 30, 2013 or December 31, 2012.

Cleco and Cleco Power maintain a master netting agreement policy and monitor credit risk exposure through review of counterparty credit quality, counterparty credit exposure, and counterparty concentration levels. Cleco manages these risks by establishing appropriate credit and concentration limits on transactions with counterparties and by requiring contractual guarantees, cash deposits, or letters of credit from counterparties or their affiliates, as deemed necessary. Cleco Power has agreements in place with various counterparties that authorize the netting of financial buys and sells and contract payments to mitigate credit risk for transactions entered into for risk management purposes.

Cleco has entered into various contracts to mitigate the volatility in interest rate risk. These contracts include, but are not limited to, interest rate swaps and treasury rate locks. For these contracts in which Cleco is hedging the variability of cash flows related to forecasted transactions that qualify as cash flow hedges, the changes in the fair value of such derivative instruments are reported in other comprehensive income. To qualify for hedge accounting, the relationship between the hedging instrument and the hedged item must be documented to include the risk management objective and strategy, and, at inception and on an ongoing basis, the effectiveness of the hedge in offsetting the changes in the cash flows of the item being hedged. Gains or losses accumulated in other comprehensive income are reclassified as earnings in the periods in which earnings are affected by the variability of the cash flows of the hedged item. The ineffective portions of hedges will be recognized in current period earnings unless management determines that it is probable that the costs will be recovered through the rate-making process. If management determines that it is probable that the costs will be recovered from customers, then they will be recognized as a regulatory asset or liability and amortized to earnings over the life of the related debt. For those contracts in which Cleco is hedging the variability of cash flows related to forecasted transactions that do not qualify as cash flow hedges, the changes in the fair value of such derivative instruments will be recognized in current period earnings unless management determines that it is probable that the costs will be recovered from customers through the rate-making process. If management determines that it is probable that the costs will be recovered from customers, then they will be recognized as a regulatory asset or liability and amortized to earnings over the life of the related debt. For more information on the interest rate risk contracts, see Note 4 — "Fair Value Accounting — Interest Rate Derivatives."

Earnings per Average Common Share

The following tables show the calculation of basic and diluted earnings per share:

	FOR THE THREE MONTHS ENDED JUNE 30,					
			2013			2012
(THOUSANDS, EXCEPT SHARES AND PER SHARE AMOUNTS)	INCOME	SHARES	PER SHARE AMOUNT	INCOME	SHARES	PER SHARE AMOUNT
Basic net income applicable to common stock	$42,032	60,445,617	$0.70	$46,686	60,421,028	$ 0.77
Effect of dilutive securities						
Add: stock option grants		—			1,504	
Add: restricted stock (LTICP)		267,757			238,170	
Diluted net income applicable to common stock	$42,032	60,713,374	$0.69	$46,686	60,660,702	$ 0.77

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	FOR THE SIX MONTHS ENDED JUNE 30,					
			2013			2012
(THOUSANDS, EXCEPT SHARES AND PER SHARE AMOUNTS)	INCOME	SHARES	PER SHARE AMOUNT	INCOME	SHARES	PER SHARE AMOUNT
Basic net income applicable to common stock	$69,166	60,419,588	$ 1.15	$76,718	60,387,388	$ 1.27
Effect of dilutive securities						
Add: stock option grants		—			4,455	
Add: restricted stock (LTICP)		250,524			233,534	
Diluted net income applicable to common stock	$69,166	60,670,112	$ 1.14	$76,718	60,625,377	$ 1.27

Stock option grants are excluded from the computation of diluted earnings per share if the exercise price is higher than the average market price. There were no stock option grants excluded from the computation of diluted earnings per share for the three and six months ended June 30, 2012, due to the average market price being higher than the exercise prices of the stock options. All stock options were exercised during 2012 and no additional options were granted during the six months ended June 30, 2013.

Stock-Based Compensation

At June 30, 2013, Cleco had two stock-based compensation plans, the ESPP and the LTICP. Substantially all employees, excluding officers and general managers, may choose to participate in the ESPP and purchase a limited amount of

common stock at a discount through a stock option agreement. Options or restricted shares of stock, known as non-vested stock as defined by the authoritative guidance on stock-based compensation, common stock equivalents, and stock appreciation rights may be granted to certain officers, key employees, or directors of Cleco Corporation and its subsidiaries pursuant to the LTICP.

During the six months ended June 30, 2013, Cleco granted 139,048 shares of non-vested stock to certain officers, key employees, and directors of Cleco Corporation and its subsidiaries pursuant to the LTICP.

Cleco and Cleco Power reported pre-tax compensation expense for their share-based compensation plans as shown in the following table:

	CLECO CORPORATION		CLECO POWER		CLECO CORPORATION		CLECO POWER	
	FOR THE THREE MONTHS ENDED JUNE 30,				FOR THE SIX MONTHS ENDED JUNE 30,			
(THOUSANDS)	2013	2012	2013	2012	2013	2012	2013	2012
Equity classification								
Non-vested stock	$1,474	$1,076	$381	$277	$2,902	$2,132	$711	$491
Stock options	—	5	—	—	—	9	—	—
Total equity classification	$1,474	$1,081	$381	$277	$2,902	$2,141	$711	$491
Liability classification								
Common stock equivalent units	$—	$518	$—	$210	$1	$706	$1	$294
	$1,474	$1,599	$381	$487	$2,903	$2,847	$712	$785

Total pre-tax compensation expense								
Tax benefit	$567	$615	$146	$187	$1,117	$1,095	$274	$302

Note 2 — Recent Authoritative Guidance
The Registrants adopted, or will adopt, the recent authoritative guidance listed below on their respective effective dates.
In July 2012, FASB issued guidance on testing indefinite-lived intangible assets for impairment. This guidance is intended to reduce costs and complexity of testing indefinite-lived intangible assets other than goodwill for impairment. Entities are allowed to perform a "qualitative" assessment to determine whether further impairment testing of indefinite-lived intangible assets is necessary, similar in approach to the goodwill impairment test. The adoption of this guidance is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. The adoption of this guidance did not have any impact on the financial condition or results of operations of the Registrants.
In February 2013, FASB clarified the scope of revised disclosure requirements related to balance sheet offsetting that was issued in December 2011. The amendment clarifies that the scope applies to derivatives accounted for in accordance with the authoritative guidance for derivatives and hedging. The adoption of this revision is required for interim and annual periods beginning on or after January 1, 2013. The adoption of this revision did not have any impact on the financial condition or results of operations of the Registrants because it

relates to disclosures, and no additional disclosures were required.
In February 2013, FASB revised the disclosure requirements related to items reclassified out of accumulated other comprehensive income. This guidance is intended to improve the transparency of changes in OCI. This revision is effective for fiscal years, and interim periods within those years, beginning after December 15, 2012. Cleco adopted the revisions to this amendment during the first quarter of 2013. The adoption of this revision did not have any impact on the financial condition or results of operations of the Registrants because it relates to disclosures. For more information on items reclassified out of accumulated other comprehensive income, see Note 14 — "Accumulated Other Comprehensive Loss."
In March 2013, FASB issued guidance for the recognition, measurement, and disclosure of obligations resulting from joint and several liability arrangements for which the total amount of the obligation is fixed at the reporting date. The adoption of this guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. The adoption of this guidance is not expected to have a material impact on the financial condition or results of operations of the Registrants.
In April 2013, FASB issued guidance on applying the liquidation basis of accounting and the related disclosure

requirements. Under this accounting standards update, an entity must use the liquidation basis of accounting to present its financial statements when it determines that liquidation is imminent, unless the liquidation is the same as that under the plan specified in an entity's governing documents created at its inception. The adoption of this standard is effective for entities that determine liquidation is imminent during annual reporting periods beginning after December 15, 2013, and interim reporting periods therein. The adoption of this guidance will not have any effect on the financial condition or results of operations of the Registrants.

Note 3 — Regulatory Assets and Liabilities

Cleco Power follows the authoritative guidance on regulated operations, which allows utilities to capitalize or defer certain costs based on regulatory approval and management’s ongoing assessment that it is probable these items will be recovered through the ratemaking process. The following table summarizes Cleco Power’s regulatory assets and liabilities at June 30, 2013 and December 31, 2012:

(THOUSANDS)	AT JUNE 30, 2013	AT DEC. 31, 2012
Regulatory assets – deferred taxes, net	$213,061	$210,445
Mining costs	$15,294	$16,569
Interest costs	6,123	6,304
Asset removal costs	901	867
Postretirement plan costs	149,884	156,458
Tree trimming costs	4,299	5,656
Training costs	7,252	7,330
Storm surcredits, net	7,654	6,211
Construction carrying costs	1,563	4,697
Lignite mining agreement contingency	3,781	3,781
Power purchase agreement capacity costs	11,912	6,217
AMI deferred revenue requirement	2,907	1,483
AFUDC equity gross-up	73,785	74,158
Rate case costs	313	581
Acadia Unit 1 acquisition costs	2,813	2,865
IRP/RFP costs	—	39
AMI pilot costs	—	22
Financing costs	9,957	7,282
Biomass costs	129	145
Total regulatory assets – other	$298,567	$300,665
Construction carrying costs	—	(8,255)
Fuel and purchased power	9,593	7,833
Total regulatory assets, net	$521,221	$510,688

Tree Trimming Costs

In January 2008, the LPSC approved Cleco Power’s request to establish a regulatory asset for costs incurred to trim, cut, or remove trees that were damaged by hurricanes Katrina and Rita, but were not addressed as part of the restoration efforts. The regulatory asset was capped at $12.0 million in actual expenditures plus a 12.4% grossed-up rate of return. Recovery of these expenditures was requested in Cleco Power’s base rate application filed in July 2008 and was approved by the LPSC in October 2009. In February 2010, Cleco Power began amortizing the regulatory asset over a five-year period.

On January 29, 2013, Cleco Power requested to expend and defer up to $8.0 million in additional tree management costs. Cleco Power requested similar accounting treatment as authorized in the initial tree extraction request and requested authorization to accrue actual expenditures to a regulatory asset through the completion date of the tree extraction effort. Cleco Power anticipates a completion date of December 31, 2014 for this phase of the tree extraction project. The LPSC approved this request on April 4, 2013.

Construction Carrying Costs
In February 2006, the LPSC approved Cleco Power's plans to build Madison Unit 3. Terms of the approval included authorization for Cleco Power to collect from customers a portion of the carrying costs of capital during the construction phase of the unit. Cleco Power's retail rate plan established that Cleco Power return carrying costs to customers and record a regulatory asset for all carrying costs incurred by Cleco Power above the actual amount collected from customers. These costs are being amortized over a four-year period. As of June 30, 2013, Cleco Power had returned $166.0 million to customers, which represents all amounts due to be refunded to customers.

Power Purchase Agreement Capacity Costs
In March 2012, Cleco Power received approval from the LPSC for a three-year power purchase agreement with Evangeline providing 730 MW of capacity and energy beginning May 1, 2012, and ending April 30, 2015. The LPSC order allows Cleco Power to defer and recover a portion of capacity costs associated with the power purchase agreement. The deferred costs are being collected over the term of the contract.

AMI Deferred Revenue Requirement
In February 2011, the LPSC approved Cleco Power's stipulated settlement in Docket No. U-31393 allowing Cleco Power to defer, as a regulatory asset, the estimated revenue requirements for the AMI project. The amount of the regulatory asset, including carrying charges, is capped by the LPSC at $20.0 million. The regulatory asset will amortize over the economic life of the project, currently estimated at 15 years.

Financing Costs
In 2011, Cleco Power entered into and settled two treasury rate locks. Also in 2011, Cleco Power entered into a forward starting swap contract. These derivatives were entered into in order to mitigate the interest rate exposure on coupon payments related to forecasted debt issuances. In May 2013, the forward starting interest rate swap was settled at a loss of $3.3 million. Cleco Power deferred $2.9 million of the losses as a regulatory asset. As a result of management's assessment that it is probable that these costs will be recovered through the rate-making process, in May 2013, Cleco Power began amortizing the regulatory asset over the 25-year term of the related debt.

Fuel and Purchased Power Costs
The cost of fuel used for electric generation and the cost of power purchased for utility customers are recovered through the LPSC-established FAC, which enables Cleco Power to pass on to its customers substantially all such charges. For the three months ended June 30, 2013, approximately 88% of Cleco Power's total fuel cost was regulated by the LPSC, while the remainder was regulated by FERC.
The $1.8 million increase in the under-recovered costs was primarily due to an increase in per-unit costs of fuel and purchased power and higher volumes of fuel used for electric

generation, partially offset by lower volumes of purchased power.

Note 4 — Fair Value Accounting

The amounts reflected in Cleco and Cleco Power's Condensed Consolidated Balance Sheets at June 30, 2013 and December 31, 2012, for cash and cash equivalents, restricted cash and cash equivalents, accounts receivable, other accounts receivable, accounts payable, and short-term debt

approximate fair value because of their short-term nature. Estimates of the fair value of Cleco and Cleco Power's long-term debt are based upon the quoted market price for the same or similar issues or by a discounted present value analysis of future cash flows using current rates obtained by Cleco and Cleco Power for debt with similar maturities. The following tables summarize the carrying value and estimated market value of Cleco and Cleco Power's financial instruments subject to fair value accounting.

Cleco

	AT JUNE 30, 2013		AT DEC. 31, 2012	
(THOUSANDS)	CARRYING VALUE	ESTIMATED FAIR VALUE	CARRYING VALUE	ESTIMATED FAIR VALUE
Financial instruments not marked-to-market:				
Cash and cash equivalents	$7,567	$ 7,567	$31,020	$ 31,020
Restricted cash and cash equivalents	$12,490	$ 12,490	$14,221	$ 14,221
Short-term debt, excluding debt issuance costs	$3,000	$ 3,000	$—	$ —
Long-term debt, excluding debt issuance costs	$1,338,069	$ 1,455,061	$1,345,198	$ 1,579,674

Cleco Power

	AT JUNE 30, 2013		AT DEC. 31, 2012	
(THOUSANDS)	CARRYING VALUE	ESTIMATED FAIR VALUE	CARRYING VALUE	ESTIMATED FAIR VALUE
Financial instruments not marked-to-market:				
Cash and cash equivalents	$2,743	$ 2,743	$23,368	$ 23,368
Restricted cash and cash equivalents	$12,394	$ 12,394	$14,124	$ 14,124
Short-term debt, excluding debt issuance costs	$3,000	$ 3,000	$—	$ —
Long-term debt, excluding debt issuance costs	$1,313,069	$ 1,430,061	$1,320,198	$ 1,554,674

At June 30, 2013, Cleco and Cleco Power were exposed to concentrations of credit risk through their short-term investments classified as cash equivalents and restricted cash equivalents. Cleco had $16.3 million ($3.9 million of cash equivalents and $12.4 million of restricted cash equivalents) in short-term investments in institutional money market funds. Cleco Power had $12.6 million ($0.3 million of cash equivalents and $12.3 million of restricted cash equivalents) in short-term investments in institutional money market funds. If the money market funds failed to perform under the terms of the investments, Cleco and Cleco Power would be exposed to a loss of the invested amounts. Collateral on these types of investments is not required by either Cleco or Cleco Power.

Restricted Investments

In September 2007, the LPSC authorized the funding and securitization of a $50.0 million reserve for Cleco Power's future storm costs. On July 1, 2012, Cleco Power transferred $13.0 million of the related restricted cash and cash equivalents to an outside investment manager. Investments made by the investment manager are restricted to the criteria established by management in Cleco Power's guidelines for short-term investments. At June 30, 2013, the investments included cash and cash equivalents and debt securities.

The cash and cash equivalents are reflected in Cleco and Cleco Power’s Condensed Consolidated Balance Sheets at June 30, 2013, as restricted cash and cash equivalents and approximate fair value because of their short-term nature. The debt securities are recorded at fair value on Cleco and Cleco Power’s Condensed Consolidated Balance Sheets at June 30, 2013, as restricted investments. The investments in debt securities include municipal bonds, corporate bonds, and commercial paper with original maturity dates of more than three months and are classified as available-for-sale securities and reported at fair value. Because Cleco Power’s

investment strategy for these investments is within the requirements established by the LPSC for the restricted reserve fund, realized and unrealized gains and losses, interest income, investment management fees, and custody fees are recorded directly to Cleco Power’s restricted storm reserve rather than in earnings or other comprehensive income. As a result, no amounts will be recorded to other comprehensive income for these investments.

Quarterly, Cleco Power’s available-for-sale debt securities are evaluated on an individual basis to determine if a decline in fair value below the carrying value is other-than-temporary.

Management determines whether it intends to sell or if it is more likely than not that it will be required to sell impaired securities. This determination considers current and forecasted liquidity and regulatory requirements. For Cleco Power’s impaired debt securities for which there was no intent or expected requirement to sell, the evaluation assesses whether it is likely the amortized cost will be recovered considering the nature of the securities, credit rating, financial condition of the issuer, or the extent and duration of the unrealized loss and market conditions. If Cleco Power determines that an other-than-temporary decline in value exists on its debt securities, the investments would be written down to fair value with a new basis established. Declines in fair value below cost basis that are determined to be other-than-temporary would be recorded to Cleco Power’s restricted storm reserve. The unrealized losses on Cleco Power’s debt securities as of June 30, 2013, were caused by interest rate movements. Cleco Power does not intend to sell the debt securities and has determined it is more likely than not that it will not be required to sell the investments before recovery of the amortized cost value. Cleco Power determined there were no material other-than-temporary impairments on its debt securities at June 30, 2013.

The following table provides a reconciliation of Cleco Power's available-for-sale debt securities from amortized cost to fair value at June 30, 2013 and December 31, 2012:

	AT JUNE 30, 2013				AT DEC. 31, 2012			
(THOUSANDS)	AMORTIZED COST	TOTAL UNREALIZED GAINS [1]	TOTAL UNREALIZED LOSSES [1]	FAIR VALUE	AMORTIZED COST	TOTAL UNREALIZED GAINS [1]	TOTAL UNREALIZED LOSSES [1]	FAIR VALUE
Municipal bonds	$9,774	$ 3	$ 23	$9,754	$10,228	$ 3	$ 28	$10,203
Corporate bonds	516	—	4	512	—	—	—	—
Commercial paper	2,282	—	—	2,282	649	—	—	649
Total available-for-sale debt securities	$12,572	$ 3	$ 27	$12,548	$10,877	$ 3	$ 28	$10,852

[1] Unrealized gains and losses are recorded to the restricted storm reserve.

Cleco Power recognized less than $0.1 million unrealized mark-to-market losses and less than $0.1 million unrealized mark-to-market gains in the restricted storm reserve for the three and six months ended June 30, 2013, respectively.
The following table summarizes the debt securities that were in an unrealized loss position at June 30, 2013, but for which no other-than-temporary impairment was recognized:

	LESS THAN 12 MONTHS		12 MONTHS OR LONGER	
(THOUSANDS)	AGGREGATE UNREALIZED LOSS	AGGREGATE RELATED FAIR VALUE	AGGREGATE UNREALIZED LOSS	AGGREGATE RELATED FAIR VALUE
Municipal bonds	$23	$5,528	$—	$—
Corporate bonds	4	512	—	—
Total	$27	$6,040	$—	$—

At June 30, 2013, the fair value of Cleco Power's available-for-sale debt securities by contractual maturity was:

(THOUSANDS)	AT JUNE 30, 2013
One year or less	$6,191
Over one year through five years	6,357
Total fair value	$12,548

There were no realized gains or losses on Cleco Power's available-for-sale debt securities during the three and six months ended June 30, 2013. Realized gains and losses will be determined on a specific identification basis.

Interest Rate Derivatives

Forward Starting Interest Rate Swap

On November 14, 2011, Cleco Power entered into a pay fixed/receive variable forward starting interest rate swap contract in order to mitigate the interest rate exposure on coupon payments related to the remaining $50.0 million fixed-rate forecasted debt issuance. The forward starting interest rate swap had a spot 30-year all-in swap rate of 3.05%, notional amount of $50.0 million, with the pricing date of May 14, 2013, or the issuance of the notes, whichever was earlier. The forward starting interest rate swap met the criteria of a cash flow hedge under the authoritative guidance as it related to derivatives and hedging and was carried on the balance sheet at its fair value. Because of the inputs and common techniques used to calculate fair value, the swap valuation was considered Level 2.

During the first quarter of 2013, Cleco determined that the forward starting interest rate swap ceased to be highly effective in offsetting changes in the cash flows of the forecasted coupon payments and discontinued hedge accounting prospectively. The forward starting interest rate swap was settled on May 7, 2013, upon pricing of the 2008 Series B GO Zone bonds. Cleco Power settled the forward starting interest rate swap at a loss of $3.3 million. In March 2013, a $0.4 million loss on the forward starting interest rate swap was recorded in accumulated other comprehensive income. At June 30, 2013, Cleco Power deferred $2.9 million of losses as a regulatory asset related to the settlement of the forward starting interest rate swap as a result of management’s assessment that it is probable that the losses will be recovered through the rate-making process. In May 2013, Cleco Power began amortizing these amounts over the 25-year term of the related debt. For more information about the 2008 Series B GO Zone bonds, see Note 5 — “Debt.”

Fair Value Measurements and Disclosures

The authoritative guidance on fair value measurements requires entities to classify assets and liabilities that are either measured or disclosed at their fair value according to three different levels depending on the inputs used in determining fair value.

The following tables disclose for Cleco and Cleco Power the fair value of financial assets and liabilities measured or disclosed on a recurring basis and within the scope of the authoritative guidance for fair value measurements and disclosures.

Cleco

	CLECO CONSOLIDATED FAIR VALUE MEASUREMENTS AT REPORTING DATE USING:							
(THOUSANDS)	AT JUNE 30, 2013	QUOTED PRICES IN ACTIVE MARKETS FOR IDENTICAL ASSETS (LEVEL 1)	SIGNIFICANT OTHER OBSERVABLE INPUTS (LEVEL 2)	SIGNIFICANT UNOBSERVABLE INPUTS (LEVEL 3)	AT DEC. 31, 2012	QUOTED PRICES IN ACTIVE MARKETS FOR IDENTICAL ASSETS (LEVEL 1)	SIGNIFICANT OTHER OBSERVABLE INPUTS (LEVEL 2)	SIGNIFICANT UNOBSERVABLE INPUTS (LEVEL 3)
Asset Description								
Institutional money market funds	$18,672	$ —	$ 18,672	$ —	$39,489	$ —	$ 39,489	$ —
Municipal bonds	9,754	—	9,754	—	10,203	—	10,203	—
Corporate bonds	512	—	512	—	—	—	—	—
Total assets	$28,938	$ —	$ 28,938	$ —	$49,692	$ —	$ 49,692	$ —
Liability Description								
Interest rate derivatives	$—	$ —	$ —	$ —	$2,627	$ —	$ 2,627	$ —
Long-term debt	1,455,061	—	1,455,061	—	1,579,674	—	1,579,674	—
Total liabilities	$1,455,061	$ —	$ 1,455,061	$ —	$1,582,301	$ —	$ 1,582,301	$ —

Cleco Power

	CLECO POWER FAIR VALUE MEASUREMENTS AT REPORTING DATE USING:							
(THOUSANDS)	AT JUNE 30, 2013	QUOTED PRICES IN ACTIVE MARKETS FOR IDENTICAL ASSETS (LEVEL 1)	SIGNIFICANT OTHER OBSERVABLE INPUTS (LEVEL 2)	SIGNIFICANT UNOBSERVABLE INPUTS (LEVEL 3)	AT DEC. 31, 2012	QUOTED PRICES IN ACTIVE MARKETS FOR IDENTICAL ASSETS (LEVEL 1)	SIGNIFICANT OTHER OBSERVABLE INPUTS (LEVEL 2)	SIGNIFICANT UNOBSERVABLE INPUTS (LEVEL 3)
Asset Description								
Institutional money market funds	$14,976	$ —	$ 14,976	$ —	$33,292	$ —	$ 33,292	$ —
Municipal bonds	9,754	—	9,754	—	10,203	—	10,203	—
Corporate bonds	512	—	512	—	—	—	—	—
Total assets	$25,242	$ —	$ 25,242	$ —	$43,495	$ —	$ 43,495	$ —
Liability Description								
Interest rate derivatives	$—	$ —	$ —	$ —	$2,627	$ —	$ 2,627	$ —
Long-term debt	1,430,061	—	1,430,061	—	1,554,674	—	1,554,674	—
Total liabilities	$1,430,061	$ —	$ 1,430,061	$ —	$1,557,301	$ —	$ 1,557,301	$ —

The institutional money market funds were reported on the Cleco Condensed Consolidated Balance Sheet in cash and cash equivalents, current restricted cash and cash equivalents, non-current restricted cash and cash equivalents, and restricted investments of $3.9 million, $8.1 million, $4.4 million, and $2.3 million, respectively, at June 30, 2013. At Cleco Power, the institutional money market funds were reported on the Condensed Consolidated Balance Sheet in cash and cash equivalents, current restricted cash and cash equivalents, non-current restricted cash and cash equivalents, and restricted investments and were $0.3 million, $8.1 million, $4.3 million, and $2.3 million, respectively, at June 30, 2013.

The municipal and corporate bonds were reported on Cleco and Cleco Power's Condensed Consolidated Balance Sheets in restricted investments in the amount of $9.8 million and $0.5 million at June 30, 2013, respectively.

Cleco utilizes different valuation techniques for fair value calculations. In order to measure the fair value for Level 1 assets and liabilities, Cleco obtains the closing price from published indices in active markets for the various instruments and multiplies this price by the appropriate number of instruments held. Level 2 fair values for assets and liabilities are determined by obtaining the closing price from published indices in active markets for instruments that are similar to Cleco's assets and liabilities. The fair value obtained is then discounted to the current period using a U.S. Treasury published interest rate as a proxy for a risk-free rate of return. For some options, Cleco uses the Black-Scholes model using observable and available inputs to calculate the fair value, consistent with the income approach. These techniques have

been applied consistently from fiscal period to fiscal period. Level 3 fair values allow for situations in which there is little, if any, market activity for the asset or liability at the measurement date. Cleco had no Level 3 assets or liabilities at June 30, 2013 or December 31, 2012.

The assets and liabilities reported at fair value are grouped into classes based on the underlying nature and risks associated with the individual asset or liability.

The Level 2 institutional money market funds asset consists of a single class. In order to capture interest income and minimize risk, cash is invested in money market funds that invest primarily in short-term securities issued by the U.S. Treasury in order to maintain liquidity and achieve the goal of a net asset value of a dollar. The risks associated with this class are counterparty risk of the fund manager and risk of price volatility associated with the underlying securities of the fund.

The Level 2 municipal bonds and the Level 2 corporate bonds consisted of a single class. In order to maximize income and to meet the requirements established by the LPSC for the restricted reserve fund, restricted cash and cash equivalents were invested in short-term, fixed-income debt instruments in order to maintain safety and liquidity. The risks associated with this class are counterparty risk of the fund manager and risk of price volatility associated with the municipal bonds and corporate bonds. Quarterly, Cleco receives reports from the trustee for the investment manager which provides the fair value measurement. Cleco performs an evaluation of those reports to verify the fair value of the securities.

The Level 2 interest rate derivative was one forward starting interest rate swap liability that consisted of a single class that contained only one instrument. The risks were changes in the three-month LIBOR rate and counterparty risk. This instrument was with a direct counterparty and not traded through an exchange.

The Level 2 long-term debt liability consists of a single class. In order to fund capital requirements, Cleco issues long-term, fixed rate debt with various tenors. The fair value of this class fluctuates as the market interest rates for fixed rate debt with similar tenors and credit ratings change. The fair value of the debt could also change from period to period due to changes in the credit rating of the Cleco entity that issued the debt.

Cleco has a policy that transfers between Levels 1, 2, and 3 are recognized at the end of a reporting period. During the six months ended June 30, 2013, and the year ended December 31, 2012, Cleco did not experience any transfers between levels.

Derivatives and Hedging

The authoritative guidance on derivatives and hedging requires entities to provide transparent disclosures about a company’s derivative activities and how the related hedged items affect a company’s financial position, financial performance, and cash flows. Cleco is required to provide qualitative and quantitative disclosures about derivative fair value, gains and losses, and credit-risk-related contingent features in derivative agreements.

For the three and six months ended June 30, 2013, there was no effect on Cleco and Cleco Power’s Condensed Consolidated Statements of Income for derivatives not designated as hedging instruments. For the three and six months ended June 30, 2012, Cleco and Cleco Power recognized losses of $4.1 million and $7.6 million, respectively, on derivatives not designated as hedging instruments. In accordance with the authoritative guidance for regulated operations, there were no unrealized gains or losses and no deferred losses associated with fuel cost hedges reported in Accumulated deferred fuel on the balance sheet as of June 30, 2013 and December 31, 2012. As gains and losses are realized in future periods, they will be reported as Fuel used for electric generation on Cleco and Cleco Power’s Condensed Consolidated Statements of Income.

At December 31, 2012, Cleco and Cleco Power’s Condensed Consolidated Balance Sheets had no derivative instruments not designated as hedging instruments.

At June 30, 2013 and December 31, 2012, Cleco Power had no open positions hedged for natural gas.

During the first quarter of 2013, Cleco determined that the forward starting interest rate swap ceased to be highly effective in offsetting changes in the cash flows of the forecasted coupon payments and discontinued hedge accounting prospectively. The forward starting interest rate swap was settled on May 7, 2013, upon pricing of the 2008 Series B GO Zone bonds. Cleco Power settled the forward starting interest rate swap at a loss of $3.3 million. In March 2013, a $0.4 million loss on the forward starting interest rate swap was recorded in accumulated other comprehensive income. At June 30, 2013, Cleco Power deferred $2.9 million of losses as a regulatory asset related to the settlement of the forward starting interest rate swap as a result of management’s assessment that it is probable that the losses will be recovered through the rate-making process. In May 2013, Cleco Power

began amortizing these amounts over the 25-year term of the related debt. For more information about the 2008 Series B GO Zone bonds, see Note 5 — “Debt.”

The following table presents the effect of derivatives designated as hedging instruments on Cleco and Cleco Power’s Condensed Consolidated Statements of Income for the three and six months ended June 30, 2013 and 2012.

	FOR THE THREE MONTHS ENDED JUNE 30,			
	2013		2012	
(THOUSANDS)	AMOUNT OF GAIN RECOGNIZED IN OCI	AMOUNT OF LOSS RECLASSIFIED FROM ACCUMULATED OCI INTO INCOME	AMOUNT OF LOSS RECOGNIZED IN OCI	AMOUNT OF LOSS RECLASSIFIED FROM ACCUMULATED OCI INTO INCOME

		(EFFECTIVE PORTION)		(EFFECTIVE PORTION)
Interest rate derivatives [1]	$—	$(59)*	$(6,191)	$(57)*

* The loss reclassified from accumulated OCI into income (effective portion) is reflected in interest charges.
[1] During the three months ended June 30, 2013, Cleco recorded $2.8 million of ineffectiveness and losses and for the three months ended June 30, 2012 Cleco had no ineffectiveness and losses related to the interest rate derivatives as a regulatory asset.

	FOR THE SIX MONTHS ENDED JUNE 30,			
	2013		2012	
(THOUSANDS)	AMOUNT OF GAIN RECOGNIZED IN OCI	AMOUNT OF LOSS RECLASSIFIED FROM ACCUMULATED OCI INTO INCOME (EFFECTIVE PORTION)	AMOUNT OF LOSS RECOGNIZED IN OCI	AMOUNT OF LOSS RECLASSIFIED FROM ACCUMULATED OCI INTO INCOME (EFFECTIVE PORTION)
Interest rate derivatives [1]	$1,762	$(79)*	$(1,535)	$(57)*

* The loss reclassified from accumulated OCI into income (effective portion) is reflected in interest charges.
[1] During the six months ended June 30, 2013 and 2012, Cleco recorded ineffectiveness and losses related to the interest rate derivatives as a regulatory asset of $3.3 million and $2.6 million, respectively.

At June 30, 2013, Cleco Power expected $0.3 million of the effective portion of deferred net losses related to interest rate derivatives to be reclassed from accumulated OCI to interest charges over the next 12 months.
Note 5 — Debt

Short-term Debt
At June 30, 2013, Cleco and Cleco Power had $3.0 million of short-term debt outstanding under Cleco Power’s uncommitted line of credit. The short-term debt had an interest rate of 1.95% and was repaid on July 1, 2013. Cleco and Cleco Power had no short-term debt outstanding at December 31, 2012.

Long-term Debt
At June 30, 2013, Cleco’s long-term debt outstanding was $1.34 billion, of which $16.7 million was due within one year. The long-term debt due within one year at June 30, 2013, represents $14.5 million principal payments for the Cleco Katrina/Rita storm recovery bonds and $2.2 million of capital lease payments.
For Cleco, long-term debt decreased $8.0 million from December 31, 2012, primarily due to a $75.0 million repayment of senior notes, $60.0 million of solid waste disposal bonds reacquired in March 2013, a $25.0 million payment on the bank term loan entered into in March 2013, a $7.1 million scheduled Cleco Katrina/Rita storm recovery bond principal payment made in March 2013, and a $1.1 million decrease in capital lease obligations. These decreases were partially offset by a $60.0 million bank term loan entered into in March 2013, the issuance of $50.0 million Series A GO Zone bonds

and $50.0 million Series B GO Zone bonds in May 2013, and debt discount amortizations of $0.2 million.
At June 30, 2013, Cleco Power’s long-term debt outstanding was $1.32 billion of which $16.7 million was due within one year. The long-term debt due within one year at June 30, 2013, represents $14.5 million principal payments for the Cleco Katrina/Rita storm recovery bonds and $2.2 million of capital lease payments.
For Cleco Power, long-term debt decreased $8.0 million from December 31, 2012, primarily due to a $75.0 million repayment of senior notes, $60.0 million of solid waste disposal bonds reacquired in March 2013, a $25.0 million payment on the bank term loan entered into in March 2013, a $7.1 million scheduled Cleco Katrina/Rita storm recovery bond principal payment made in March 2013, and a $1.1 million decrease in capital lease obligations. These decreases were partially offset by a $60.0 million bank term loan entered into in March 2013, the issuance of $50.0 million Series A GO Zone bonds and $50.0 million Series B GO Zone bonds in May 2013, and debt discount amortizations of $0.2 million.
Cleco Power’s $60.0 million solid waste disposal facility bonds due 2037, which were issued by the Rapides Finance Authority for the benefit of Cleco Power in November 2007, were required to be mandatorily tendered by the bondholders for purchase on March 1, 2013, pursuant to the terms of the indenture. The bonds were issued in connection with a loan agreement between the Rapides Finance Authority and Cleco Power. On March 1, 2013, Cleco Power purchased all $60.0 million outstanding bonds at face value plus $1.6 million of accrued interest, using draws under Cleco Power’s revolving credit facility. In connection with the purchase, the interest rate of the bonds will reset each week based on the Securities Industry and Financial Markets Association index. The initial interest rate of the bonds at March 1, 2013, was 0.11% per annum. Interest expense will continue to be recorded with a corresponding amount recorded as interest income, excluding amortization of debt issuance costs. Although the bonds remain outstanding, Cleco Power has the right to redeem and cancel the debt at any time without approval of the Rapides Finance Authority. In accordance with the authoritative guidance, the bonds are considered extinguished and Cleco Power is holding the debt as treasury bonds, resulting in a net presentation on Cleco and Cleco Power's Condensed Consolidated Balance Sheets. Cleco Power has the option to remarket the bonds for new terms and new interest rates, both to be determined by market conditions.
On March 20, 2013, Cleco Power entered into a bank term loan agreement in the amount of $60.0 million. Proceeds of the loan agreement were used to repay draws under Cleco Power’s revolving credit facility. Cleco Power made a $25.0 million payment on the loan on May 8, 2013, reducing the balance outstanding to $35.0 million. The interest rate under the agreement at June 30, 2013, was 1.075%. The interest rate is based on LIBOR and resets on a monthly basis. The loan matures on May 29, 2015.
On May 3, 2013, Cleco Power remarketed $50.0 million of its 2008 Series A GO Zone bonds which had previously been purchased by Cleco Power and was being held as treasury bonds, at an interest rate based on 0.82% plus 65% of LIBOR. The rate resets monthly. The 2008 Series A GO Zone bonds will be subject to remarketing on May 3, 2015. The proceeds were used to fund the partial repayment of the $60.0 million solid waste disposal bonds described above.

On May 8, 2013, Cleco Power remarketed $50.0 million of its 2008 Series B GO Zone bonds which had previously been purchased by Cleco Power and was being held as treasury bonds, at a fixed interest rate of 4.25%. The 2008 Series B GO Zone bonds mature on December 1, 2038. The proceeds were used to partially fund the maturity of Cleco Power's 5.375% senior notes on May 1, 2013.

Credit Facilities
At June 30, 2013, Cleco Corporation had $25.0 million borrowings outstanding under its $250.0 million credit facility at an interest rate of 1.70%. The borrowings under the credit facility are considered to be long-term because the credit facility expires in 2016. The borrowing costs under the facility are equal to one-month LIBOR plus 1.50% or ABR, plus facility fees of 0.25%. The existing borrowings had 30-day terms. Of the $25.0 million borrowings outstanding at June 30, 2013, $15.0 million matured and was renewed for an additional amount on July 15, 2013 and the remaining $10.0 million matured and was not renewed on July 31, 2013.

At June 30, 2013, Cleco Power had no borrowings outstanding under its existing credit facility.

Note 6 — Pension Plan and Employee Benefits

Pension Plan and Other Benefits Plan

Most employees hired before August 1, 2007, are covered by a non-contributory, defined benefit pension plan. Benefits under the plan reflect an employee's years of service, age at retirement, and highest total average compensation for any consecutive five calendar years during the last ten years of employment with Cleco. Cleco's policy is to base its contributions to the employee pension plan upon actuarial computations utilizing the projected unit credit method, subject to the IRS's full funding limitation. In January 2013, Cleco Power made $34.0 million in discretionary contributions to the pension plan designated for the 2012 plan year. Cleco does not expect to make any additional discretionary contributions to the pension plan for the remainder of the year. During 2012, Cleco made no discretionary or required contributions to the pension plan. The required contributions are driven by liability funding target percentages set by law which could cause the required contributions to be uneven among the years. The ultimate amount and timing of the contributions may be affected by changes in the discount rate, changes in the funding regulations, and actual returns on fund assets. Cleco Power is considered the plan sponsor and Support Group is considered the plan administrator.

Cleco's retirees and their dependents are eligible to receive medical, dental, vision, and life insurance benefits (other benefits). Cleco recognizes the expected cost of these other benefits during the periods in which the benefits are earned.

The components of net periodic pension and other benefit cost for the three and six months ended June 30, 2013 and 2012, are as follows:

	PENSION BENEFITS		OTHER BENEFITS	
	FOR THE THREE MONTHS ENDED JUNE 30,			
(THOUSANDS)	2013	2012	2013	2012
Components of periodic benefit cost:				
Service cost	$2,460	$2,007	$314	$397
Interest cost	4,533	4,697	481	476
Expected return on plan assets	(5,958)	(5,209)	—	—
Amortizations:				
Transition obligation	—	—	4	5
Prior period service cost (credit)	(18)	(18)	—	—
Net loss	3,236	2,390	319	200
Net periodic benefit cost	$4,253	$3,867	$1,118	$1,078

	PENSION BENEFITS		OTHER BENEFITS	
	FOR THE SIX MONTHS ENDED JUNE 30,			
(THOUSANDS)	2013	2012	2013	2012
Components of periodic benefit cost:				
Service cost	$4,945	$4,156	$628	$793
Interest cost	8,970	9,127	962	953
Expected return on plan assets	(11,723)	(10,403)	—	—
Amortizations:				
Transition obligation	—	—	8	10
Prior period service cost (credit)	(36)	(36)	—	—
Net loss	6,609	4,173	637	400
Net periodic benefit cost	$8,765	$7,017	$2,235	$2,156

Because Cleco Power is the pension plan sponsor and the related trust holds the assets, the net unfunded status of the pension plan is reflected at Cleco Power. The liability of Cleco's other subsidiaries is transferred with a like amount of assets to Cleco Power monthly. The expense of the pension plan related to Cleco's other subsidiaries for the three and six months ended June 30, 2013, was $0.6 million and $1.2 million, respectively. The amounts for the same periods in 2012 were $0.5 million and $1.1 million, respectively.

Cleco Corporation is the plan sponsor for the other benefit plans. There are no assets set aside in a trust and the liabilities are reported on the individual subsidiaries' financial statements. The current portion of the other benefits liability for Cleco was $3.1 million at June 30, 2013. The amount at December 31, 2012, was also $3.1 million. The current portion of the other benefits liability for Cleco Power was $2.9 million at June 30, 2013. The amount at December 31, 2012, was also $2.9 million. The expense related to other benefits reflected in Cleco Power's Condensed Consolidated Statements of Income for the three and six months ended June 30, 2013, was $1.0 million and $1.9 million, respectively. The amounts for the same periods in 2012 were $0.9 million and $1.8 million, respectively.

SERP

Certain Cleco executive officers are covered by the SERP. The SERP is a non-qualified, non-contributory, defined-benefit pension plan. Benefits under the plan reflect an employee's years of service, age at retirement, and the sum of the highest base salary paid out of the last five calendar years plus the average of the three highest bonuses paid during the 60 months prior to retirement, reduced by benefits received from any other defined benefit pension plan, SERP Plan, or Cleco contributions under the enhanced 401(k) Plan to the extent such contributions exceed the limits of the 401(k) Plan. Cleco does not fund the SERP liability but instead pays for current benefits out of the general funds available. Cleco Power has formed a Rabbi Trust designated as the beneficiary for life insurance policies issued on the SERP participants. Proceeds from the life insurance policies are expected to be used to pay the SERP participants' life insurance benefits, as well as future SERP payments. However, because SERP is a non-qualified plan, the assets of the trust could be used to satisfy general creditors of Cleco Power in the event of insolvency. All SERP benefits are paid out of the general cash available of the respective companies from which the officer retired. No contributions to the SERP were made during the six months ended June 30, 2013 or 2012. Cleco Power is considered the plan sponsor and Support Group is considered the plan administrator. The components of net periodic SERP benefit cost for the three and six months ended June 30, 2013 and 2012, are as follows:

	FOR THE THREE MONTHS ENDED JUNE 30,		FOR THE SIX MONTHS ENDED JUNE 30,	
(THOUSANDS)	2013	2012	2013	2012
Components of periodic benefit cost:				
Service cost (credit)	$521	$(258)	$1,028	$744
Interest cost	612	690	1,289	1,263
Amortizations:				
Prior period service cost	13	13	27	27
Net loss	616	573	1,152	882
Net periodic benefit cost	$1,762	$1,018	$3,496	$2,916

The SERP liabilities are reported on the individual subsidiaries' financial statements. At June 30, 2013 and December 31, 2012, the current portion of the SERP liability for Cleco was $2.7 million and $2.5 million, respectively. The current portion of the SERP liability for Cleco Power was $0.8 million at June 30, 2013. The amount at December 31, 2012, was also $0.8 million. The expense related to the SERP reflected on Cleco Power's Condensed Consolidated Statements of Income was $0.4 million and $0.8 million for the three and six months ended June 30, 2013, compared to $0.4 million and $0.7 million for the same period in 2012.

401(k) Plan

Most employees are eligible to participate in the 401(k) Plan. Under the 401(k) Plan, Cleco makes matching contributions and funds dividend reinvestments with cash. Cleco's 401(k) Plan expense for the three and six months ended June 30, 2013 and 2012 is as follows:

	FOR THE THREE MONTHS ENDED JUNE 30,		FOR THE SIX MONTHS ENDED JUNE 30,	
(THOUSANDS)	2013	2012	2013	2012
401(k) Plan expense	$1,145	$847	$2,424	$2,341

Cleco Power is the plan sponsor for the 401(k) Plan. The expense of the 401(k) Plan related to Cleco's other subsidiaries for the three and six months ended June 30, 2013, was $0.2 million and $0.6 million, respectively. The amounts for the same periods in 2012 were also $0.2 million and $0.6 million, respectively.

Note 7 — Income Taxes

The following table summarizes the effective income tax rates for Cleco and Cleco Power for the three and six month periods ended June 30, 2013 and 2012.

	FOR THE THREE MONTHS ENDED JUNE 30,				FOR THE SIX MONTHS ENDED JUNE 30,			
	2013		2012		2013		2012	
Cleco	31.6	%	30.5	%	32.0	%	30.7	%
Cleco Power	34.3	%	35.5	%	34.1	%	35.3	%

Effective Tax Rates
For the three and six months ended June 30, 2013 and 2012, the effective income tax rate for Cleco was different than the federal statutory rate due to permanent tax deductions, flow-through of tax benefits associated with AFUDC equity, tax benefits delivered from Cleco's investment in the NMTC Fund, and state tax expense.
For the three and six months ended June 30, 2013 and 2012, the effective income tax rate for Cleco Power was different than the federal statutory rate due to permanent tax deductions, flow-through of tax benefits associated with AFUDC equity, and state tax expense.

Valuation Allowance
Valuation allowances are recorded to reduce deferred tax assets when it is more likely than not that a tax benefit will not be realized. As of June 30, 2013 and December 31, 2012, Cleco had a deferred tax asset resulting from NMTC carryforwards of $87.1 million and $78.8 million, respectively. If the NMTC carryforwards are not utilized, they will begin to expire in 2029. Management considers it more likely than not that all deferred tax assets related to NMTC carryforwards will be realized; therefore, no valuation allowance has been recorded.

Net Operating Losses
As of June 30, 2013, Cleco had a net operating loss carryforward primarily related to a tax accounting method change for bonus depreciation associated with Madison Unit 3. Cleco considers it more likely than not that these income tax losses generated will be utilized to reduce future income taxes. Cleco expects to utilize the entire net operating loss carryforward within the statutory deadlines.

Uncertain Tax Positions
Cleco classifies all interest related to uncertain tax positions as a component of interest payable and interest expense. The total amounts of uncertain tax positions and related interest payable and interest expense, as reflected on Cleco and Cleco Power’s Condensed Consolidated Balance Sheets and Statements of Income, are shown in the following tables.

(THOUSANDS)	AT JUNE 30, 2013	AT DEC. 31, 2012
Interest payable		
Cleco	$1,131	$1,420
Cleco Power	$3,600	$3,358

The interest payable reflects the amount of interest anticipated to be paid to taxing authorities. These amounts do not include any offset for amounts that may be recovered from customers under existing rate orders. The amounts expected to be recoverable from Cleco Power’s customers under existing rate orders at June 30, 2013 and December 31, 2012, are $7.7 million and $6.2 million, respectively.

	FOR THE THREE MONTHS ENDED JUNE 30,				FOR THE SIX MONTHS ENDED JUNE 30,			
(THOUSANDS)	2013		2012		2013		2012	
Interest charges								
Cleco	$(221	)	$(2,716	)	$(290	)	$(8,355	)
Cleco Power	$121		$(2,271	)	$242		$(9,636	)

The interest charges reflect the amount of interest anticipated to be paid to or received from taxing authorities. These amounts do not include any offset for the amounts that may be recovered from or owed to customers under the existing rate orders.

The federal income tax years that remain subject to examination by the IRS are 2007 through 2012. The Louisiana state income tax years that remain subject to examination by the Louisiana Department of Revenue are 2002 through 2011. At December 31, 2012, Cleco had $60.4 million deposited with the IRS, of which $43.5 million remained to either offset tax and interest liabilities for tax years subsequent to 2003 or to be refunded. Cleco received a refund of tax and interest in January 2013 from the IRS of $42.3 million relating to tax years 2001 through 2008.

Cleco is currently under audit by the IRS for the years 2010 through 2012. Cleco estimates that it is reasonably possible that the balance of unrecognized tax benefits as of June 30, 2013, could decrease by a maximum of $0.7 million for Cleco and the balance for Cleco Power would be unchanged in the next 12 months as a result of reaching settlements with the IRS and state tax authorities. The settlements could involve the payment of additional taxes, the adjustment of deferred taxes, and/or the recognition of tax benefits, which may have an effect on Cleco’s effective tax rate.

Cleco classifies income tax penalties as a component of other expense. During 2013 and 2012, the amount of penalties recognized was immaterial.

Note 8 — Disclosures about Segments

Cleco’s reportable segments are based on its method of internal reporting, which disaggregates business units by its first-tier subsidiary. Cleco’s reportable segments are Cleco Power and Midstream. The holding company, a shared services subsidiary, two transmission interconnection facility subsidiaries, and an investment subsidiary are shown as Other in the following tables.

Each reportable segment engages in business activities from which it earns revenue and incurs expenses. Segment managers report periodically to Cleco’s Chief Executive Officer (the chief operating decision-maker) with discrete financial information and, at least quarterly, present discrete financial information to Cleco Corporation’s Board of Directors. Each reportable segment prepared budgets for 2013 that were presented to and approved by Cleco Corporation’s Board of Directors.

The financial results of Cleco’s segments are presented on an accrual basis. Management evaluates the performance of its segments and allocates resources to them based on segment profit and the requirements to implement new strategic initiatives and projects to meet current business objectives. Material intercompany transactions occur on a regular basis. These intercompany transactions relate primarily to the power purchase agreement between Cleco Power and Evangeline that began in 2012 and joint and common administrative support services provided by Support Group.

SEGMENT INFORMATION FOR THE THREE MONTHS ENDED JUNE 30,

2013 (THOUSANDS)	CLECO POWER	MIDSTREAM	OTHER	ELIMINATIONS	CONSOLIDATED
Revenue					
Electric operations	$252,765	$ —	$—	$ —	$ 252,765
Tolling operations	—	9,307	—	(9,307)	—
Other operations	11,027	—	504	—	11,531
Electric customer credits	(402)	—	—	—	(402)
Affiliate revenue	335	—	15,168	(15,503)	—
Operating revenue, net	$263,725	$ 9,307	$15,672	$ (24,810)	$ 263,894
Depreciation	$32,959	$ 1,501	$280	$ —	$ 34,740
Interest charges	$20,878	$ (411)	$281	$ 140	$ 20,888
Interest income	$255	$ —	$(138)	$ 140	$ 257
Federal and state income tax expense (benefit)	$17,965	$ 3,979	$(2,521)	$ (1)	$ 19,422
Net income	$34,464	$ 6,350	$1,218	$ —	$ 42,032
Additions to long-lived assets	$44,588	$ 497	$710	$ —	$ 45,795
Equity investment in investees	$14,532	$ —	$8	$ 1	$ 14,541
Total segment assets	$3,871,862	$ 212,595	$146,538	$ (114,859)	$ 4,116,136

2012 (THOUSANDS)	CLECO POWER	MIDSTREAM	OTHER	ELIMINATIONS	CONSOLIDATED
Revenue					
Electric operations	$228,293	$ —	$—	$ —	$ 228,293
Tolling operations	—	6,309	—	(6,309)	—
Other operations	11,613	1	497	—	12,111
Electric customer credits	(281)	—	—	—	(281)
Affiliate revenue	342	—	13,590	(13,932)	$ —
Operating revenue, net	$239,967	$ 6,310	$14,087	$ (20,241)	$ 240,123
Depreciation	$30,559	$ 1,460	$232	$ (1)	$ 32,250
Interest charges	$20,805	$ (1,159)	$824	$ 146	$ 20,616
Interest income	$(6)	$ —	$(141)	$ 144	$ (3)
Federal and state income tax expense (benefit)	$20,501	$ 4,051	$(4,031)	$ (1)	$ 20,520
Net income	$37,284	$ 6,534	$2,868	$ —	$ 46,686
Additions to long-lived assets	$55,785	$ 6,025	$482	$ —	$ 62,292
Equity investment in investees [(1)]	$14,532	$ —	$8	$ —	$ 14,540
Total segment assets [(1)]	$3,871,729	$ 215,342	$201,678	$ (141,400)	$ 4,147,349

[(1)] Balances as of December 31, 2012

SEGMENT INFORMATION FOR THE SIX MONTHS ENDED JUNE 30,

2013 (THOUSANDS)	CLECO POWER	MIDSTREAM	OTHER	ELIMINATIONS	CONSOLIDATED
Revenue					
Electric operations	$482,191	$ —	$—	$ —	$ 482,191
Tolling operations	—	14,144	—	(14,144)	—
Other operations	22,064	1	1,008	1	23,074

Electric customer credits	(424)	—	—	—	(424)
Affiliate revenue	670	—	27,093	(27,763)	—
Operating revenue	$504,501	$ 14,145	$28,101	$ (41,906)	$ 504,841
Depreciation	$65,288	$ 3,001	$483	$ 1	$ 68,773
Interest charges	$42,227	$ (649)	$444	$ 322	$ 42,344
Interest income	$453	$ —	$(318)	$ 322	$ 457
Federal and state income tax expense (benefit)	$32,203	$ 3,139	$(2,839)	$ —	$ 32,503
Net income	$62,257	$ 5,016	$1,893	$ —	$ 69,166
Additions to long-lived assets	$86,147	$ 2,326	$1,271	$ —	$ 89,744
Equity investment in investees	$14,532	$ —	$8	$ 1	$ 14,541
Total segment assets	$3,871,862	$ 212,595	$146,538	$ (114,859)	$ 4,116,136

2012 (THOUSANDS)	CLECO POWER	MIDSTREAM	OTHER	ELIMINATIONS	CONSOLIDATED
Revenue					
Electric operations	$437,883	$ —	$—	$ —	$ 437,883
Tolling operations	—	7,543	—	(7,543)	—
Other operations	22,062	1	994	(1)	23,056
Electric customer credits	1,955	—	—	—	1,955
Affiliate revenue	687	—	25,197	(25,884)	—
Operating revenue	$462,587	$ 7,544	$26,191	$ (33,428)	$ 462,894
Depreciation	$60,648	$ 2,992	$456	$ 1	$ 64,097
Interest charges	$39,291	$ 313	$1,444	$ 192	$ 41,240
Interest income	$23	$ —	$(185)	$ 193	$ 31
Equity income from investees, before tax	$—	$ —	$1	$ —	$ 1
Federal and state income tax expense (benefit)	$35,008	$ 4,789	$(5,866)	$ (1)	$ 33,930
Net income	$64,089	$ 7,624	$5,004	$ 1	$ 76,718
Additions to long-lived assets	$94,762	$ 6,012	$869	$ —	$ 101,643
Equity investment in investees [(1)]	$14,532	$ —	$8	$ —	$ 14,540
Total segment assets [(1)]	$3,871,729	$ 215,342	$201,678	$ (141,400)	$ 4,147,349

[(1)] Balances as of December 31, 2012

Note 9 — Electric Customer Credits

The current amount of Cleco Power's annual retail earnings is subject to the terms of an FRP established by the LPSC effective February 12, 2010. The FRP allows Cleco Power the opportunity to earn a target return on equity of 10.7%, including returning to retail customers 60% of retail earnings between 11.3% and 12.3% and all retail earnings over 12.3%. The amount of credits due customers, if any, is determined by Cleco Power and the LPSC annually. Cleco Power must file annual monitoring reports no later than October 31 for the 12-month period ending June 30. In April 2013, Cleco Power filed an application with the LPSC to extend its current FRP and seek rate recovery of the Coughlin asset. Cleco Power requested in its application that the FRP extension be effective through June 2020.

On October 31, 2012, Cleco Power filed its report for the 12 months ended June 30, 2012, which indicated that $1.7 million was due to be returned to customers. On June 26, 2013, the LPSC approved the monitoring report for the 12 months ended June 30, 2012, with a recommended adjusted refund of $2.4 million. The increase in refund was the result of changes to revenue requirements for certain FRP Rider items. Cleco Power anticipates issuing refunds on customers' bills in the third quarter of 2013. The accrual for estimated electric customer credits reflected on Cleco Corporation and Cleco Power's Condensed Consolidated Balance Sheets at June 30, 2013 and December 31, 2012, was $4.6 million and $4.2 million, respectively.

Note 10 — Variable Interest Entities

Cleco reports its investments in VIEs in accordance with the authoritative guidance. Cleco and Cleco Power report the investment in Oxbow on the equity method of accounting. Under the equity method, the assets and liabilities of this entity are reported as equity investment in investees on Cleco and Cleco Power's Condensed Consolidated Balance Sheets. The revenue and expenses (excluding income taxes) of this entity are netted and reported as equity income or loss from investees on Cleco and Cleco Power's Condensed Consolidated Statements of Income.

Equity Method VIEs

Equity investment in investees at June 30, 2013, primarily represented Cleco Power's $14.5 million investment in Oxbow. Equity investments that are less than 100% owned by Diversified Lands represented less than $0.1 million of the total balance.

Oxbow

Oxbow is owned 50% by Cleco Power and 50% by SWEPCO and is accounted for as an equity method investment. Cleco Power is not the primary beneficiary because it shares the power to control Oxbow's significant activities with SWEPCO. Cleco's current assessment of its maximum exposure to loss related to Oxbow at June 30, 2013, consisted of its equity investment of $14.5 million. The following table presents the components of Cleco Power's equity investment in Oxbow.

INCEPTION TO DATE (THOUSANDS)	AT JUNE 30, 2013	AT DEC. 31, 2012
Purchase price	$12,873	$12,873
Cash contributions	1,659	1,659
Total equity investment in investee	$14,532	$14,532

The following table compares the carrying amount of Oxbow's assets and liabilities with Cleco's maximum exposure to loss related to its investment in Oxbow.

(THOUSANDS)	AT JUNE 30, 2013	AT DEC. 31, 2012
Oxbow's net assets/liabilities	$29,065	$29,065
Cleco Power's 50% equity	$14,532	$14,532
Cleco's maximum exposure to loss	$14,532	$14,532

The following tables contain summarized financial information for Oxbow.

(THOUSANDS)	AT JUNE 30, 2013	AT DEC. 31, 2012
Current assets	$2,039	$1,814
Property, plant, and equipment, net	22,823	23,029
Other assets	4,661	4,248
Total assets	$29,523	$29,091
Current liabilities	$458	$26
Partners' capital	29,065	29,065
Total liabilities and partners' capital	$29,523	$29,091

	FOR THE THREE MONTHS ENDED JUNE 30,		FOR THE SIX MONTHS ENDED JUNE 30,	
(THOUSANDS)	2013	2012	2013	2012
Operating revenue	$510	$294	$939	$676
Operating expenses	510	294	939	676
Income before taxes	$—	$—	$—	$—

Oxbow's property, plant, and equipment, net consists of land and lignite reserves. The lignite reserves are intended to be used to provide fuel to the Dolet Hills Power Station. DHLC mines the lignite reserves at Oxbow through the Amended Lignite Mining Agreement.

Oxbow has no third-party agreements, guarantees, or other third-party commitments that contain obligations affecting Cleco Power's investment in Oxbow.

Note 11 — Litigation, Other Commitments and Contingencies, and Disclosures about Guarantees

Litigation

Devil's Swamp

In October 2007, Cleco received a Special Notice for Remedial Investigation and Feasibility Study (RI/FS) from the EPA pursuant to CERCLA (also known as the Superfund statute). CERCLA establishes several classes of PRPs for a contaminated site, and imposes strict, joint, and several liability on those PRPs for the cost of response to the contamination. The special notice requested that Cleco Corporation and Cleco Power, along with many other listed PRPs, enter into negotiations with the EPA for the performance of an RI/FS at an area known as the Devil's Swamp Lake site just northwest of Baton Rouge, Louisiana. The EPA has identified Cleco as one of many companies sending PCB wastes for disposal to the site. The Devil's Swamp Lake site has been proposed to be added to the National Priorities List based on the release of PCBs to fisheries and wetlands located on the site, but no final determination has been made. The PRPs began discussing a potential proposal to the EPA in February 2008. The EPA issued a Unilateral Administrative Order to PRP's Clean Harbors, Inc. and Baton Rouge Disposal to Conduct an RI/FS on December 3, 2009. The Tier 1 part of the study was complete as of June 25, 2012. Currently, the study/remedy selection task continues. Therefore, management is unable to determine how significant Cleco's share of the costs associated with the RI/FS and possible response action at the facility site, if any, may be and whether or not this will have a material adverse effect on the Registrants' financial condition, results of operations, or cash flows.

Discrimination Complaints

In December 2009, a complaint was filed in the U.S. District Court for the Western District of Louisiana (the Court) on behalf of eight current employees and four former employees alleging that Cleco discriminated against each of them on the basis of race. Each is seeking various remedies provided under applicable statutes prohibiting racial discrimination in the workplace, and together, the plaintiffs seek monetary compensation exceeding $35.0 million. In July 2010, the plaintiffs moved to add an additional current employee alleging that Cleco had discriminated on the basis of race. The additional plaintiff seeks compensation of no less than $2.5 million and became the thirteenth plaintiff. In April 2011, Cleco

entered into a settlement with one of the current employees which resulted in a dismissal of one of the thirteen cases with prejudice. In September 2011, the Court ruled on Cleco's summary judgment motions, with the end result that eleven of the twelve remaining plaintiffs had at least one claim remaining. In February 2013, the Court ruled on the second motion for summary judgment, filed by Cleco in March 2012, in each of the eleven cases and each such case was dismissed with prejudice. Appeals were filed in ten of the eleven dismissed cases to the United States Court of Appeals for the Fifth Circuit (the Fifth Circuit). In June 2013, the Fifth Circuit clerk dismissed the appeals of two of the current employees due to their failure to file a brief in support of their respective appeals. Eight cases remain on appeal before the Fifth Circuit, five pursued by current employees and three by former employees. Briefing in each of the eight remaining appeals was completed in July 2013. The dismissal in the eleventh case, which was not appealed, is now final.

City of Opelousas

In March 2010, a complaint was filed in the 27th Judicial District Court of St. Landry Parish, State of Louisiana, on behalf of three Cleco Power customers in Opelousas, Louisiana. The complaint alleges that Cleco Power overcharged the plaintiffs by applying to customers in Opelousas the same retail rates as Cleco Power applies to all of its retail customers. The plaintiffs claim that Cleco Power owes customers in Opelousas more than $30.0 million as a result of the alleged overcharges. The plaintiffs allege that Cleco Power should have established, solely for customers in Opelousas, retail rates that are separate and distinct from the retail rates that apply to other customers of Cleco Power and that Cleco Power should not collect from customers in Opelousas the storm surcharge approved by the LPSC following hurricanes Katrina and Rita. Cleco Power currently operates in Opelousas pursuant to a franchise granted to Cleco Power by the City of Opelousas in 1986 and an operating and franchise agreement dated May 14, 1991, pursuant to which Cleco Power operates its own electric facilities and leases and operates electric facilities owned by the City of Opelousas. In July 2011, the operating and franchise agreements were amended and extended for a period of ten years, until August 2021. In April 2010, Cleco Power filed a petition with the LPSC appealing to its expertise in declaring that the ratepayers of Opelousas have been properly charged the rates that are applicable to Cleco Power's retail customers and that no overcharges have been collected. In addition, Cleco Power removed the purported class action lawsuit filed on behalf of Opelousas electric customers from the state court to the U.S. District Court for the Western District of Louisiana in April 2010, so that it could be properly addressed under the terms of the Class Action Fairness Act.

In May 2010, a second class action lawsuit was filed in the 27th Judicial District Court for St. Landry Parish, State of Louisiana, repeating the allegations of the first complaint, which was submitted on behalf of 249 Opelousas residents. Cleco Power responded in the same manner as with the first class action lawsuit. In September 2010, the federal court remanded both cases to the state court in which they were originally filed for further proceedings. In January 2011, the presiding judge in the state court proceeding ruled that the jurisdiction to hear the two class actions resides in the state court and not with the LPSC as argued by both Cleco and the LPSC Staff. Both Cleco and the LPSC Staff appealed this

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ruling to the Third Circuit Court of Appeals for the State of Louisiana (Third Circuit). In September 2011, the Third Circuit denied both appeals. In October 2011, both Cleco and the LPSC appealed the Third Circuit's ruling to the Louisiana Supreme Court. In November 2011, the Louisiana Supreme Court granted the appeals and remanded the case to the Third Circuit for further briefing, argument, and opinion. In February 2011, the administrative law judge (ALJ) in the LPSC proceeding ruled that the LPSC has jurisdiction to decide the claims raised by the class action plaintiffs. At its December 2011 Business and Executive Session, the LPSC adopted the ALJ's recommendation that Cleco be granted summary judgment in its declaratory action finding that Cleco's ratepayers in the City of Opelousas have been served under applicable rates and policies approved by the LPSC and Cleco's Opelousas ratepayers have not been overcharged in connection with LPSC rates or ratemaking. In January 2012, the class action plaintiffs filed their appeal of such LPSC decision to the 19th Judicial District Court for Baton Rouge Parish, State of Louisiana. In February 2012, the Third Circuit ruled that the state court, and not the LPSC, has jurisdiction to hear the case. In March 2012, Cleco Power appealed the Third Circuit's ruling to the Louisiana Supreme Court asking that it overturn the Third Circuit decision and confirm the LPSC's exclusive jurisdiction over this matter. The LPSC also appealed the Third Circuit's ruling to the Louisiana Supreme Court in March 2012. In May 2012, the Louisiana Supreme Court granted the writ application of Cleco Power and the LPSC and set the matter for further briefing on the merits of the jurisdiction question raised in the writ application. In December 2012, the Louisiana Supreme Court issued its opinion accepting Cleco's jurisdictional arguments and dismissed the state court claims. The only matter remaining is before the 19th Judicial District Court to review the LPSC ruling in Cleco's favor that it had properly charged the ratepayers of Opelousas. In view of the uncertainty of the claims, management is not able to predict or give a reasonable estimate of the possible range of liability, if any, of these claims. However, if it is found that Cleco Power overcharged customers resulting in a refund, any such refund could have a material adverse effect on the Registrants' results of operations, financial condition, and cash flows.

Other

Cleco is involved in various litigation matters, including regulatory, environmental, and administrative proceedings before various courts, regulatory commissions, arbitrators, and governmental agencies regarding matters arising in the ordinary course of business. The liability Cleco may ultimately incur with respect to any one of these matters in the event of a negative outcome may be in excess of amounts currently accrued. Management regularly analyzes current information and, as of June 30, 2013, believes the probable and reasonably estimable liabilities based on the eventual disposition of these matters is approximately $4.6 million and has accrued this amount.

Off-Balance Sheet Commitments

Cleco Corporation and Cleco Power have entered into various off-balance sheet commitments, in the form of guarantees and standby letters of credit, in order to facilitate their activities and the activities of Cleco Corporation's subsidiaries and equity investees (affiliates). Cleco Corporation and Cleco Power have also agreed to contractual terms that require them to pay

third parties if certain triggering events occur. These contractual terms generally are defined as guarantees in the authoritative guidance.

Cleco Corporation entered into these off-balance sheet commitments in order to entice desired counterparties to contract with its affiliates by providing some measure of credit assurance to the counterparty in the event Cleco's affiliates do not fulfill certain contractual obligations. If Cleco Corporation had not provided the off-balance sheet commitments, the desired counterparties may not have contracted with Cleco's affiliates, or may have contracted with them at terms less favorable to its affiliates.

The off-balance sheet commitments are not recognized on Cleco's Condensed Consolidated Balance Sheets because management has determined that Cleco's affiliates are able to perform these obligations under their contracts and that it is not probable that payments by Cleco will be required. Cleco's off-balance sheet commitments as of June 30, 2013, are summarized in the following table and a discussion of the off-balance sheet commitments follows the table. The discussion should be read in conjunction with the table to understand the impact of the off-balance sheet commitments on Cleco's financial condition.

	AT JUNE 30, 2013		
(THOUSANDS)	FACE AMOUNT	REDUCTIONS	NET AMOUNT
Cleco Corporation			
Guarantee issued to Entergy Mississippi on behalf of Attala	$500	$—	$500
Cleco Power			
Obligations under standby letter of credit issued to the Louisiana Department of Labor	3,725	—	3,725
Total	$4,225	$—	$4,225

In January 2006, Cleco Corporation provided a $0.5 million guarantee to Entergy Mississippi for Attala's obligations under the Interconnection Agreement. This guarantee will be effective through the life of the agreement.
The State of Louisiana allows employers of certain financial net worth to self-insure their workers' compensation benefits. Cleco Power has a certificate of self-insurance from the Louisiana Office of Workers' Compensation and is required to post a $3.7 million letter of credit, an amount equal to 110% of the average losses over the previous three years, as surety.

Disclosures about Guarantees
Cleco Corporation provided a limited guarantee and an indemnification to Entergy Louisiana and Entergy Gulf States for Perryville's performance, indemnity, representation, and warranty obligations under the Sale Agreement, the Power Purchase Agreement, and other ancillary agreements related to the sale of the Perryville facility in 2004. This is a continuing guarantee and all obligations of Cleco Corporation shall continue until the guaranteed obligations have been fully performed or otherwise extinguished. The discounted probability-weighted liability under the guarantees and indemnifications recognized on Cleco's Condensed Consolidated Balance Sheet as of June 30, 2013, was $0.2 million. The maximum amount of the potential payment to Entergy Louisiana and Entergy Gulf States is $42.4 million. Currently, management does not expect to be required to pay Entergy Louisiana and Entergy Gulf States under the guarantee.

In February 2010, Cleco Power acquired Acadia Unit 1 and limited guarantees and indemnifications were provided to Cleco Power. The maximum amount of the potential payment to Cleco Power for indemnifications is $30.0 million, except for indemnifications relating to the fundamental organizational structure of which there is no maximum amount. Cleco Corporation is obligated to pay a maximum of $10.0 million if the claims are not paid to Cleco Power pursuant to the guarantee. An indemnification liability of $13.5 million which represents the fair value of these indemnifications was recorded on Cleco's Condensed Consolidated Balance Sheet.

The indemnification liabilities are reduced through expiration of the contractual life or through a reduction in the probability of a claim arising. The indemnification obligation had a term of approximately three years. At June 30, 2013, a residual value of less than $0.1 million remained. As these underlying indemnifications expire, income is recognized on Cleco's Condensed Consolidated Statements of Income. For the three months ended June 30, 2013, no income was recognized and for the six months ended June 30, 2013, $0.3 million was recognized. For the three months ended June 30, 2012, no income was recognized and for the six months ended June 30, 2012, $7.2 million was recognized.

In April 2011, Acadia completed its disposition of Acadia Unit 2 to Entergy Louisiana. Limited guarantees and indemnifications were provided to Entergy Louisiana and an indemnification liability of $21.8 million, which represents the fair value of these indemnifications was recorded on Cleco's Condensed Consolidated Balance Sheet. The indemnification liabilities are reduced through expiration of the contractual life or through a reduction in the probability of a claim arising. The indemnification obligation is expected to have a term of three years. After the three-year period, a residual value of approximately $0.2 million will remain. At June 30, 2013, an indemnification liability of $0.9 million remained, which represents the risk of payment, as a contingent sale obligation recorded on Cleco's Condensed Consolidated Balance Sheet. Income of $6.9 million was recognized for the three and six months ended June 30, 2013. Income of $11.8 million was recognized for the three and six months ended June 30, 2012. The recognition of income was due to the contractual expiration of the underlying indemnifications. The maximum amount of the potential payment to Entergy Louisiana for the indemnifications is the purchase price of $298.8 million, except for the liabilities retained for which there is no maximum amount. Cleco Corporation is obligated to pay the same maximum amounts

as Acadia if Acadia is unable to pay claims to Entergy Louisiana pursuant to the guarantee.

As part of the Amended Lignite Mining Agreement, Cleco Power and SWEPCO, joint owners of Dolet Hills, have agreed to pay the lignite miner's loan and lease principal obligations when due if the lignite miner does not have sufficient funds or credit to pay. Any amounts paid on behalf of the miner would be credited by the lignite miner against the next invoice for lignite delivered. At June 30, 2013, Cleco Power had a liability of $3.8 million related to the amended agreement. The maximum projected payment by Cleco Power under this guarantee is estimated to be $72.5 million; however, the Amended Lignite Mining Agreement does not contain a cap. The projection is based on the forecasted loan and lease obligations to be incurred by DHLC, primarily for purchases of equipment. Cleco Power has the right to dispute the incurrence of loan and lease obligations through the review of the mining plan before the incurrence of such loan and lease obligations. The Amended Lignite Mining Agreement does not terminate pursuant to its terms until 2026 and does not affect the amount the Registrants can borrow under their credit facilities. Currently, management does not expect to be required to pay DHLC under the guarantee.

In its bylaws, Cleco Corporation has agreed to indemnify directors, officers, agents, and employees who are made a party to a pending or completed suit, arbitration, investigation, or other proceeding whether civil, criminal, investigative, or administrative, if the basis of inclusion arises as the result of acts conducted in the discharge of their official capacity. Cleco Corporation has purchased various insurance policies to reduce the risks associated with the indemnification. In its operating agreement, Cleco Power provides for the same indemnification as described above with respect to its managers, officers, agents, and employees.

Generally, neither Cleco Corporation nor Cleco Power has recourse that would enable them to recover amounts paid under their guarantee or indemnification obligations. The one exception is the insurance contracts associated with the indemnification of directors, managers, officers, agents, and employees. There are no assets held as collateral for third

parties that either Cleco Corporation or Cleco Power could obtain and liquidate to recover amounts paid pursuant to the guarantees or indemnification obligations.
The following table summarizes the expected amount of commitment termination per period of off-balance sheet commitments and on-balance sheet guarantees discussed above.

					AT JUNE 30, 2013
		AMOUNT OF COMMITMENT EXPIRATION PER PERIOD			
(THOUSANDS)	NET AMOUNT COMMITTED	LESS THAN ONE YEAR	1-3 YEARS	3-5 YEARS	MORE THAN 5 YEARS
Off-balance sheet commitments	$ 4,225	$ 3,725	$ —	$—	$ 500
On-balance sheet guarantees	4,956	950	—	—	4,006
Total	$ 9,181	$ 4,675	$ —	$—	$ 4,506

Other Commitments

NMTC Fund
In 2008, Cleco Corporation and US Bancorp Community Development Corporation (USBCDC) formed the NMTC Fund. Cleco has a 99.9% membership interest in the NMTC Fund and USBCDC has a 0.1% interest. The purpose of the NMTC

Fund is to invest in projects located in qualified active low-income communities that are underserved by typical debt capital markets. These investments are designed to generate NMTCs and Historical Rehabilitation tax credits. The NMTC Fund was later amended to include renewable energy investments. The majority of the energy investments qualify for grants under Section 1603 of the American Recovery and Reinvestment Tax Act of 2009. The tax benefits received from the NMTC Fund reduce the federal income tax obligations of Cleco Corporation. In total, Cleco Corporation will contribute $283.9 million of equity contributions to the NMTC Fund and will receive at least $302.2 million in the form of tax credits, tax losses, capital gains/losses, earnings, and cash over the life of the investment, which ends in 2017. The $18.3 million difference between equity contributions and total benefits received will be recognized over the life of the Fund as net tax benefits are delivered. The following table reflects remaining future equity contributions.

(THOUSANDS)	CONTRIBUTION
Six months ending Dec. 31, 2013	$26,876
Years ending Dec. 31,	
2014	43,407
2015	11,870
2016	7,307
2017	2,865
Total	$92,325

Of the $92.3 million, $47.2 million is due to be paid within the next 12 months. Due to the right of offset, the investment and associated debt are presented on Cleco's Condensed Consolidated Balance Sheet in the line item titled Tax credit fund investment, net. The amount of tax benefits delivered in excess of capital contributions as of June 30, 2013, was $91.4 million. The amount of tax benefits delivered but not utilized as of June 30, 2013, was $106.1 million and is reflected as a deferred tax asset.

The equity contribution does not contain a stated rate of interest. Cleco Corporation has recorded the liability and investment at its calculated fair value within the framework of the authoritative guidance. In order to calculate the fair value, management used an imputed rate of interest assuming that Cleco Corporation obtained financing of a similar nature from a third party. The imputed interest rate was used in a net present value model in order to calculate the fair value of the remaining portion of the delayed equity contributions. The following table contains the disclosures required by the authoritative guidelines for equity investments with an imputed interest rate.

(THOUSANDS)	
Equity contributions, imputed interest rate 6%	
Principal payment schedule above:	$92,325
Less: unamortized discount	6,724
Total	$85,601

The gross investment amortization expense will be recognized over a ten-year period, with four years remaining under the new amendment, using the cost method in accordance with the authoritative guidance for investments. The grants received under Section 1603, which allow certain projects to receive a federal grant in lieu of tax credits, and other cash reduce the basis of the investment. Periodic amortization of the investment and the deferred taxes generated by the basis reduction temporary difference are included as components of income tax expense.

Other

Cleco has accrued for liabilities related to third parties and employee medical benefits.

Risks and Uncertainties

Cleco Corporation

Cleco Corporation could be subject to possible adverse consequences if Cleco's counterparties fail to perform their obligations or if Cleco Corporation or its affiliates are not in compliance with loan agreements or bond indentures.

Other

Access to capital markets is a significant source of funding for both short- and long-term capital requirements not satisfied by operating cash flows. After assessing the current operating performance, liquidity, and credit ratings of Cleco Corporation, management believes that Cleco will have access to the capital markets at prevailing market rates for companies with comparable credit ratings. If Cleco Corporation's credit ratings were to be downgraded by Moody's or S&P, Cleco Corporation would be required to pay additional fees and higher interest rates under its bank credit and other debt agreements.

Changes in the regulatory environment or market forces could cause Cleco to determine its assets have suffered an other-than-temporary decline in value, whereby an impairment would be required to be taken and Cleco's financial condition could be materially adversely affected.

Cleco Power

Cleco Power supplies the majority of its customers' electric power requirements from its own generation facilities. In addition to power obtained from power purchase agreements, Cleco Power purchases power from other utilities and marketers to supplement its generation at times of relatively high demand or when the purchase price of power is less than its own cost of generation. Due to its location on the transmission grid, Cleco Power relies on two main suppliers of electric transmission when accessing external power markets. At times, constraints limit the amount of purchased power these transmission providers can deliver into Cleco Power's service territory.

Access to capital markets is a significant source of funding for both short- and long-term capital requirements not satisfied by operating cash flows. After assessing the current operating performance, liquidity, and credit ratings of Cleco Power, management believes that Cleco Power will have access to the capital markets at prevailing market rates for companies with comparable credit ratings. Cleco Power pays fees and interest under its bank credit agreements based on the highest rating held. If Cleco Power's credit ratings were to be downgraded by Moody's or S&P, Cleco Power would be required to pay additional fees and higher interest rates under its bank credit agreements. Cleco Power's collateral for derivatives is based on the lowest rating held. If Cleco Power's credit ratings were to be downgraded by Moody's or S&P, Cleco Power would be required to pay additional collateral for derivatives.

Note 12 — Affiliate Transactions

Cleco Power has affiliate balances that are payable to or due from its affiliates. The following table is a summary of those balances.

(THOUSANDS)	AT JUNE 30, 2013 ACCOUNTS RECEIVABLE	AT JUNE 30, 2013 ACCOUNTS PAYABLE	AT DEC. 31, 2012 ACCOUNTS RECEIVABLE	AT DEC. 31, 2012 ACCOUNTS PAYABLE
Cleco Corporation	$76	$293	$139	$1,140
Support Group	681	6,510	2,777	7,528
Midstream	30	27	27	5
Evangeline	3	4,543	6	1,401
Diversified Lands	5	—	42	23
Other [(1)]	1	—	—	—
Total	$796	$11,373	$2,991	$10,097

[(1)] Represents Perryville and Attala

Note 13 — Storm Restoration

On August 28, 2012, Hurricane Isaac made landfall in south Louisiana as a Category 1 hurricane, causing power outages to approximately 95,000, or 34%, of Cleco Power's electric customers and affecting Cleco Power's entire service territory.

By September 2, 2012, power was restored to 100% of customers who could receive power.
The cost of restoration for Hurricane Isaac was $24.3 million. The damage to equipment from the storm required replacement, as well as repair of existing assets. Therefore, the balance sheets of Cleco and Cleco Power reflect the capitalization of approximately 56.0% of the restoration costs recorded at June 30, 2013, or approximately $13.6 million. The remaining cost was offset against Cleco Power's existing storm damage reserve.

Note 14 — Accumulated Other Comprehensive Loss

The components of accumulated other comprehensive loss are summarized in the following tables for Cleco and Cleco Power. All amounts are reported net of income taxes and amounts in parentheses indicate debits.

Cleco

	FOR THE THREE MONTHS ENDED JUNE 30, 2013		
(THOUSANDS)	POSTRETIREMENT BENEFIT NET (LOSS) GAIN	NET (LOSS) GAIN ON CASH FLOW HEDGES	TOTAL ACCUMULATED OTHER COMPREHENSIVE (LOSS) GAIN
Balances, Mar. 31, 2013	$ (24,205)	$(6,292)	$ (30,497)
Amounts reclassified from accumulated other comprehensive income:			
Amortization of postretirement benefit net loss	586	—	586
Reclassification of net loss to interest charges	—	36	36
Net current-period other comprehensive income	586	36	622
Balances, June 30, 2013	$ (23,619)	$(6,256)	$ (29,875)

	FOR THE SIX MONTHS ENDED JUNE 30, 2013		
(THOUSANDS)	POSTRETIREMENT BENEFIT NET (LOSS) GAIN	NET (LOSS) GAIN ON CASH FLOW HEDGES	TOTAL ACCUMULATED OTHER COMPREHENSIVE (LOSS) GAIN
Balances, Dec. 31, 2012	$ (24,741)	$(7,629)	$ (32,370)

Other comprehensive income before reclassifications:			
Net derivative gain	—	1,355	1,355
Amounts reclassified from accumulated other comprehensive income:			
Amortization of postretirement benefit net loss	1,122	—	1,122
Reclassification of net loss to interest charges	—	49	49
Reclassification of ineffectiveness to regulatory asset	—	(31)	(31)
Net current-period other comprehensive income	1,122	1,373	2,495
Balances, June 30, 2013	$ (23,619)	$(6,256)	$ (29,875)

Cleco Power

	FOR THE THREE MONTHS ENDED JUNE 30, 2013		
(THOUSANDS)	POSTRETIREMENT BENEFIT NET (LOSS) GAIN	NET (LOSS) GAIN ON CASH FLOW HEDGES	TOTAL ACCUMULATED OTHER COMPREHENSIVE (LOSS) GAIN
Balances, Mar. 31, 2013	$ (12,541)	$(6,292)	$ (18,833)
Amounts reclassified from accumulated other comprehensive income:			
Amortization of postretirement benefit net loss	269	—	269
Reclassification of net loss to interest charges	—	36	36
Net current-period other comprehensive income	269	36	305
Balances, June 30, 2013	$ (12,272)	$(6,256)	$ (18,528)

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(THOUSANDS)	FOR THE SIX MONTHS ENDED JUNE 30, 2013 POSTRETIREMENT BENEFIT NET (LOSS) GAIN	NET (LOSS) GAIN ON CASH FLOW HEDGES	TOTAL ACCUMULATED OTHER COMPREHENSIVE (LOSS) GAIN
Balances, Dec. 31, 2012	$ (12,792)	$ (7,629)	$ (20,421)
Other comprehensive income before reclassifications:			
Net derivative gain	—	1,355	1,355
Amounts reclassified from accumulated other comprehensive income:			
Amortization of postretirement benefit net loss	520	—	520
Reclassification of net loss to interest charges	—	49	49
Reclassification of ineffectiveness to regulatory asset	—	(31)	(31)
Net current-period other comprehensive income	520	1,373	1,893
Balances, June 30, 2013	$ (12,272)	$ (6,256)	$ (18,528)

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis should be read in combination with the Registrants' Combined Annual Report on Form 10-K for the fiscal year ended December 31, 2012, and Cleco and Cleco Power's Condensed Consolidated Financial Statements contained in this Combined Quarterly Report on Form 10-Q. The information included therein is essential to understanding the following discussion and analysis. Below is information concerning the consolidated results of operations of Cleco for the three and six months ended June 30, 2013 and June 30, 2012.

RESULTS OF OPERATIONS

Overview

Cleco is a regional energy company that conducts substantially all of its business operations through its two primary subsidiaries:

- Cleco Power, a regulated electric utility company, which owns 9 generating units with a total nameplate capacity of 2,565 MW and serves approximately 283,000 customers in Louisiana through its retail business and 10 communities across Louisiana and Mississippi through wholesale power contracts and
- Midstream, a wholesale energy business, which owns Evangeline (which operates Coughlin).

Cleco Power

Many factors affect Cleco Power's primary business of selling electricity. These factors include the presence of a stable regulatory environment, which impacts cost recovery and return on equity, as well as the recovery of costs related to growing energy demand and rising fuel prices; the ability to increase energy sales while containing costs; and the ability to meet increasingly stringent regulatory and environmental standards. Key initiatives that Cleco Power is currently working on include the completion of the AMI project, implementation of various environmental controls to comply with the MATS ruling, completion of the transfer of ownership and control of Coughlin from Evangeline, extension of its current FRP, and integration into MISO. These initiatives are discussed below.

AMI Project

In May 2010, Cleco Power accepted the terms of a $20.0 million grant from the DOE under the DOE's small-grant process to implement advanced metering technology for all of Cleco Power's retail customers. Cleco Power estimates the project will cost $72.4 million, with the DOE grant providing $20.0 million toward the project and Cleco Power providing the remaining $52.4 million. The grant program is a part of the American Recovery and Reinvestment Act of 2009, an economic stimulus package passed by Congress in February 2009. Advanced metering technology includes the installation of electric meters that enable two-way communication capabilities between a utility customer and the utility. At June 30, 2013, Cleco Power had incurred $68.5 million in project costs, of which $20.0 million has been reimbursed by the DOE. The installation of the advanced meters was substantially completed in May 2013, with the project to be fully functional by the fourth quarter of 2013. For more information on the AMI Project, see "— Financial Condition — Regulatory and Other Matters — AMI Project."

MATS

The MATS rule was finalized in February 2012 and requires affected electric generating units to meet specific numeric emission standards and work practice standards to address hazardous air pollutants. MATS imposes strict emission limits on new and existing coal- and liquid oil-fired electric generating units for mercury, acid gases, and non-mercury metallic pollutants. Cleco Power units impacted by the rule include Rodemacher Unit 2, Madison Unit 3, and Dolet Hills. MATS allows existing sources approximately three years to comply with the rule. The actual compliance deadline is April 16, 2015. Cleco Power completed its evaluation of control technology options and has identified capital expenditures that will be required to engineer, procure, and install pollution controls and emissions monitoring equipment to ensure Cleco Power will be in a position to comply with MATS in a timely manner. New equipment to be installed and operational by the compliance date at Rodemacher Unit 2 and Dolet Hills includes dry sorbent injection for acid gas control and fabric filters (baghouses) for metal particulate control. In addition, activated carbon injection for mercury control is to be installed and operational by the compliance date at Rodemacher Unit 2, Madison Unit 3, and Dolet Hills. Cleco Power has completed the design work for this equipment and a project construction schedule has been crafted and initiated for timely installation. The MATS project is expected to cost $265.0 million, of which Cleco Power's portion is $111.3 million. As of June 30, 2013, $59.0 million was spent on the project, of which Cleco Power's portion was $24.0 million.

Power Supply Options/Coughlin Transfer from Midstream

Cleco Power issued an RFP seeking up to approximately 750 MW of capacity and energy, for a three- or five-year period starting May 1, 2012. Cleco Power selected Evangeline's proposal for a 730-MW product beginning May 1, 2012, and ending April 30, 2015. The definitive agreement between Evangeline and Cleco Power was executed in January 2012 and approved by the LPSC in March 2012 and FERC in April 2012. In May 2012, Cleco Power issued a draft RFP seeking long-term resources beyond April 2015. The final RFP was issued in July 2012 and proposals were received from potential suppliers in August 2012. On October 30, 2012, Cleco Power announced Evangeline as the winning bidder in Cleco Power's 2012 Long-Term RFP. In December 2012, Cleco Power and Evangeline executed definitive agreements to transfer ownership and control of Coughlin from Evangeline to Cleco Power. Cleco Power's application seeking regulatory approval was listed in the LPSC's Official Bulletin, dated April 12, 2013. In May 2013, Cleco Power filed its application with FERC seeking authorization to acquire Coughlin. The transaction is expected to close on or by April 30, 2014, following regulatory approvals by both the LPSC and FERC.

Extension of FRP

In April 2013, Cleco Power filed an application with the LPSC to extend its current FRP and to seek rate recovery of the Coughlin asset. Cleco Power requested in its application that the FRP extension be effective through June 2020.

MISO

Cleco Power's transmission system is heavily interconnected with Entergy's system; therefore, Cleco Power plans to follow Entergy and join MISO in December 2013. On December 6, 2012, Cleco Power filed an application with the LPSC indicating Cleco's intent to join MISO, asking the commission to find that transferring control of certain transmission assets to MISO is in the public interest, to create an accounting order deferring costs related to Cleco Power's transition into the MISO market, and to expedite treatment. On June 26, 2013, the LPSC unanimously approved Cleco Power's change of control request. On June 18, 2013, Cleco Power filed a related application with the LPSC requesting approval of Cleco Power's proposed MISO integration, implementation, and rate-making plans.

Cleco Midstream

Evangeline

In December 2011, Evangeline was notified that Cleco Power selected its proposal to fulfill Cleco Power's capacity and energy needs as defined in the Cleco Power RFP for contractual resources beginning in 2012. The proposal was for a 730-MW product beginning May 1, 2012, and ending April 30, 2015. The definitive agreement between Evangeline and Cleco Power was executed in January 2012 and was approved by the LPSC in March 2012 and FERC in April 2012. Midstream was marketing Coughlin's capacity for periods beginning after April 30, 2015, and had been evaluating various options to optimize Coughlin's value. On October 30, 2012, Cleco Power announced that Evangeline was the winning bidder in Cleco Power's 2012 Long-Term RFP. In December 2012, Cleco Power and Evangeline executed definitive agreements to transfer ownership and control of Coughlin from Evangeline to Cleco Power. For more

information, see "— Financial Condition — Regulatory and Other Matters — Generation RFP."

Comparison of the Three Months Ended June 30, 2013 and 2012

Cleco Consolidated

	FOR THE THREE MONTHS ENDED JUNE 30,			
			FAVORABLE/(UNFAVORABLE)	
(THOUSANDS)	2013	2012	VARIANCE	CHANGE
Operating revenue, net	$263,894	$240,123	$23,771	9.9 %
Operating expenses	189,140	165,880	(23,260)	(14.0)%

Operating income	$74,754	$74,243	$511		0.7	%
Allowance for other funds used during construction	$413	$1,399	$(986	)	(70.5	)%
Other income	$8,165	$13,014	$(4,849	)	(37.3	)%
Federal and state income taxes	$19,422	$20,520	$1,098		5.4	%
Net income applicable to common stock	$42,032	$46,686	$(4,654	)	(10.0	)%

Consolidated net income applicable to common stock decreased $4.7 million, or 10.0%, in the second quarter of 2013 compared to the second quarter of 2012 primarily due to lower Cleco Power and corporate earnings.

Operating revenue, net increased $23.8 million, or 9.9%, in the second quarter of 2013 compared to the second quarter of 2012 largely as a result of higher base revenue and fuel cost recovery revenue at Cleco Power.

Operating expenses increased $23.3 million, or 14.0%, in the second quarter of 2013 compared to the second quarter of 2012 primarily due to higher per unit costs of fuel used for electric generation, higher operations and maintenance expenses, and higher depreciation expense at Cleco Power.

Allowance for other funds used during construction decreased $1.0 million, or 70.5%, during the second quarter of 2013 compared to the second quarter of 2012 primarily due to lower AFUDC accruals related to miscellaneous transmission projects at Cleco Power.

Other income decreased $4.8 million, or 37.3%, during the second quarter of 2013 compared to the second quarter of 2012 largely due to lower income related to the contractual expiration of an underlying indemnification resulting from the disposition of Acadia Unit 2.

Federal and state income taxes decreased $1.1 million, or 5.4%, during the second quarter of 2013 compared to the second quarter of 2012 primarily due to decreases of $1.8 million for the change in pre-tax income excluding AFUDC equity and $1.4 million for settlements with taxing authorities. These decreases were partially offset by $0.7 million for flowthrough of tax benefits, $0.6 million to record tax expense at the consolidated projected annual effective tax rate, $0.4 million for permanent tax deductions, and $0.4 million for tax credits.

Results of operations for Cleco Power and Midstream are more fully described below.

Cleco Power

	FOR THE THREE MONTHS ENDED JUNE 30,			
			FAVORABLE/(UNFAVORABLE)	
(THOUSANDS)	2013	2012	VARIANCE	CHANGE
Operating revenue				
Base	$160,031	$156,192	$3,839	2.5 %
Fuel cost recovery	92,734	72,101	20,633	28.6 %
Electric customer credits	(402)	(281)	(121)	(43.1)%
Other operations	11,027	11,613	(586)	(5.0)%
Affiliate revenue	335	342	(7)	(2.0)%
Operating revenue, net	263,725	239,967	23,758	9.9 %
Operating expenses				
Recoverable fuel used for electric generation	71,907	54,205	(17,702)	(32.7)%
Recoverable power purchased for utility customers	20,826	17,899	(2,927)	(16.4)%
FAC non-recoverable fuel and power purchased	3,125	4,958	1,833	37.0 %
Other operations	29,540	27,243	(2,297)	(8.4)%
Maintenance	23,585	19,630	(3,955)	(20.1)%
Depreciation	32,959	30,559	(2,400)	(7.9)%
Taxes other than income taxes	9,204	8,682	(522)	(6.0)%
Gain on sale of assets	—	(1)	(1)	(100.0)%
Total operating expenses	191,146	163,175	(27,971)	(17.1)%
Operating income	$72,579	$76,792	$(4,213)	(5.5)%
Allowance for other funds used during construction	$413	$1,399	$(986)	(70.5)%
Federal and state income taxes	$17,965	$20,501	$2,536	12.4 %
Net income	$34,464	$37,284	$(2,820)	(7.6)%

Cleco Power’s net income in the second quarter of 2013 decreased $2.8 million, or 7.6%, compared to the second quarter of 2012. Contributing factors include:

- higher other operations and maintenance expenses,
- higher depreciation expenses,
- lower allowance for other funds used during construction,
- lower other operations revenue, and
- higher taxes other than income taxes.

These factors were partially offset by:

- higher base revenue,
- lower income taxes, and
- lower FAC non-recoverable fuel and power purchased.

	FOR THE THREE MONTHS ENDED JUNE 30,		
(MILLION kWh)	2013	2012	FAVORABLE/ (UNFAVORABLE)
Electric sales			

Residential	801	848	(5.5)%
Commercial	632	667	(5.2)%
Industrial	575	578	(0.5)%
Other retail	33	33	— %
Total retail	2,041	2,126	(4.0)%
Sales for resale	498	466	6.9 %
Unbilled	215	168	28.0 %
Total retail and wholesale customer sales	2,754	2,760	(0.2)%

	FOR THE THREE MONTHS ENDED JUNE 30,		
(THOUSANDS)	2013	2012	FAVORABLE/ (UNFAVORABLE)
Electric sales			
Residential	$64,815	$66,150	(2.0)%
Commercial	44,679	44,317	0.8 %
Industrial	22,061	21,132	4.4 %
Other retail	2,494	2,407	3.6 %
Surcharge	2,054	2,036	0.9 %
Other	(1,566)	(1,566)	— %
Total retail	134,537	134,476	— %
Sales for resale	13,299	11,710	13.6 %
Unbilled	12,195	10,006	21.9 %
Total retail and wholesale customer sales	$160,031	$156,192	2.5 %

Cleco Power's residential customers' demand for electricity largely is affected by weather. Weather generally is measured in cooling-degree days and heating-degree days. A cooling-degree day is an indication of the likelihood that a consumer will use air conditioning, while a heating-degree day is an indication of the likelihood that a consumer will use heating. An increase in heating-degree days does not produce the same increase in revenue as an increase in cooling-degree days, because alternative heating sources are more available and because winter energy is priced below the rate charged for energy used in the summer. Normal heating-degree days and cooling-degree days are calculated for a month by separately calculating the average actual heating- and cooling-degree days for that month over a period of 30 years.

The following table shows how cooling-degree days varied from normal conditions and from the prior period. Cleco Power uses weather data provided by the National Oceanic and Atmospheric Administration to determine degree days.

	FOR THE THREE MONTHS ENDED JUNE 30,				
				2013 CHANGE	
	2013	2012	NORMAL	PRIOR YEAR	NORMAL
Cooling-degree days	952	1,143	942	(16.7)%	1.1 %

Base

Base revenue increased $3.8 million, or 2.5%, during the second quarter of 2013 compared to the second quarter of 2012 primarily due to an annual rate adjustment associated with Cleco Power's FRP, which resulted in an approximate $4.3 million increase to base revenue, partially offset by milder summer weather, which resulted in an approximate $0.5 million decrease to base revenue.

Cleco Power expects to begin providing service to expansions of current customers' operations, as well as service to new retail customers. These expansions of service to current customers and service to new customers are expected to contribute additional base revenue of $1.5 million for the remainder of 2013, an additional $1.6 million in 2014, and an additional $3.4 million in 2015. Cleco Power also anticipates additional base revenue for the remainder of 2013 of approximately $3.8 million associated with the implementation of a FERC formula rate methodology for transmission

services and $1.0 million associated with the recovery of expenditures for compliance with anticipated environmental laws.
On December 31, 2013, an existing wholesale customer contract will expire. Cleco Power anticipates a decrease in

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annual base revenue associated with this contract of approximately $4.0 million. During the second quarter of 2013, Cleco Power received notification from a second wholesale customer that it had elected to exercise its option to early terminate its power supply agreement after December 31, 2014. Annual base revenue, excluding FRP revenue, associated with this contract is approximately $23.0 million. In Cleco Power's application for an extension of its FRP, filed with the LPSC on April 13, 2013, Cleco Power requested consideration for the ability to file for relief in the event of the termination of this agreement. The loss of this revenue will not have an impact on Cleco Power's retail customers, financial condition, results of operations, or cash flows until 2015. In January 2012, Cleco Power signed a new 10-year wholesale power contract with service to begin in April 2014. Cleco Power also expects to begin providing additional services to two existing wholesale customers. The anticipated increase in annual base revenue related to these customers is approximately $39.0 million in 2014 and $54.0 million in 2015.
For information on the effects of future energy sales on Cleco Power's financial condition, results of operations, and cash flows, see "Risk Factors — Future Electricity Sales" in the Registrants' Combined Annual Report on Form 10-K for the fiscal year ended December 31, 2012.

Fuel Cost Recovery
Fuel cost recovery revenue billed to customers increased $20.6 million, or 28.6%, during the second quarter of 2013 compared to the second quarter of 2012 primarily due to increases in the per-unit cost of fuel used for electric generation and power purchased for utility customers. Partially offsetting the increase were lower volumes of power purchased for utility customers. Changes in fuel costs historically have not significantly affected Cleco Power's net income. Generally, fuel and purchased power expenses are recovered through the LPSC-established FAC, which enables Cleco Power to pass on to its customers substantially all such charges. Approximately 88% of Cleco Power's total fuel cost during the second quarter of 2013 was regulated by the LPSC, while the remainder was regulated by FERC. Recovery of FAC costs is subject to refund until approval is received from the LPSC.

Electric Customer Credits
Electric customer credits increased $0.1 million, or 43.1%, during the second quarter of 2013 compared to the second quarter of 2012 primarily due to an adjustment in 2013 for the 2012 cycle accrual. For more information on the accrual for electric customer credits, see Item 1, "Notes to the Unaudited Condensed Consolidated Financial Statements — Note 9 — Electric Customer Credits."

Other Operations
Other operations revenue decreased $0.6 million, or 5.0%, in the second quarter of 2013 compared to the second quarter of 2012 primarily due to $2.0 million of lower wholesale sales and $0.2 million of lower other miscellaneous revenue. This decrease was partially offset by $1.6 million of additional transmission revenue as a result of the implementation of new transmission rates.

Operating Expenses
Operating expenses increased $28.0 million, or 17.1%, in the second quarter of 2013 compared to the second quarter of

2012. Recoverable fuel used for electric generation increased $17.7 million, or 32.7%, primarily due to higher per unit costs of fuel used for electric generation as compared to the second quarter of 2012. Recoverable power purchased for utility customers increased $2.9 million, or 16.4%, largely due to higher per unit costs of purchased power. Partially offsetting this increase were lower volumes of purchased power. Fuel used for electric generation and power purchased for utility customers generally are influenced by natural gas prices as well as availability of transmission. However, other factors such as scheduled and/or unscheduled outages, unusual maintenance or repairs, or other developments may affect fuel used for electric generation and power purchased for utility customers. FAC non-recoverable fuel and power purchased decreased $1.8 million, or 37.0%, primarily due to lower non-recoverable wholesale power purchases. Other operations expense increased $2.3 million, or 8.4%, primarily due to higher consulting expenses and higher transmission expenses. Maintenance expense increased $4.0 million, or 20.1%, primarily due to higher generation expenses relating to outages. Depreciation expense increased $2.4 million, or 7.9%, primarily due to amortization of the Evangeline capacity costs and normal recurring additions to fixed assets. Taxes other than income taxes increased $0.5 million, or 6.0%, primarily due to higher property taxes.

Allowance for Other Funds Used During Construction

Allowance for other funds used during construction decreased $1.0 million, or 70.5%, during the second quarter of 2013 compared to the second quarter of 2012 primarily due to lower AFUDC accruals resulting from the completion of miscellaneous transmission projects.

Income Taxes

Federal and state income taxes decreased $2.5 million, or 12.4%, during the second quarter of 2013 compared to the second quarter of 2012. The decrease is primarily due to $1.7 million of lower pre-tax income excluding AFUDC equity, $1.4 million for settlements with taxing authorities, and $1.3 million to record tax expense at the projected annual effective rate. These decreases were partially offset by $0.9 million for permanent tax deductions, $0.7 million for flowthrough of tax benefits, $0.2 million for tax credits, and $0.1 million for miscellaneous tax items.

Midstream

	FOR THE THREE MONTHS ENDED JUNE 30,			
			FAVORABLE/(UNFAVORABLE)	
(THOUSANDS)	2013	2012	VARIANCE	CHANGE
Operating revenue				
Tolling operations	$9,307	$6,309	$2,998	47.5 %
Other operations	—	1	(1)	(100.0)%
Operating revenue	9,307	6,310	2,997	47.5 %
Operating expenses				
Fuel used for electric generation	—	304	304	100.0 %
Power purchased for utility customers	—	9	9	100.0 %
Other operations	1,846	1,873	27	1.4 %
Maintenance	2,503	4,452	1,949	43.8 %
Depreciation	1,501	1,460	(41)	(2.8)%
Taxes other than income taxes	623	612	(11)	(1.8)%
Gain on sale of assets	(188)	(21)	167	795.2 %
Total operating expenses	6,285	8,689	2,404	27.7 %
Operating income (loss)	$3,022	$(2,379)	$5,401	227.0 %
Other income	$6,900	$11,809	$(4,909)	(41.6)%
Interest charges	$(411)	$(1,159)	$(748)	(64.5)%
Federal and state income tax expense	$3,979	$4,051	$72	1.8 %
Net income	$6,350	$6,534	$(184)	(2.8)%

Factors affecting Midstream during the second quarter of 2013 are described below.

Operating Revenue
Operating revenue increased $3.0 million, or 47.5%, in the second quarter of 2013 compared to the second quarter of 2012 primarily due to higher tolling revenue at Evangeline resulting from the absence of availability penalties related to Coughlin Unit 7.

Operating Expenses
Operating expenses decreased $2.4 million, or 27.7%, in the second quarter of 2013 compared to the second quarter of 2012 primarily due to lower routine maintenance expenses, lower spring outage expenses, and lower turbine maintenance expenses at Evangeline.

Other Income
Other income decreased $4.9 million, or 41.6%, in the second quarter of 2013 compared to the second quarter of 2012 largely due to lower income related to the contractual expiration of an underlying indemnification resulting from the disposition of Acadia Unit 2.

Interest Charges
Interest charges increased $0.7 million, or 64.5%, during the second quarter of 2013 compared to the second quarter of 2012 primarily related to uncertain tax positions.

Income Taxes
Federal and state income taxes decreased $0.1 million, or 1.8%, during the second quarter of 2013 compared to the second quarter of 2012 primarily due to lower pre-tax income.

Comparison of the Six Months Ended June 30, 2013 and 2012
Cleco Consolidated

	FOR THE SIX MONTHS ENDED JUNE 30,			
			FAVORABLE/(UNFAVORABLE)	
(THOUSANDS)	2013	2012	VARIANCE	CHANGE
Operating revenue, net	$504,841	$462,894	$41,947	9.1 %
Operating expenses	371,617	334,357	(37,260)	(11.1)%
Operating income	$133,224	$128,537	$4,687	3.6 %
Allowance for other funds used during construction	$1,577	$2,416	$(839)	(34.7)%
Other income	$10,438	$22,389	$(11,951)	(53.4)%
Interest charges	$42,344	$41,240	$(1,104)	(2.7)%
Federal and state income taxes	$32,503	$33,930	$1,427	4.2 %
Net income applicable to common stock	$69,166	$76,718	$(7,552)	(9.8)%

Consolidated net income applicable to common stock decreased $7.6 million, or 9.8%, in the first six months of 2013 compared to the first six months of 2012 primarily due to lower Cleco Power, Midstream, and corporate earnings.
Operating revenue, net increased $41.9 million, or 9.1%, in the first six months of 2013 compared to the first six months of 2012 largely as a result of higher base revenue and higher fuel cost recovery revenue at Cleco Power.
Operating expenses increased $37.3 million, or 11.1%, in the first six months of 2013 compared to the first six months of 2012 primarily due to higher per unit costs and volumes of fuel used for electric generation, higher operations and maintenance expenses, higher depreciation expense, and higher taxes other than income taxes at Cleco Power.
Allowance for other funds used during construction decreased $0.8 million, or 34.7%, in the first six months of 2013 compared to the first six months of 2012 primarily due to lower AFUDC accruals related to miscellaneous transmission projects at Cleco Power.
Other income decreased $12.0 million, or 53.4%, in the first six months of 2013 compared to the first six months of 2012 largely due to lower income related to the contractual expiration of underlying indemnifications resulting from the disposition of Acadia Units 1 and 2.
Interest charges increased $1.1 million, or 2.7%, during the first six months of 2013 compared to the first six months of 2012 primarily due to higher interest charges at Cleco Power, partially offset by lower interest charges at Midstream.
Federal and state income taxes decreased $1.4 million, or 4.2%, during the first six months of 2013 compared to the first six months of 2012 primarily due to $3.1 million for the change in pre-tax income excluding AFUDC equity, $1.4 million for settlements with taxing authorities, and $0.2 million to record tax expense at the consolidated projected annual effective tax rate. These decreases were partially offset by $1.3 million for tax credits, $0.9 million for permanent tax deductions, $0.9 million for flowthrough of tax benefits, and $0.2 million for miscellaneous tax credits.
Results of operations for Cleco Power and Midstream are more fully described below.

Cleco Power

	FOR THE SIX MONTHS ENDED JUNE 30,			
			FAVORABLE/(UNFAVORABLE)	
(THOUSANDS)	2013	2012	VARIANCE	CHANGE
Operating revenue				
Base	$298,234	$285,524	$12,710	4.5 %
Fuel cost recovery	183,957	152,359	31,598	20.7 %
Electric customer credits	(424)	1,955	(2,379)	(121.7)%
Other operations	22,064	22,062	2	— %
Affiliate revenue	670	687	(17)	(2.5)%
Operating revenue, net	504,501	462,587	41,914	9.1 %
Operating expenses				
Recoverable fuel used for electric generation	156,442	126,883	(29,559)	(23.3)%
Recoverable power purchased for utility customers	27,517	25,479	(2,038)	(8.0)%
FAC non-recoverable fuel and power purchased	6,957	7,636	679	8.9 %
Other operations	54,912	53,585	(1,327)	(2.5)%
Maintenance	38,379	35,644	(2,735)	(7.7)%
Depreciation	65,288	60,648	(4,640)	(7.7)%
Taxes other than income taxes	20,662	17,614	(3,048)	(17.3)%
Gain on sale of assets	—	(1)	(1)	(100.0)%
Total operating expenses	370,157	327,488	(42,669)	(13.0)%
Operating income	$134,344	$135,099	$(755)	(0.6)%
Allowance for other funds used during construction	$1,577	$2,416	$(839)	(34.7)%
Interest charges	$42,227	$39,291	$(2,936)	(7.5)%
Federal and state income taxes	$32,203	$35,008	$2,805	8.0 %
Net income	$62,257	$64,089	$(1,832)	(2.9)%

Cleco Power's net income in the first six months of 2013 decreased $1.8 million, or 2.9%, compared to the first six months of 2012. Contributing factors include:

- higher depreciation expense,
- higher other operations and maintenance expenses,
- higher taxes other than income taxes,
- higher interest charges,
- higher electric customer credits, and
- lower allowance for other funds used during construction.

These were partially offset by:

- higher base revenue,
- lower income taxes, and
- lower FAC non-recoverable fuel and power purchased.

	FOR THE SIX MONTHS ENDED JUNE 30,		
(Million kWh)	2013	2012	FAVORABLE/ (UNFAVORABLE)
Electric sales			
Residential	1,642	1,632	0.6 %
Commercial	1,214	1,237	(1.9)%
Industrial	1,130	1,128	0.2 %
Other retail	65	65	— %
Total retail	4,051	4,062	(0.3)%
Sales for resale	939	856	9.7 %
Unbilled	152	80	90.0 %
Total retail and wholesale customer sales	5,142	4,998	2.9 %

	FOR THE SIX MONTHS ENDED JUNE 30,		
(THOUSANDS)	2013	2012	FAVORABLE/ (UNFAVORABLE)
Electric sales			
Residential	$126,515	$122,540	3.2 %
Commercial	88,728	86,064	3.1 %
Industrial	43,186	41,224	4.8 %
Other retail	5,061	4,767	6.2 %
Surcharge	4,291	4,851	(11.5)%
Other	(3,131)	(3,120)	(0.4)%
Total retail	264,650	256,326	3.2 %
Sales for resale	25,577	23,495	8.9 %
Unbilled	8,007	5,703	40.4 %
Total retail and wholesale customer sales	$298,234	$285,524	4.5 %

The following chart shows how cooling- and heating-degree days varied from normal conditions and from the prior period. Cleco Power uses weather data provided by the National Oceanic and Atmospheric Administration to determine degree days.

			FOR THE SIX MONTHS ENDED JUNE 30,		
				2013 CHANGE	
	2013	2012	NORMAL	PRIOR YEAR	NORMAL
Heating-degree days	874	500	948	74.8 %	(7.8)%
Cooling-degree days	1,016	1,394	1,021	(27.1)%	(0.5)%

Base

Base revenue increased $12.7 million, or 4.5%, during the first six months of 2013 compared to the first six months of 2012 primarily due to an annual rate adjustment associated with Cleco's FRP, which resulted in an approximate $7.9 million increase to base revenue, and increased sales from favorable weather, which resulted in an approximate $4.8 million increase to base revenue. For information on the anticipated effects of changes in base revenue in future periods, see "— Comparison of the Three Months Ended June 30, 2013 and 2012 — Cleco Power — Base." For information on the effects of future energy sales on Cleco Power's financial condition, results of operations, and cash flows, see "Risk Factors — Future Electricity Sales" in the Registrants' Combined Annual Report on Form 10-K for the fiscal year ended December 31, 2012.

Fuel Cost Recovery

Fuel cost recovery revenue billed to customers increased $31.6 million, or 20.7%, during the first six months of 2013 compared to the first six months in 2012 primarily due to increases in the per-unit cost of fuel used for electric generation and power purchased for utility customers. Also

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contributing to the increase were higher volumes of fuel used for electric generation. Partially offsetting the increase were lower volumes of power purchased for utility customers. For information on Cleco Power's ability to recover fuel and purchase power costs, see "— Comparison of the Three Months Ended June 30, 2013 and 2012 — Cleco Power — Fuel Cost Recovery."

Electric Customer Credits
Electric customer credits increased $2.4 million, or 121.7%, during the first six months of 2013 compared to the first six months of 2012 primarily due to the absence of the reversals of the 2012 cycle accrual and fuel audit reserves. For additional information on the accrual of electric customer credits, see Item 1, "Notes to the Unaudited Condensed Consolidated Financial Statements — Note 9 — Electric Customer Credits."

Operating Expenses
Operating expenses increased $42.7 million, or 13.0%, in the first six months of 2013 compared to the first six months of 2012. Recoverable fuel used for electric generation increased $29.6 million, or 23.3%, primarily due to higher per unit costs and volumes of fuel used as compared to the first six months of 2012. Recoverable power purchased for utility customers increased $2.0 million, or 8.0%, largely due to higher per-unit costs of purchased power. Partially offsetting this increase were lower volumes of purchased power. Fuel used for electric generation and power purchased for utility customers generally are influenced by natural gas prices, as well as availability of transmission. However, other factors such as scheduled and/or unscheduled outages, unusual maintenance or repairs, or other developments may affect fuel used for electric generation and power purchased for utility customers. FAC non-recoverable fuel and purchased power decreased $0.7 million, or 8.9%, primarily due to lower capacity payments. Other operations expense increased $1.3 million, or 2.5%, primarily due to higher consulting expenses. Maintenance expense increased $2.7 million, or 7.7%, primarily due to higher generation expenses relating to outages in the first six months of 2013. Depreciation expense increased $4.6 million, or 7.7%, primarily due to amortization of the Evangeline capacity costs and normal recurring additions to fixed assets. Taxes other than income taxes increased $3.0 million, or 17.3%, primarily due to higher property taxes.

Allowance for Other Funds Used During Construction
Allowance for other funds used during construction decreased $0.8 million, or 34.7%, during the first six months of 2013 compared to the first six months of 2012 primarily due to lower AFUDC accruals resulting from the completion of miscellaneous transmission projects.

Interest Charges
Interest charges increased $2.9 million, or 7.5%, during the first six months of 2013 compared to the first six months of 2012 primarily due to $4.8 million related to uncertain tax positions and $0.3 million related to other net miscellaneous interest charges. Partially offsetting these increases were $1.1 million of lower interest charges due to reacquired debt and $1.1 million due to the retirement of pollution control bonds in May 2012.

Income Taxes
Federal and state income taxes decreased $2.8 million, or 8.0%, during the first six months of 2013 compared to the first six months of 2012. The decrease is primarily due to $2.1 million to record tax expense at the projected annual effective tax rate, $1.5 million for the change in pre-tax income excluding AFUDC equity, and $1.4 million for settlements with taxing authorities. These decreases were partially offset by $1.0 million for permanent tax deductions, $0.9 million for flowthrough of tax benefits, $0.2 million for tax credits, and $0.1 million for miscellaneous tax items.
Midstream

FOR THE SIX MONTHS ENDED JUNE 30,

(THOUSANDS)	2013	2012	FAVORABLE/(UNFAVORABLE) VARIANCE	CHANGE
Operating revenue				
Tolling operations	$14,144	$7,543	$6,601	87.5 %
Other operations	1	1	—	— %
Operating revenue	14,145	7,544	6,601	87.5 %
Operating expenses				
Fuel used for electric generation	—	304	304	100.0 %
Power purchased for utility customers	—	9	9	100.0 %
Other operations	3,569	3,656	87	2.4 %
Maintenance	5,165	5,625	460	8.2 %
Depreciation	3,001	2,992	(9)	(0.3)%
Taxes other than income taxes	1,251	1,284	33	2.6 %
Loss (gain) on sale of assets	846	(43)	(889)	*
Total operating expenses	13,832	13,827	(5)	— %
Operating income (loss)	$313	$(6,283)	$6,596	105.0 %
Other income	$7,200	$19,016	$(11,816)	(62.1)%
Interest charges	$(649)	$313	$962	307.3 %
Federal and state income tax expense	$3,139	$4,789	$1,650	34.5 %
Net income	$5,016	$7,624	$(2,608)	(34.2)%

* Not meaningful

Factors affecting Midstream during the first six months of 2013 are described below.

Operating Revenue

Operating revenue increased $6.6 million, or 87.5%, during the first six months of 2013 compared to the first six months of 2012 primarily due to higher tolling revenue at Evangeline resulting from a new power purchase agreement with Cleco Power for Coughlin Units 6 and 7 that began in May 2012 as compared to the power purchase agreement with Cleco Power for Coughlin Unit 6 in effect from January through April 2012. Also contributing to this increase was the absence of availability penalties from Coughlin Unit 7 in June 2012.

Loss on Sale of Assets

Loss on sale of assets increased $0.9 million, during the first six months of 2013 compared to the first six months of 2012 primarily due to the disposal of assets at Evangeline from the 2013 spring outage.

Other Income

Other income decreased $11.8 million, or 62.1%, during the first six months of 2013 compared to the first six months of

2012 largely due to lower income related to the contractual expiration of underlying indemnifications resulting from the disposition of Acadia Units 1 and 2.

Interest Charges
Interest charges decreased $1.0 million, or 307.3%, during the first six months of 2013 compared to the first six months of 2012 primarily related to uncertain tax positions.

Income Taxes
Federal and state income taxes decreased $1.7 million, or 34.5%, during the first six months of 2013 compared to the first six months of 2012 primarily due to a decrease in pre-tax income.
FINANCIAL CONDITION

Liquidity and Capital Resources

General Considerations and Credit-Related Risks

Credit Ratings and Counterparties
Financing for operational needs and capital expenditure requirements not satisfied by operating cash flows depends upon the cost and availability of external funds through both short- and long-term financing. The inability to raise capital on favorable terms could negatively affect Cleco's or Cleco Power's ability to maintain or expand its businesses. Access to funds is dependent upon factors such as general economic and capital market conditions, regulatory authorizations and policies, Cleco Corporation's and Cleco Power's credit ratings, the cash flows from routine operations, and the credit ratings of project counterparties. After assessing the current operating performance, liquidity, and credit ratings of Cleco Corporation and Cleco Power, management believes that Cleco Corporation and Cleco Power will have access to the capital markets at prevailing market rates for companies with comparable credit ratings. The following table presents the credit ratings of Cleco Corporation and Cleco Power at June 30, 2013.

	SENIOR UNSECURED DEBT		CORPORATE CREDIT
	MOODY'S	S&P	S&P
Cleco Corporation	Baa3	N/A	*BBB
Cleco Power	Baa2	*BBB	N/A

* The credit ratings for both Cleco Corporation and Cleco Power were upgraded by S&P to BBB+ on July 26, 2013.

Cleco notes that credit ratings are not recommendations to buy, sell, or hold securities and may be subject to revision or withdrawal at any time by the assigning rating agency. Each rating should be evaluated independently of any other rating.
During the six-months ended June 30, 2013, there were no changes to Cleco Corporation or Cleco Power's credit ratings. At June 30, 2013, Moody's outlooks for both Cleco Corporation and Cleco Power were stable and S&P outlooks for both Cleco Corporation and Cleco Power were positive. On July 26, 2013, S&P upgraded the Cleco Corporation corporate credit rating and Cleco Power's unsecured credit rating to BBB+ from BBB. At that time, S&P revised the outlook to stable. Cleco Corporation and Cleco Power pay fees and interest under their bank credit agreements based on the highest rating held. If Cleco Corporation or Cleco Power's credit rating were to be downgraded by Moody's or S&P, Cleco Corporation and/or

Cleco Power would be required to pay additional fees and incur higher interest rates for borrowings under their bank credit agreements. Cleco Power's collateral for derivatives is based on the lowest rating held. If Cleco Power's credit ratings were to be downgraded by Moody's or S&P, Cleco Power would be required to post additional collateral for derivatives.

With respect to any open power or natural gas trading positions that Cleco may initiate in the future, Cleco may be required to provide credit support or pay liquidated damages. The amount of credit support that Cleco may be required to provide at any point in the future is dependent on the amount of the initial transaction, changes in the market price of power and natural gas, the changes in open power and gas positions, and changes in the amount counterparties owe Cleco. Changes in any of these factors could cause the amount of requested credit support to increase or decrease.

In June 2013, the LPSC approved Cleco Power's application to join MISO and to find that transferring control of certain transmission assets to MISO was in the public interest, to create an accounting order deferring costs related to Cleco Power's transition into the MISO market, and to expedite treatment. MISO operates a fully functioning RTO market. The vast majority of the transactions are settled through the day-ahead market; however, MISO also operates a real-time energy market to address the deviations between day-ahead and real-time schedules. Due to the timing of the settlement of such schedules, Cleco Power may be required to provide credit support for MISO and this may cause the amount of requested credit support to increase or decrease.

Global and U.S. Economic Environment

The current economic environment and uncertainty may have an impact on Cleco's business and financial condition. Access to capital markets is a significant source of funding for both short- and long-term capital requirements not satisfied by operating cash flows. Market conditions in the past years have limited the availability and have increased the costs of capital for many companies. Although the Registrants have not experienced restrictions in the financial markets, their ability to access the capital markets may be restricted at a time when the Registrants would like, or need, to do so. Any restrictions could have a material impact on the Registrants' ability to fund capital expenditures or debt service, or on their flexibility to react to changing economic and business conditions. Credit constraints could have a material negative impact on the Registrants' lenders or customers, causing them to fail to meet their obligations to the Registrants or to delay payment of such obligations. The lower interest rates that the Registrants have been exposed to have been beneficial to recent debt issuances; however, these rates have negatively affected interest income for the Registrants' short-term investments.

Fair Value Measurements

Various accounting pronouncements require certain assets and liabilities to be measured at their fair values. Some assets and liabilities are required to be measured at their fair value each reporting period, while others are required to be measured only one time, generally the date of acquisition or debt issuance. Cleco and Cleco Power are required to disclose the fair value of certain assets and liabilities by one of three levels when required for recognition purposes under GAAP. Other financial assets and liabilities, such as long-term debt, are reported at their carrying values at their date of issuance on the consolidated balance sheets with their fair values as of the balance sheet date disclosed within the three levels. For more information about fair value levels, see Item 1, "Notes to the Unaudited Condensed Consolidated Financial Statements — Note 4 — Fair Value Accounting."

Cash Generation and Cash Requirements

Restricted Cash and Cash Equivalents

Various agreements to which Cleco is subject contain covenants that restrict its use of cash. As certain provisions under these agreements are met, cash is transferred out of related escrow accounts and becomes available for its intended purposes and/or general corporate purposes. Cleco's restricted cash and cash equivalents consisted of:

(THOUSANDS)	AT JUNE 30, 2013	AT DEC. 31, 2012
Diversified Lands' mitigation escrow	$97	$97
Cleco Katrina/Rita's storm recovery bonds	8,067	8,781
Cleco Power's future storm restoration costs	4,326	5,343
Total restricted cash and cash equivalents	$12,490	$14,221

Cleco Katrina/Rita has the right to bill and collect storm restoration costs from Cleco Power's customers. As cash is collected, it is restricted for payment of operating expenses, interest, and principal on storm recovery bonds. During the six months ended June 30, 2013, Cleco Katrina/Rita collected $9.7 million net of operating expenses. In March 2013, Cleco Katrina/Rita used $7.1 million for scheduled storm recovery bond principal payments and $3.3 million for related interest.

Debt

Cleco Consolidated

At June 30, 2013, Cleco had $3.0 million of short-term debt outstanding under Cleco Power's uncommitted line of credit, compared to no short-term debt outstanding at December 31, 2012. The short-term debt had an interest rate of 1.95% and was repaid on July 1, 2013.

At June 30, 2013, Cleco's long-term debt outstanding was $1.34 billion, of which $16.7 million was due within one year. The long-term debt due within one year at June 30, 2013, represents $14.5 million principal payments for the Cleco Katrina/Rita storm recovery bonds and $2.2 million of capital lease payments.

For Cleco, long-term debt decreased $8.0 million primarily due to a $75.0 million repayment of senior notes, $60.0 million of solid waste disposal bonds reacquired in March 2013, a $25.0 million payment on the bank term loan entered into in March 2013, a $7.1 million scheduled Cleco Katrina/Rita storm recovery bond principal payment made in March 2013, and a $1.1 million decrease in capital lease obligations. These decreases were partially offset by a $60.0 million bank term loan entered into in March 2013, the issuance of $50.0 million of 2008 Series A GO Zone bonds and $50.0 million of 2008 series B GO Zone bonds in May 2013, and debt discount amortizations of $0.2 million.

Cash and cash equivalents available at June 30, 2013, were $7.6 million combined with $525.0 million credit facility capacity ($225.0 million from Cleco Corporation and $300.0 million from Cleco Power) for total liquidity of $532.6 million. Cash and cash equivalents available at June 30, 2013, decreased $23.5 million when compared to cash and cash equivalents available at December 31, 2012. This decrease

was primarily due to higher vendor payments, the payment of common stock dividends, contributions to the pension plan, interest payments, routine working capital fluctuations, and payment of property taxes. An increase in customer receipts and the receipt of tax refunds partially offset this decrease.

At June 30, 2013, Cleco and Cleco Power were exposed to concentrations of credit risk through their short-term investments classified as cash equivalents. In order to mitigate potential credit risk, Cleco and Cleco Power have established guidelines for short-term investments. For more information on the concentration of credit risk through

short-term investments classified as cash equivalents, see Item 1, “Notes to the Unaudited Condensed Consolidated Financial Statements — Note 4 — Fair Value Accounting.”
At June 30, 2013 and December 31, 2012, Cleco had a working capital surplus of $152.1 million and $152.7 million, respectively. The $0.6 million decrease in working capital is primarily due to:

- a $97.1 million net increase in current tax liabilities and uncertain tax positions and related interest charges expected to be settled in the next 12 months and
- a $23.5 million decrease in unrestricted cash and cash equivalents as discussed above.

These decreases in working capital were partially offset by:

- a $74.5 million decrease in long-term debt due within one year which reflects the refinancing of long-term debt,
- a $9.4 million increase in customer accounts receivable,
- an $8.7 million decrease in accounts payable primarily due to payments of ad valorem tax, employee incentives and fuel that were accrued at year end,
- an $8.3 million decrease in regulatory liabilities due to the return of customer owed carrying costs related to the construction of Madison Unit 3,
- a $7.4 million increase in unbilled revenue, and
- a $6.4 million increase in fuel inventory.

Cleco Corporation (Holding Company Level)
Cleco Corporation had no short-term debt outstanding at June 30, 2013 or December 31, 2012.
At June 30, 2013 and December 31, 2012, Cleco Corporation had $25.0 million draws outstanding under its $250.0 million credit facility. This facility provides for working capital and other needs. Cleco Corporation and Cleco Power have uncommitted lines of credit with a bank that allow up to $10.0 million each in short term borrowings, but no more than $10.0 million in aggregate, to support their working capital needs.
Cash and cash equivalents available at June 30, 2013, were $4.6 million, combined with $225.0 million credit facility capacity for total liquidity of $229.6 million. Cash and cash equivalents available at June 30, 2013, decreased $2.8 million when compared to cash and cash equivalents available at December 31, 2012, primarily due to higher vendor payments, the payment of common stock dividends, routine working capital fluctuations, and payment of property taxes. Partially offsetting this decrease was a tax refund.

Cleco Power

At June 30, 2013, Cleco Power had $3.0 million of short-term debt outstanding under its uncommitted line of credit, compared to no short-term debt outstanding at December 31, 2012. The short-term debt had an interest rate of 1.95% and was repaid on July 1, 2013.

At June 30, 2013, Cleco Power's long-term debt outstanding was $1.32 billion, of which $16.7 million was due within one year. The long-term debt due within one year at June 30, 2013, represents $14.5 million principal payments for the Cleco Katrina/Rita storm recovery bonds and $2.2 million of capital lease payments.

For Cleco Power, long-term debt decreased $8.0 million primarily due to a $75.0 million repayment of senior notes, $60.0 million solid waste disposal bonds reacquired in March 2013, a $25.0 million payment on the bank term loan entered into in March 2013, a $7.1 million scheduled Cleco Katrina/Rita storm recovery bond principal payment made in March 2013, and a $1.1 million of lower capital lease obligations. These decreases were partially offset by a $60.0 million bank term loan entered into in March 2013, issuance of $50.0 million of 2008 Series A GO Zone bonds and $50.0 million of 2008 series B GO Zone bonds in May 2013, and debt discount amortizations of $0.2 million.

At June 30, 2013 and December 31, 2012, there were no borrowings outstanding under Cleco Power's $300.0 million credit facility. This facility provides for working capital and other needs.

Cleco Corporation and Cleco Power have uncommitted lines of credit with a bank that allow up to $10.0 million each in short term borrowings, but no more than $10.0 million in aggregate, to support their working capital needs. At June 30, 2013, Cleco Power had $3.0 million in outstanding borrowings under its uncommitted line of credit.

Cash and cash equivalents available at June 30, 2013, were $2.7 million, combined with $300.0 million facility capacity for total liquidity of $302.7 million. Cash and cash equivalents decreased $20.6 million, when compared to cash and cash equivalents at December 31, 2012. This decrease is primarily due to higher vendor payments, contributions to the pension plan, interest payments, payment of property taxes, and routine working capital fluctuations. Partially offsetting this decrease was an increase in customer receipts.

At June 30, 2013 and December 31, 2012, Cleco Power had a working capital surplus of $133.1 million and $96.3 million, respectively. The $36.8 million increase in working capital is primarily due to:

- a $74.5 million decrease in long-term debt due within one year which reflects the refinancing of long-term debt,
- a $9.4 million increase in customer accounts receivable,
- an $8.3 million decrease in regulatory liabilities due to the return of customer owed carrying costs related to the construction of Madison Unit 3,
- a $7.4 million increase in unbilled revenue,
- a $6.4 million increase in fuel inventory, and
- a $3.2 million decrease in accounts payable primarily due to payments of ad valorem tax, employee incentive and fuel that were accrued at year end.

These increases in working capital were partially offset by:

- a $49.9 million net increase in current tax liabilities and uncertain tax positions and related interest charges expected to be settled in the next 12 months and
- a $20.6 million decrease in unrestricted cash and cash equivalents, as discussed above.

Cleco Power's $60.0 million solid waste disposal facility bonds due 2037, which were issued by the Rapides Finance Authority for the benefit of Cleco Power in November 2007, were required to be mandatorily tendered by the bondholders for purchase on March 1, 2013, pursuant to the terms of the indenture. The bonds were issued in connection with a loan agreement between the Rapides Finance Authority and Cleco Power. On March 1, 2013, Cleco Power purchased all $60.0 million outstanding bonds at face value plus $1.6 million of accrued interest, using draws under Cleco Power's revolving credit facility. In connection with the purchase, the interest rate of the bonds will reset each week based on the Securities Industry and Financial Markets Association index. The initial interest rate of the bonds at March 1, 2013, was 0.11% per annum. Interest expense will continue to be recorded with a corresponding amount recorded as interest income, excluding amortization of debt issuance costs. Although the bonds remain outstanding, Cleco Power has the right to redeem and cancel the debt at any time without approval of the Rapides Finance Authority. In accordance with the authoritative guidance, the bonds are considered extinguished and Cleco Power is holding the debt as treasury bonds, resulting in a net presentation on Cleco and Cleco Power's Condensed Consolidated Balance Sheets. Cleco Power has the option to remarket the bonds for new terms and new interest rates, both to be determined by market conditions.

On March 20, 2013, Cleco Power entered into a bank term loan agreement in the amount of $60.0 million. Proceeds of the loan agreement were used to repay draws under Cleco Power’s revolving credit facility. Cleco Power made a $25.0 million payment on the loan on May 8, 2013, reducing the balance outstanding to $35.0 million. The interest rate under the agreement at June 30, 2013, was 1.075%. The interest rate is based on LIBOR and resets on a monthly basis. The loan matures on May 29, 2015.

On May 3, 2013, Cleco Power remarketed $50.0 million of its 2008 Series A GO Zone bonds which had previously been purchased by Cleco Power and was being held as treasury bonds, at an interest rate based on 0.82% plus 65% of LIBOR. The rate resets monthly. The 2008 Series A GO Zone bonds will be subject to remarketing on May 3, 2015. The proceeds were used to fund the partial repayment of the $60.0 million solid waste disposal bonds described above.

On May 8, 2013, Cleco Power remarketed $50.0 million of its 2008 Series B GO Zone bonds which had previously been purchased by Cleco Power and was being held as treasury bonds, at a fixed interest rate of 4.25%. The 2008 Series B GO Zone bonds mature on December 1, 2038. The proceeds were used to partially fund the maturity of Cleco Power's 5.375% senior notes on May 1, 2013.

Credit Facilities

At June 30, 2013, Cleco Corporation had $25.0 million borrowings outstanding under its $250.0 million credit facility at an interest rate of 1.70%. The borrowings under the credit facility are considered to be long-term as the credit facility expires in 2016. The borrowing costs under the facility are equal to one-month LIBOR plus 1.50% or ABR, plus facility fees of 0.25%. The existing borrowings had 30-day terms. Of the $25.0 million borrowings outstanding at June 30, 2013, $15.0 million matured and was renewed for an additional amount on July 15, 2013 and the remaining $10.0 million matured and was not renewed on July 31, 2013.

If Cleco Corporation's credit ratings were to be downgraded one level, Cleco Corporation would be required to pay fees and interest at a rate of 0.25% higher than the level for its current credit facility.

At June 30, 2013, Cleco Power had no borrowings outstanding under its existing credit facility. Cleco Power's current credit facility agreement has a maximum capacity of $300.0 million and matures on October 7, 2016. The borrowing costs are LIBOR plus 1.275% or ABR, plus facility fees of 0.225%. If Cleco Power's credit ratings were to be downgraded one level, Cleco Power would be required to pay fees and interest at a rate of 0.25% higher than the level on its current credit facility.

At June 30, 2013, Cleco Corporation and Cleco Power were in compliance with the covenants in their credit facilities. If Cleco Corporation were to default under the covenants in its credit facility or other debt agreements, it would be unable to borrow additional funds under the facility and the lenders could accelerate all principal and interest outstanding. Further, if Cleco Power were to default under its credit facility or other debt agreements, Cleco Corporation would be considered in default under its credit facility.

Midstream

Midstream had no debt outstanding at June 30, 2013 or December 31, 2012.

Cleco Consolidated Cash Flows

Net Operating Cash Flow

Net cash provided by operating activities was $135.4 million during the first six months of 2013, compared to $103.3 million during the first six months of 2012. Cash provided by operating activities during the first six months of 2013 increased $32.1 million from the first six months of 2012 primarily due to the following items:

- higher income tax refunds of $45.8 million,
- lower vendor payments of $13.6 million,
- lower refund of Madison Unit 3 carrying costs of $5.9 million due to extinguishment of the liability,
- lower payroll of $5.8 million, and
- lower payments for power purchases of $2.7 million.

These increases were partially offset by higher pension plan contributions of $34.0 million.

Net Investing Cash Flow

Net cash used in investing activities was $107.1 million during the first six months of 2013, compared to $99.8 million during the first six months of 2012. Net cash used in investing activities during the first six months of 2013 was higher than the first six months of 2012 primarily due to a lower return of investment in the NMTC Fund, partially offset by lower additions to property, plant, and equipment.

During the first six months of 2013, Cleco had additions to property, plant, and equipment, net of AFUDC of $83.8 million,

a $24.2 million investment in the NMTC Fund, and $4.3 million of purchases of restricted investments. This was partially offset by $2.6 million of maturities of restricted investments.

During the first six months of 2012, Cleco had additions to property, plant, and equipment, net of AFUDC of $99.9 million and a $31.3 million investment in the NMTC Fund. This was partially offset by a $22.2 million return of investment in the NMTC Fund and a $5.5 million insurance reimbursement for a property loss.

Net Financing Cash Flow
Net cash used in financing activities was $51.7 million during the first six months of 2013 compared to $73.4 million during the first six months of 2012. Net cash used in financing activities during the first six months of 2013 was lower than the first six months of 2012 primarily due to higher issuance of long-term debt and credit facility activity. This was partially offset by the repurchase of long-term debt and higher retirements of long-term debt.
During the first six months of 2013, Cleco used $173.0 million for payments on the credit facility, $107.1 for the retirement of long-term debt, $60.0 million for the repurchase of long-term debt, and $42.5 million for payment of common stock dividends. This was partially offset by $173.0 million of draws on the credit facility and $160.0 million for the issuance of long-term debt.
During the first six months of 2012, Cleco retired $68.0 million of long-term debt and made $10.0 million of payments on the credit facility. Cleco also used $38.1 million for dividend payments. This was partially offset by the issuance of $50.0 million of long-term debt.

Cleco Power Cash Flows

Net Operating Cash Flow
Net cash provided by operating activities was $92.2 million during the first six months of 2013, compared to $93.5 million during the first six months of 2012. Cash provided by operating activities during the first six months of 2013 decreased $1.3 million from the first six months of 2012 primarily due to higher pension plan contributions of $34.0 million. This decrease was partially offset by:

- lower vendor payments of $13.8 million,
- lower refund of Madison Unit 3 carrying costs of $5.9 million due to extinguishment of the liability,
- lower payroll of $4.0 million, and
- lower payments for power purchases of $2.7 million.

Net Investing Cash Flow
Net cash used in investing activities was $78.7 million during the first six months of 2013, compared to $91.6 million during the first six months of 2012. Net cash used in investing activities during the first six months of 2013 was lower than the first six months of 2012 primarily due to lower additions to property, plant, and equipment, partially offset by the purchase of restricted investments.
During the first six months of 2013, Cleco Power had additions to property, plant, and equipment, net of AFUDC of $79.9 million and purchases of restricted investments, net of premium and interest of $4.3 million. This was partially offset by $2.6 million from the maturities of restricted investments.
During the first six months of 2012, Cleco Power had additions to property, plant, and equipment, net of AFUDC of

$97.0 million. This was partially offset by $4.6 million of property, plant, and equipment grants received.

Net Financing Cash Flow
Net cash used in financing activities was $34.2 million during the first six months of 2013 compared to $59.2 million during the first six months of 2012. Net cash used in financing activities during the first six months of 2013 was lower than the first six months of 2012 primarily due to higher issuances of long-term debt and $15.0 million of lower distributions to Cleco Corporation. This was partially offset by the repurchase of long-term debt and higher retirements of long-term debt.

Contractual Obligations and Other Commitments
Cleco, in the normal course of business activities, enters into a variety of contractual obligations. Some of these result in direct obligations that are reflected in the Condensed Consolidated Balance Sheets while other commitments, some firm and some based on uncertainties, are not reflected in the Condensed Consolidated Financial Statements.
For more information regarding Cleco's Contractual Obligations and Other Commitments, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations — Financial Condition — Contractual Obligations and Other Commitments" in the Registrants' Combined Annual Report on Form 10-K for the fiscal year ended December 31, 2012.

Off-Balance Sheet Commitments and Disclosures about Guarantees
Cleco Corporation and Cleco Power have entered into various off-balance sheet commitments, in the form of guarantees and standby letters of credit, in order to facilitate their activities and the activities of Cleco Corporation's subsidiaries and equity investees (affiliates). Cleco Corporation and Cleco Power have also agreed to contractual terms that require them to pay third parties if certain triggering events occur. These contractual terms generally are defined as guarantees in the authoritative guidance. For more information on off-balance sheet commitments, see Item 1, "Notes to the Unaudited Condensed Consolidated Financial Statements — Note 11 — Litigation, Other Commitments and Contingencies, and Disclosures about Guarantees — Off-Balance Sheet Commitments" and "— Disclosures about Guarantees."

Regulatory and Other Matters

Generation RFP

Renewable Energy Pilot Program
In November 2010, the LPSC established a two-part renewable energy pilot program implementation plan consisting of a research component and an RFP component. Cleco Power is meeting the requirements of the research component by developing eight self-build renewable energy projects, each with a maximum nameplate rating of 300 kilowatts. The RFP component of the program requires each LPSC jurisdictional utility to conduct an RFP for new long-term renewable resources, while prohibiting the utilities from bidding self-build projects into the long-term RFP. Cleco Power's requirement is 43 MW of renewable energy with a minimum term of 10 years and a maximum term of 20 years, and can reasonably be expected to be deliverable within the 2011-2014 time period. Because Madison Unit 3 is designed to burn biomass fuel, with

minor modifications, in addition to its primary fuel, Cleco Power has been given an exception allowing it to conduct an RFP for biomass fuel along with identifying the costs to co-fire biomass fuel in Madison Unit 3. In November 2011, Cleco Power received LPSC approval for recovery of the test burn costs, and performed a biomass test burn at Madison Unit 3. Cleco Power issued its final RFP for biomass fuel in February 2012, and received all proposals in April 2012. In August 2012, Cleco Power filed a written report to the LPSC regarding co-firing biomass fuel in Madison Unit 3. Following its review of the results of Cleco Power's RFP and written report, the LPSC may authorize

Cleco Power to pursue co-firing biomass fuel in Madison Unit 3 or require Cleco Power to conduct an additional RFP for 43 MW of renewable energy as discussed above. For more information on Cleco's renewable energy pilot program, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations — Financial Condition — Regulatory and Other Matters — Generation RFP" in the Registrants' Combined Annual Report on Form 10-K for the fiscal year ended December 31, 2012.

RFP for Contractual Resources Beginning in May 2012

In September 2011, Cleco Power issued a draft RFP for resources and conducted a technical and bidders conference on October 13, 2011. The final RFP seeking up to approximately 750 MW of capacity and energy for a three- or five-year term was published on October 21, 2011. In March 2012, Cleco Power received approval from the LPSC for a three-year power purchase agreement with Evangeline providing 730 MW of capacity and energy for a delivery term beginning May 1, 2012, and ending April 30, 2015. Because Cleco Power and Evangeline are affiliates, Cleco Power also received approval from FERC to make power sales between affiliates pursuant to Section 205 of the Federal Power Act.

2012 Long-Term RFP for Capacity and Energy Resources

In May 2012, Cleco Power issued a draft RFP seeking up to approximately 800 MW beginning May 2015 to meet long-term capacity and energy needs due to load growth, environmental regulations, and the expiration of the Evangeline power purchase agreement discussed above. Cleco Power conducted a technical and bidders conference in May 2012, issued its final RFP in July 2012, and received proposals from potential suppliers in August 2012. In October 2012, Cleco Power announced Evangeline as the winning bidder in Cleco Power's 2012 Long-Term RFP, subject to further due diligence, the completion of definitive agreements, and regulatory approvals from the LPSC and FERC. In December 2012, Cleco Power and Evangeline executed definitive agreements to transfer ownership and control of Coughlin from Evangeline to Cleco Power. Cleco Power's application seeking regulatory approval is listed in the LPSC's Official Bulletin, dated April 12, 2013. In May 2013, Cleco Power filed its application with FERC seeking authorization to acquire Coughlin. The transaction is expected to close on or by April 30, 2014, following regulatory approvals by both the LPSC and FERC.

Environmental Matters

Cleco is subject to extensive environmental regulation by federal, state, and local authorities and is required to comply with numerous environmental laws and regulations, and to obtain and comply with numerous governmental permits, in operating its facilities. In addition, existing environmental laws, regulations, and permits could be revised or reinterpreted; new laws and regulations could be adopted or become applicable to Cleco or its facilities; and future changes in environmental laws and regulations could occur, including potential regulatory and enforcement developments related to air emissions. Cleco may incur significant additional costs to comply with these revisions, reinterpretations, and requirements. Cleco Power would then seek recovery of additional environmental compliance costs as riders through the LPSC's environmental adjustment clause or its FRP, or as a base rate adjustment as appropriate. If Cleco fails to comply with these revisions, reinterpretations, and requirements, it could be subject to civil or criminal liabilities and fines.

Cleco's facilities also are subject to federal and state laws and regulations regarding wastewater discharges. Cleco has received from the EPA and the LDEQ permits required under the federal Clean Water Act (CWA) for wastewater discharges from its generating stations. The CWA requires the EPA to periodically review and, if appropriate, revise technology based effluent limitations guidelines for categories of industrial facilities, including power generating facilities. The EPA issued proposed revised steam electric effluent limitations guidelines in April 2013. Final revised steam electric effluent limitations guidelines are expected by June 2014. Because there are a number of regulatory options being considered by the EPA, Cleco is unable to predict what the new effluent limitations guidelines will be or how significant the compliance costs may be.

For a discussion of other Cleco environmental matters, please read "Business — Environmental Matters" in the Registrants' Combined Annual Report on Form 10-K for the fiscal year ended December 31, 2012.

Retail Rates of Cleco Power

For information concerning Cleco Power's current FRP, the pending request for extension of the FRP, amounts accrued and refunded by Cleco Power as a result of the FRP, and information on the LPSC Staff's FRP reviews, see Item 1, "Notes to the Unaudited Condensed Consolidated Financial Statements — Note 9 — Electric Customer Credits."

In August 2009, the LPSC opened a docket to study the promotion of energy efficiency by jurisdictional electric and natural gas utilities. At the June 26, 2013 Business and Executive Session, the LPSC voted to restudy the energy efficiency rules previously rescinded by the LPSC's order on March 28, 2013. The proposed rules are not expected to have a material impact on the results of operations, financial condition, or cash flows of Cleco Power.

For information on certain other regulatory aspects of retail rates concerning Cleco Power, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations — Financial Condition — Regulatory and Other Matters — Retail Rates of Cleco Power" in the Registrants' Combined Annual Report on Form 10-K for the fiscal year ended December 31, 2012.

Transmission Rates of Cleco Power

Transmission Service

On March 29, 2012, Cleco Power filed a request with FERC for revisions to its OATT. The revisions were proposed to allow adoption of a formula rate methodology for transmission delivery and ancillary services provided by Cleco Power under the OATT and the existing bilateral Electric System Interconnection Agreements that preceded the OATT. The new

formula rates permit recovery of Cleco Power's FERC-jurisdictional investments in transmission and other assets placed in service since the existing rates were established. In May 2012, FERC issued an order accepting the rates for scheduling, system control and dispatch service, and the loss factors effective June 1, 2012. The remaining proposed rates were suspended for the maximum five-month statutory period and were effective November 1, 2012, subject to refund. On February 6, 2013, Cleco Power received notification that FERC had approved its settlement agreement filed on December 21, 2012. This settlement agreement allows for a return on equity of 10.5%, with an equity ratio of 53%. In accordance with the settlement, Cleco Power shall discount the charges produced by the formula rate by 10% until the earlier of December 31, 2014, or the date upon which Cleco commences operations under the MISO tariff, currently anticipated to be December 2013.

On December 6, 2012, Cleco Power filed an application with the LPSC requesting a public interest determination to find in favor of the transfer of functional control of certain transmission assets to MISO. At the June 26, 2013 Business and Executive Session, the LPSC approved this request. On June 18, 2013, Cleco Power filed a related application with the LPSC requesting approval of Cleco Power's proposed MISO integration, implementation, and rate-making plans.

For more information on the transmission rates of Cleco Power, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations — Financial Condition — Regulatory and Other Matters — Wholesale Rates of Cleco" in the Registrants' Combined Annual Report on Form 10-K for the fiscal year ended December 31, 2012.

Market Restructuring

Wholesale Electric Markets

Regional Transmission Organization

On December 6, 2012, Cleco Power filed an application with the LPSC indicating Cleco's intent to join MISO, asking the commission to find that transferring control of certain transmission assets to MISO is in the public interest, to create an accounting order deferring costs related to Cleco Power's transition into the MISO market, and to expedite treatment. On June 26, 2013, the LPSC unanimously approved Cleco Power's change of control request. On June 18, 2013, Cleco Power filed a related application with the LPSC requesting approval of Cleco Power's proposed MISO integration, implementation, and rate-making plans. Cleco Power anticipates joining the MISO RTO in December 2013.

For more information on regulatory aspects of wholesale electric markets affecting Cleco, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations — Financial Condition — Regulatory and Other Matters — Market Restructuring — Wholesale Electric Markets" in the Registrants' Combined Annual Report on Form 10-K for the fiscal year ended December 31, 2012.

Retail Electric Markets

For a discussion of the regulatory aspects of retail electric markets affecting Cleco Power, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations — Financial Condition — Regulatory and Other Matters — Market Restructuring — Retail Electric Markets" in the Registrants' Combined Annual Report on Form 10-K for the fiscal year ended December 31, 2012.

Lignite Deferral
At June 30, 2013 and December 31, 2012, Cleco Power had $15.3 million and $16.6 million, respectively, in deferred lignite mining costs remaining uncollected.
For more information on Cleco Power's deferred lignite mining expenditures, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations — Financial Condition — Regulatory and Other Matters — Lignite Deferral" in the Registrants' Combined Annual Report on Form 10-K for the fiscal year ended December 31, 2012.

AMI Project
In May 2010, Cleco Power accepted the terms of a $20.0 million grant from the DOE under the DOE's small-grant process to implement advanced metering technology for all of Cleco Power's retail customers. Cleco Power estimates the project will cost $72.4 million, with the DOE grant providing $20.0 million toward the project and Cleco Power providing the remaining $52.4 million. The grant program is a part of the American Recovery and Reinvestment Act of 2009. Advanced metering technology includes the installation of electric meters that enable two-way communication capabilities between a utility customer and the utility. At June 30, 2013, Cleco Power had incurred $68.5 million in project costs, of which $20.0 million has been reimbursed by the DOE. The installation of the advanced meters was substantially completed in May 2013, with the project to be fully functional by the fourth quarter of 2013. For more information, please read "Management's Discussion and Analysis of Financial Condition and Results of Operations — Financial Condition — Regulatory and Other Matters — AMI Project" in the Registrants' Combined Annual Report on Form 10-K for the fiscal year ended December 31, 2012.

Financial Reform Legislation
In July 2010, the President signed the Dodd-Frank Act into law. Title VII of the Dodd-Frank Act established a comprehensive new regulatory framework for swaps and security-based swaps, including mandatory clearing, exchange trading, collateral requirements, margin requirements, and other transparency requirements. In July 2012, the Commodity Futures Trading Commission published final rules for the definition of a swap and for the end-user exemption. Cleco Power has registered on the International Swaps and Derivatives Association (ISDA) website and submitted the required adherence letters and questionnaires pertinent to the ISDA August 2012 Dodd-Frank Act Protocol and the ISDA March 2013 Dodd-Frank Act Protocol. Management continues to review the final rules that have been issued or will be issued under the Dodd-Frank Act and will continue to monitor this law and its possible impact on the Registrants.

Franchises
On April 1, 2013, the Village of Hessmer unanimously voted to approve a new franchise agreement with Cleco Power with an effective date of April 5, 2013. The franchise agreement is for 30 years until March 2043. Approximately 453 Cleco Power customers are located in Hessmer.
On May 21, 2013, the Village of Turkey Creek voted to approve a new franchise agreement with Cleco Power with an effective date of May 21, 2013. The franchise agreement is for

40 years until May 2053. Approximately 185 Cleco Power customers are located in Turkey Creek.
On June 13, 2013, the Village of Forest Hill unanimously voted to approve a new franchise agreement with Cleco Power with an effective date of June 20, 2013. The franchise agreement is for 30 years until June 2043. Approximately 391 Cleco Power customers are located in Forest Hill.
On July 10, 2013, the Town of Cottonport unanimously voted to approve a new franchise agreement with Cleco Power with an effective date of July 16, 2013. The franchise agreement is for 30 years until July 2043. Approximately 1,085 Cleco Power customers are located in Cottonport.

On July 15, 2013, the Village of Moreauville unanimously voted to approve a new franchise agreement with Cleco Power with an effective date of July 19, 2013. The franchise agreement is for 30 years until July 2043. Approximately 573 Cleco Power customers are located in Moreauville.
For more information on other electric service franchises, please read “Business — Regulatory Matters, Industry Developments, and Franchises — Franchises” in the Registrants’ Combined Annual Report on Form 10-K for the fiscal year ended December 31, 2012.

Other Franchise Matters

For information regarding other franchise matters, see Item 1, “Notes to the Unaudited Condensed Consolidated Financial Statements — Note 11 — Litigation, Other Commitments and Contingencies, and Disclosures about Guarantees — City of Opelousas.”

Recent Authoritative Guidance

For a discussion of recent authoritative guidance, see Item 1, “Notes to the Unaudited Condensed Consolidated Financial Statements — Note 2 — Recent Authoritative Guidance” of this Combined Quarterly Report on Form 10-Q, which discussion is incorporated herein by reference.

CRITICAL ACCOUNTING POLICIES

Cleco’s critical accounting policies include those accounting policies that are both important to Cleco’s financial condition and results of operations and those that require management to make difficult, subjective, or complex judgments about future events, which could result in a material impact to the financial statements of Cleco Corporation’s segments or to Cleco as a consolidated entity. The financial statements contained in this report are prepared in accordance with GAAP, which require Cleco to make estimates and assumptions. Estimates and assumptions about future events and their effects cannot be made with certainty. Management bases its current estimates and assumptions on historical experience and on various other factors that are believed to be reasonable under the circumstances. On an ongoing basis, these estimates and assumptions are evaluated and, if necessary, adjustments are made when warranted by new or updated information or by a change in circumstances or environment. Actual results may differ significantly from these estimates under different assumptions or conditions.
For more information on Cleco’s critical accounting policies, see “Management’s Discussion and Analysis of Financial Condition and Results of Operations — Critical Accounting Policies” in the Registrant’s Combined Annual Report on Form 10-K for the fiscal year ended December 31, 2012.

CLECO POWER — NARRATIVE ANALYSIS OF RESULTS OF OPERATIONS

Set forth below is information concerning the results of operations of Cleco Power for the three and six months ended June 30, 2013 and June 30, 2012. The following should be read in combination with Cleco Power's Unaudited Condensed Consolidated Financial Statements and the Notes contained in this Combined Quarterly Report on Form 10-Q.

Cleco Power meets the conditions specified in General Instructions H(1)(a) and (b) to Form 10-Q and is therefore permitted to use the reduced disclosure format for wholly owned subsidiaries of reporting companies. Accordingly, Cleco Power has omitted from this report the information called for by Item 2 (Management's Discussion and Analysis of Financial Condition and Results of Operations) and Item 3 (Quantitative and Qualitative Disclosures about Market Risk) of Part I of Form 10-Q and the following Part II items of Form 10-Q: Item 2 (Unregistered Sales of Equity Securities and Use of Proceeds) and Item 3 (Defaults upon Senior Securities). Pursuant to the General Instructions, Cleco Power has included an explanation of the reasons for material changes in

the amount of revenue and expense items of Cleco Power between the first six months of 2013 and the first six months of 2012. Reference is made to Management's Discussion and Analysis of Financial Condition and Results of Operations in Item 7 of the Registrants' Combined Annual Report on Form 10-K for the fiscal year ended December 31, 2012.

For an explanation of material changes in the amount of revenue and expense items of Cleco Power between the second quarter of 2013 and the second quarter of 2012, see "— Results of Operations — Comparison of the Three Months Ended June 30, 2013 and 2012 — Cleco Power" of this Combined Quarterly Report on Form 10-Q, which discussion is incorporated herein by reference.

For an explanation of material changes in the amount of revenue and expense items of Cleco Power between the first six months of 2013 and the first six months of 2012, see "— Results of Operations — Comparison of the Six Months Ended June 30, 2013 and 2012 — Cleco Power" of this Combined Quarterly Report on Form 10-Q, which discussion is incorporated herein by reference.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Risk Overview

Market risk inherent in Cleco's market risk-sensitive instruments and positions includes potential changes arising from changes in interest rates and the commodity market prices of power and natural gas in the industry on different energy exchanges.

Cleco applies the authoritative guidance as it relates to derivatives and hedging to determine whether the market risk-sensitive instruments and positions are required to be marked-to-market. Generally, Cleco Power's market risk-sensitive instruments and positions qualify for the normal-purchase, normal-sale exception to mark-to-market accounting since Cleco Power takes physical delivery and the instruments and positions are used to satisfy customer requirements. When positions close, actual gains or losses are included in the FAC and reflected on customers' bills as a component of the FAC.

Cleco's exposure to market risk, as discussed below, represents an estimate of possible changes in the fair value or future earnings that would occur, assuming possible future movements in the interest rates and commodity prices of power and natural gas. Management's views on market risk are not necessarily indicative of actual results, nor do they represent the maximum possible gains or losses. The views do represent, within the parameters disclosed, what management estimates may happen.

Cleco monitors credit risk exposure through reviews of counterparty credit quality, aggregate counterparty credit exposure, and aggregate counterparty concentration levels. Cleco manages these risks by establishing appropriate credit and concentration limits on transactions with counterparties and requiring contractual guarantees, cash deposits, or letters of credit from counterparties or their affiliates, as deemed necessary. Cleco Power has agreements in place with various counterparties that authorize the netting of financial transactions and contract payments to mitigate credit risk for transactions entered into for risk management purposes.

Access to capital markets is a significant source of funding for both short- and long-term capital requirements not satisfied by operating cash flows. Market conditions during past years have limited the availability and have increased the

costs of capital for many companies. The inability to raise capital on favorable terms could negatively affect Cleco's ability to maintain and expand its businesses. After assessing the current operating performance, liquidity, and credit ratings of Cleco, management believes that it will have access to the capital markets at prevailing market rates for companies with comparable credit ratings. Cleco Corporation and Cleco Power pay fees and interest under their respective credit facilities based on the highest rating held. If Cleco Corporation or Cleco Power's credit ratings were to be downgraded by Moody's or S&P, Cleco Corporation or Cleco Power, as the case may be, would be required to pay additional fees and higher interest rates under their respective credit facilities. Cleco Power's collateral for derivatives is based on the lowest rating held. If Cleco Power's credit ratings were to be downgraded by S&P or Moody's, Cleco Power would be required to pay additional collateral for derivatives.

Interest Rate Risks

Cleco monitors its mix of fixed- and variable-rate debt obligations in light of changing market conditions and from time to time may alter that mix, for example, refinancing balances outstanding under its variable-rate credit facility with fixed-rate debt. For details, see Item 1, "Notes to the Unaudited Condensed Consolidated Financial Statements — Note 5 — Debt." Calculations of the changes in fair market value and interest expense of the debt securities are made over a one-year period.

Sensitivity to changes in interest rates for variable-rate obligations is computed by assuming a 1% change in the current interest rate applicable to such debt.

At June 30, 2013, Cleco had $3.0 million short-term variable rate debt outstanding. This short-term debt had an interest rate of 1.95% and was repaid on July 1, 2013.

At June 30, 2013, Cleco Corporation had $25.0 million borrowings outstanding under its $250.0 million credit facility at an interest rate of 1.70%. The borrowings under the credit facility are considered to be long-term as the credit facility expires in 2016. The borrowing costs under the facility are equal to one-month LIBOR plus 1.50% or ABR, plus facility fees of 0.25%. The existing borrowings had 30-day terms. Of the $25.0 million borrowings outstanding at June 30, 2013, $15.0 million matured and was renewed for an additional amount on July 15, 2013 and the remaining $10.0 million matured and was not renewed on July 31, 2013. Each 1% increase in the interest rate applicable to such debt would have resulted in a decrease in Cleco's pre-tax earnings of $0.3 million.

On November 14, 2011, Cleco Power entered into a forward starting interest rate swap contract in order to mitigate the interest rate exposure on coupon payments related to a $50.0 million fixed-rate forecasted debt issuance. The forward starting interest rate swap had a spot 30-year all-in swap rate of 3.05%, notional amount of $50.0 million, with the pricing date of May 14, 2013, or the issuance of the notes, whichever was earlier. The forward starting interest rate swap met the criteria of a cash flow hedge under the authoritative guidance as it relates to derivatives and hedging and was carried on the balance sheet at its fair value.

During the first quarter of 2013, Cleco Power determined that the forward starting interest rate swap ceased to be highly effective in offsetting changes in the cash flows of the forecasted coupon payments and discontinued hedge accounting prospectively. The forward starting interest rate swap was settled on May 7, 2013, upon pricing of the 2008 Series B GO Zone bonds. Cleco Power settled the forward starting interest rate swap at a loss of $3.3 million. In March 2013, a $0.4 million loss on the forward starting interest rate swap was recorded in accumulated other comprehensive income. At June 30, 2013, Cleco Power deferred $2.9 million of losses as a regulatory asset related to the settlement of the forward starting interest rate swap as a result of management's assessment that it is probable that the losses will be recovered through the rate-making process. In May 2013, Cleco Power began amortizing these amounts over the 25-year term of the related debt.

Commodity Price Risks

Management believes Cleco has controls in place to minimize the risks involved in its financial and energy commodity activities. Independent controls over energy commodity functions consist of a middle office (risk management), a back office (accounting), and regulatory compliance staff, as well as monitoring by a risk management committee comprised of officers, who are approved by Cleco Corporation's Board of Directors. Risk limits are recommended by the Risk Management Committee and monitored through a daily risk report that identifies the current VaR, current market conditions, and concentration of energy market positions.

Cleco Power procures fuel for generation and purchases power to meet the power demands of customers. Cleco Power may enter into positions to mitigate the volatility in customer fuel costs, as encouraged by various LPSC orders. These positions are marked-to-market with the resulting gain or loss recorded on the balance sheet as a component of the accumulated deferred fuel asset or liability and a component of the energy risk management assets or liabilities. When these positions close, actual gains or losses will be included in the FAC and reflected in customers' bills as a component of the fuel cost adjustment. There were no open positions at June 30, 2013 or December 31, 2012.

Cleco Power

Please refer to "— Risk Overview" for a discussion of market risk inherent in Cleco Power's market risk-sensitive instruments.

Cleco Power has entered into various fixed- and variable-rate debt obligations. Please refer to "— Interest Rate Risks" for a discussion of how Cleco Power monitors its mix of fixed- and variable-rate debt obligations and the manner of calculating changes in fair market value and interest expense of its debt obligations.

Cleco Power had $3.0 million short-term variable-rate debt and $85.0 million in long-term variable-rate debt as of June 30, 2013.

On March 20, 2013, Cleco Power entered into a bank term loan agreement in the amount of $60.0 million. Proceeds of the loan agreement were used to repay draws under Cleco Power's revolving credit facility. Cleco Power made a $25.0 million payment on the loan on May 8, 2013, reducing the balance outstanding to $35.0 million. The interest rate under the agreement at June 30, 2013, was 1.075%. The interest rate is based on LIBOR and resets on a monthly basis. The loan matures May 29, 2015. Each 1% increase in the interest rate applicable to such debt would have resulted in a decrease in Cleco Power's pre-tax earnings of $0.6 million.

On May 3, 2013, Cleco Power remarketed $50.0 million of its 2008 Series A GO Zone bonds which had previously been purchased by Cleco Power and was being held as treasury bonds, at an interest rate based on 0.82% plus 65% of LIBOR. The rate resets monthly. The 2008 Series A GO Zone bonds will be subject to remarketing on May 3, 2015. Each 1% increase in the interest rate applicable to such debt would have resulted in a decrease in Cleco Power’s pre-tax earnings of $0.5 million.

At June 30, 2013, Cleco Power had no borrowings outstanding under its $300.0 million credit facility.

Please refer to “— Commodity Price Risks” for a discussion of controls, transactions, VaR, and market value maturities associated with Cleco Power’s energy commodity activities.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures
As of June 30, 2013, evaluations were performed under the supervision and with the participation of Cleco Corporation and Cleco Power (individually, "Registrant" and collectively, the "Registrants") management, including the Chief Executive Officer (CEO) and Chief Financial Officer (CFO). The evaluations assessed the effectiveness of the Registrants' disclosure controls and procedures. Based on the evaluations, the CEO and CFO have concluded that the Registrants' disclosure controls and procedures are effective
to ensure that information required to be disclosed by each Registrant in reports that it files or submits under the Securities
Exchange Act of 1934 is recorded, processed, summarized,

and reported within the time periods specified in SEC rules
and forms; and that the Registrants' disclosure controls and procedures are also effective in ensuring that such information is accumulated and communicated to the Registrants' management, including the CEO and CFO, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting
There has been no change in the Registrants' internal control over financial reporting that occurred during the quarter ended June 30, 2013, that has materially affected, or is reasonably likely to materially affect, the Registrants' internal control over financial reporting.

PART II — OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

CLECO

For information on legal proceedings affecting Cleco, see Part I, Item 1, “Notes to the Unaudited Condensed Consolidated Financial Statements — Note 11 — Litigation, Other Commitments and Contingencies, and Disclosures about Guarantees — Litigation.”

CLECO POWER

For information on legal proceedings affecting Cleco Power, see Part I, Item 1, “Notes to the Unaudited Condensed Consolidated Financial Statements — Note 11 — Litigation, Other Commitments and Contingencies, and Disclosures about Guarantees — Litigation.”

ITEM 1A. RISK FACTORS

There have been no material changes from the risk factors disclosed under the heading “Risk Factors” in Item 1A of the Registrants’ Combined Annual Report on Form 10-K for the fiscal year ended December 31, 2012 (the “2012 Annual Report on Form 10-K”). For risks that could affect actual

results and cause results to differ materially from those expressed in any forward-looking statements made by, or on behalf of, the Registrants, see the risk factors disclosed under “Risk Factors” in Item 1A of the 2012 Annual Report on Form 10-K.

ITEM 4. MINE SAFETY DISCLOSURES

The information concerning mine safety violations or other regulatory matters required by Section 1503(a) of the Dodd-Frank Act and Item 104 of Regulation S-K is included in Exhibit 95 to this Combined Quarterly Report on Form 10-Q.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

CLECO CORPORATION	
3.1	Bylaws of Cleco Corporation, revised effective June 13, 2013
12(a)	Computation of Ratios of Earnings to Fixed Charges for the three-, six-, and twelve-month periods ended June 30, 2013, for Cleco Corporation
31.1	CEO Certification in accordance with section 302 of the Sarbanes-Oxley Act of 2002
31.2	CFO Certification in accordance with section 302 of the Sarbanes-Oxley Act of 2002
32.1	CEO Certification pursuant to section 906 of the Sarbanes-Oxley Act of 2002
32.2	CFO Certification pursuant to section 906 of the Sarbanes-Oxley Act of 2002
95	Mine Safety Disclosures
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation Linkbase
101.DEF	XBRL Taxonomy Extension Definition Linkbase
101.LAB	XBRL Taxonomy Extension Label Linkbase
101.PRE	XBRL Taxonomy Extension Presentation Linkbase
CLECO POWER	
12(b)	Computation of Ratios of Earnings to Fixed Charges for the three-, six-, and twelve-month periods ended June 30, 2013, for Cleco Power
31.3	CEO Certification in accordance with section 302 of the Sarbanes-Oxley Act of 2002
31.4	CFO Certification in accordance with section 302 of the Sarbanes-Oxley Act of 2002
32.3	CEO Certification pursuant to section 906 of the Sarbanes-Oxley Act of 2002
32.4	CFO Certification pursuant to section 906 of the Sarbanes-Oxley Act of 2002
95	Mine Safety Disclosures
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation Linkbase
101.DEF	XBRL Taxonomy Extension Definition Linkbase
101.LAB	XBRL Taxonomy Extension Label Linkbase
101.PRE	XBRL Taxonomy Extension Presentation Linkbase

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

CLECO CORPORATION
(Registrant)

By: /s/ Terry L. Taylor
Terry L. Taylor
Controller & Chief Accounting Officer

Date: July 31, 2013

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

CLECO POWER LLC
(Registrant)

By: /s/ Terry L. Taylor
Terry L. Taylor
Controller & Chief Accounting Officer

Date: July 31, 2013