

Success in What Matters

2006 Annual Report



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2006 Annual Report

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2006 Letter from Management

Success is measured in different ways by different organizations. There is no right or wrong method; rather it depends on where an organization places its focus. Our keys to success in 2006 were virtually unchanged from past years because we continued to focus on our customers' needs in a way that we can effectively serve and connect with them.

We pride ourselves on being a learning organization. By establishing goals and using measurements continually, we are able to look at ourselves constructively and identify where we can continuously improve. Over the past year we've identified and focused on the areas of: planning, energy conservation, and environmental improvements. We took steps this past year that will benefit our customers today and well into the future.

Future Planning

The summer of 2006 brought a new electric peak demand of 288.3 megawatts (MW) on July 31, which was a 9.3 percent increase over the previous record of 263.8 MW.

To address the growing demand for electricity and to plan for future city growth, we purchased a 50 acre parcel of land in Cascade Township, on the western edge of Rochester. Preliminary plans for the site include a new substation to enhance electrical distribution and combustion gas turbine(s) to accommodate future needs for peaking capacity.



The warm summer also brought a high demand for water. We set a new annual pumpage record of 5.07 billion gallons of water in 2006 and retail water sales were up 5.8 percent from the previous year. To accommodate this growing demand, one new well was drilled to accommodate the need for expanded water service to new subdivisions across Rochester.

Energy Conservation

RPU made a significant commitment to energy conservation in 2006 by getting approval from the Utility Board for \$1.8 million to go toward aggressive demand side management efforts. As part of our energy-saving management efforts we worked with residential and commercial customers to make energy efficient changes which resulted in a 10,000 megawatt-hour reduction in the need for energy.

Environmental Improvements

Plans to greatly reduce emissions on our largest generating unit at the Silver Lake Plant finally became a reality. The Utility Board unanimously approved the Emission Reduction Project at an estimated cost of \$34 million. This project will result in significant reductions in sulfur dioxide, nitrogen oxides, particulates and mercury.

In a year of major milestones, we are very excited to note that we were able to maintain a sound financial status. Our operating revenue increased \$19 million, due in part to higher retail sales and our continued sales into the Midwest Independent System Operators (MISO) market.

Our fiscal management didn't go unnoticed in 2006. In May, Moody's Investors Service upgraded our bond rating to Aa2. This upgrade will play a significant role in reducing our costs of borrowing for future expenditures.

On a somber note, we lost a member of the RPU family at the end of the year. Jeff Peterson, a 22-year line worker for RPU passed away on December 29. A few days later an editorial in the local newspaper, the Post-Bulletin, eloquently described the value and dedication of public employees.

We will continue working with an unwavering focus on integrity and customer service – the factors by which we at RPU measure our success. This success, as always, comes from the dedication of all RPU employees as described in this article.

Sincerely,



Richard Landwehr, Board President



Larry Koshire, General Manager



EDITORIAL:

RPU death reminds us of the value of public employees Wed, Jan 3, 2007

The death of a Rochester Public Utilities employee last week should serve as a sober reminder that there is nothing simple about maintaining basic infrastructure.

Much is made, and rightly so, about the death of a police officer or firefighter. The same respect has also been earned by those in the trades who, for example, bring electricity into our homes and business.

Such folks are called out in any and all weather to maintain the "system." It's tough work, and even with extensive safety precautions, it can be dangerous work.

The definition of who provides for public safety clearly includes police and fire service, but it also includes those hard-working men and women whose work puts them deeply behind the scenes.

Day in and day out, they are there, and most of the time nobody notices because we have come to expect lights or water or gas for heat.

But when the system goes down and we are inconvenienced, we wonder who is going to "fix it."

The men and women who work to maintain our way of life come with significant skills. They work together to diagnose and identify problems swiftly and then execute the fix.

It's an amazing ability that speaks as much to detailed system planning as individual skills. But in the end, it's often up to just a small crew to get the job done.

Make no mistake, sunny, temperate and calm days typically don't cause problems. It's the extremes that tax our infrastructure and push the crews to their limits.

When Rochester loses one of its finest on the job, it's a sad day. To the family, condolences. To those who answer the call every day, thank you.

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Meeting Customer Needs



Reliable: RP3

Reliability lies at the heart of our organization. Plans vary and weather changes, but utilities are expected to remain constant. As our community continues to grow, the strain on our electric and water system is steadily increasing. Therefore, we continually take the necessary measures to ensure that reliability remains a top priority.

In 2006, RPU's proficiency in electric reliability measures was recognized as a Reliable Public Power Provider (RP3) by the American Public Power Association (APPA). APPA formed the RP3 program to recognize utilities that excel in four key areas. To be considered for recognition in the

RP3 program utilities must demonstrate proficiency in reliability, safety, training, and system improvement. The RP3 program gives utilities an opportunity to look beyond the everyday effort of maintaining service and to benchmark practices against other leading municipal utilities throughout the nation.

We were one of seven utilities earning "diamond level" recognition in 2006, the highest level awarded by APPA. Maintaining the recognition of a diamond level RP3 utility requires an ongoing commitment to greater proficiency and betterment in the four disciplines.



Capable: New Peak Demand Set

Community growth, coupled with a drier than usual summer, put our electric system to the test this past year. 2006 produced a peak electrical demand of 288.3 MW on July 31. In comparison, the peak demand in 2005 was 263.8 MW, and in 2000 the peak demand only reached 228.2 MW. We successfully accommodated these record-breaking demands and are prepared for similarly high electrical demands in the future.

Our water distribution system was also strained with the string of warm summer days. RPU pumped 5.07 billion gallons of water this past year, breaking the total annual pumpage record set in 2003 of 5.01 billion gallons.



Expansion: Water Main Relocations and New Well Additions

Our water utility continues to be a reliable source of clean water for the city of Rochester. With reliability rates well above 99 percent, we are very proud of our service in 2006. This success can be attributed to our constant effort to stay ahead of growth and change throughout the community.

For the first time in recent history, the Water Division borrowed \$1.5 million to cover construction and upgrade expenses for the water system. By utilizing short-term borrowing for capital projects we are able to keep rates stable for customers and still meet financial goals.

Some of our major projects in 2006 involved substantial water main relocations. Half of the City of Rochester's Eastwood Golf Course was relocated to the south side of Eastwood Road, with a proposed subdivision development surrounding the course, both of which created projects for RPU. We provide oversight of the

installation of water utility facilities in all new subdivision developments, though the land developer covers the cost of distribution system infrastructure. In this case, the developer added to the project by constructing a separate golf course irrigation system for the portion of the golf course located south of Eastwood Road. In total, over 3,000 feet of piping was installed to service the immediate area affected by the change to the Eastwood Golf Course.

To provide additional water to the rapidly developing Eastwood Golf Course area RPU added a new well. Well-Booster Station #39, near the intersection of Marion Road and 20th Street SE, came online in 2006. There are also several hundred existing small lot subdivision residences in the Marion Road and Pinewood Road areas to which municipal water and sewer service has been extended.



Collaborative: CapX2020

As part of our strategic plan, we have identified our infrastructure as an integral part of meeting our long-term goals. As a result, we have been working on a collaborative transmission infrastructure project to meet increasing electricity needs and to ensure reliability. Named CapX2020, the plan is aimed at being able to support 8,000 megawatts (MW) of new electric load growth by 2020. This effort is a unique partnership of municipal, investor-owned, and co-op utilities. This collaboration will produce efficiencies in permitting, routing, and public hearings.

The CapX2020 plan includes building a 345 kilovolt (kV) transmission line that will run from Hampton Corners to LaCrosse, WI via Rochester. RPU will have an estimated 9 percent share in the 345kV line, which is estimated to cost approximately \$260 million. Depending on the approval timeline from state and federal authorities, the 150-mile transmission line is scheduled to be placed in service in the 2011-2013 timeframe.



Opportunity: Cascade Creek Combustion Turbine Rebuild

Back in December of 2005, fire and heat damaged our primary gas turbine (GT1) resulting in the need for a comprehensive overhaul and rewind of the generator. Though the event was unfortunate, it gave us an opportunity to take a closer look at one of our largest generating facilities. Its size alone makes GT1 a significant facility, but the 30 MW generator also serves as our lone “blackstart”-capable generator. As a “blackstart” unit, we are able to rely on GT1 in the event of a city-wide loss of electricity to bring other units on line.

The arduous rebuilding process took over eight months to complete. This lengthy timeline was necessary to ensure safety for workers and customers with a project of this magnitude.

The first run after the rebuild was on August 25. There were over 4,800 work hours logged, behind the scenes, to get GT1 back online. We expect this rebuild will ensure the availability of GT1 for another 30 years.

Growth: Future Generation Expansion

2006 was a year marked with strong growth, but more importantly strong planning and focus to meet future growth.

In order to keep up with demand a parcel of land was purchased in the southeast section of Cascade Township. This nearly 50 acre parcel at the intersection of 60th Avenue and 19th Street NW will be the site of RPU’s next electric distribution substation and the site of future generation expansion.



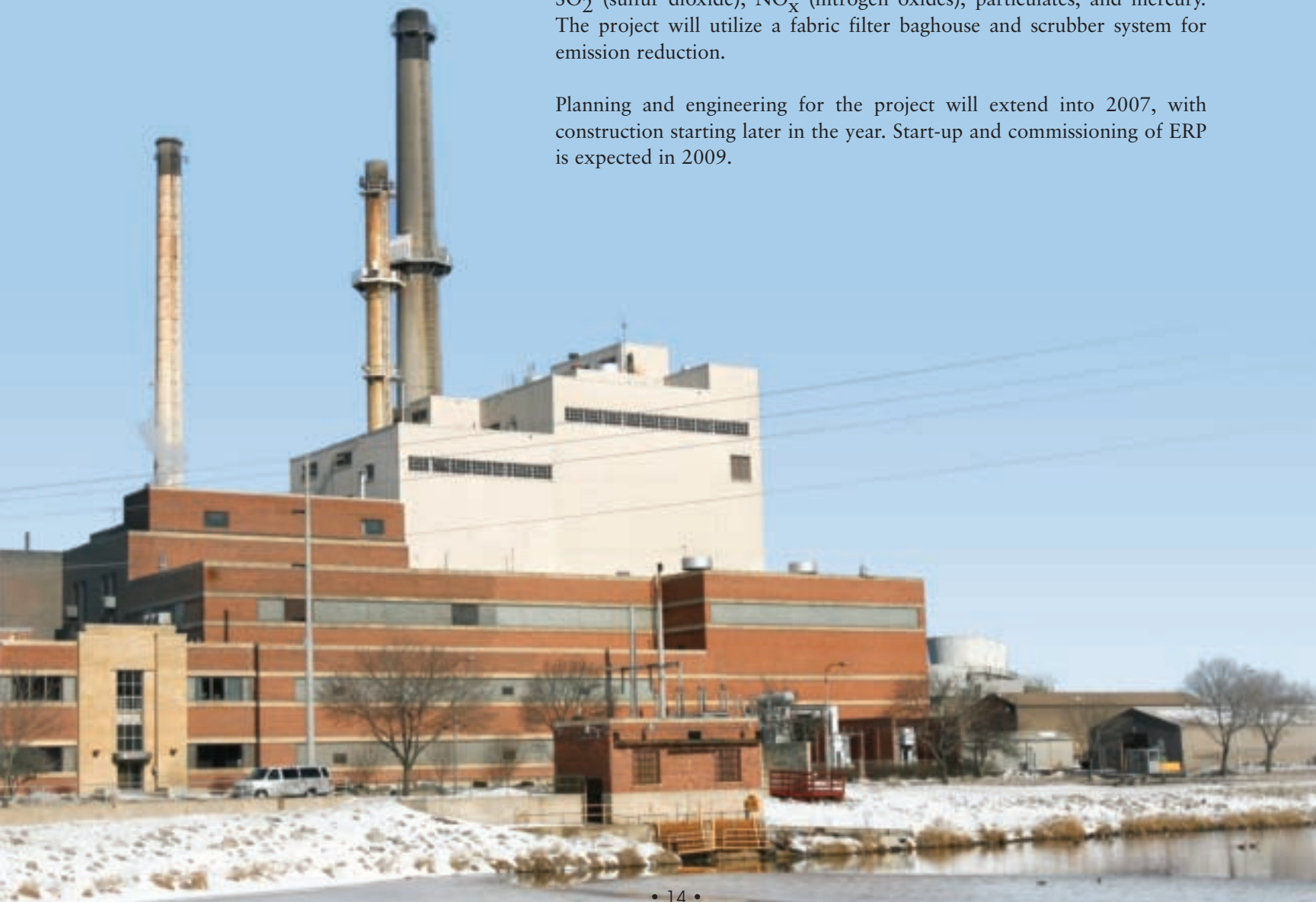
Commitment to Environmental Improvements



Environmental: Emission Reduction Project

In 2006, the RPU Utility Board and City Council approved the Emission Reduction Project (ERP) for the Silver Lake Plant Unit 4 at a cost of approximately \$34 million. While current emission levels at the plant meet all present-day state and federal regulations, there is always room for improvement. Our proactive measures to reduce emissions will position the Silver Lake Plant to meet new regulations that go into effect in 2009-2010. The complete project will produce a significant reduction in emissions of SO₂ (sulfur dioxide), NO_x (nitrogen oxides), particulates, and mercury. The project will utilize a fabric filter baghouse and scrubber system for emission reduction.

Planning and engineering for the project will extend into 2007, with construction starting later in the year. Start-up and commissioning of ERP is expected in 2009.



Research: Hybrid Energy System Study

The Hybrid Energy System Study (HESS) is a multi-year project aimed at developing a pollution-free and more efficient heating and cooling system than anything currently available. The first phase of the study focused on the construction of the test facility, located at the Quarry Hill Nature Center. It took six months to complete the facility, which includes two vertical loop geothermal wells, a fuel cell with hydrogen delivery available, and a 1.5 ton heat pump. The facility allows for every aspect of the study to be computer controlled and recorded remotely through numerous sensors located throughout the facility.

Now entering its second phase, the facility and its components are really coming together. The study continues to draw interest from utilities both at the local and national level because of the potential impact it could have on alternative energy applications. We look forward to conducting higher level research involving simulated homes and businesses in the coming year.



Hybrid Energy System Study

Rochester Public Utilities & University of Minnesota Rochester



Attention to Service



Managing Demand for Energy: Aggressive Demand Side Management

Back in 2005, we conducted a baseline infrastructure study to assess our future demand and energy needs. Findings from this study showed that by increasing our commitment to demand side management (DSM) and proactively controlling energy demand we will be able to delay the need for additional capacity.

Our response to this study was to implement an Aggressive DSM Plan for 2006. Components of this plan included setting a kilowatt-hour (KWh) goal and aligning resources to meet this goal.

We enlisted Morgan Marketing Partners and Franklin Energy to help us reach our goal of reducing energy by 9,854,000 KWh. These firms specialize in leading energy efficient programs and were able to retain and organize additional staffing support to surpass our aggressive DSM goal of 105.7% or 10,417,072 KWh saved.



We presented Glynner's Pub with a check for \$1900 through our Conserve & Save rebate program. Brad Glynn, owner of Glynner's Pub, partnered with us to install high efficiency cooling equipment that utilizes the latest technology in energy efficient building operation.

Glynner's Pub and RPU's partnership is a commitment toward energy conservation and environmental awareness. For 2006, we committed \$1.8 million toward energy conservation and demand side management.

"Local businesses, like Glynner's Pub, are becoming more aware of energy conservation and by doing so, are saving money through our programs. Customers that make the energy efficient changes will not only see the savings in rebates, but will also see savings in their future energy expenditures."

— Jan Blevins, RPU Sales Specialist.

Learning: Employee Training

We know that the talents and commitment of our employees will play a key role in shaping our organization's future. For this reason we invest in educating our employees. In order to continue to meet the changing needs of customers our employee training and development offerings emphasize a balance of technical, safety, and interpersonal skills in the workforce.

In 2006, 19 RPU employees successfully completed the eight-month Public Utilities Reports Program. The program involves independent study and monthly meetings facilitated by internal and guest experts. It is designed to teach participants about certain aspects of public utilities and the changes happening in utility operations.

We are also constantly looking for further training opportunities. In 2006 we developed an accelerated Leadership Development Program in collaboration with Central Lakes College. With this program we can utilize efficiencies to meet current and address future training needs.

In addition to our standard training programs, we partnered and/or participated with many organizations and companies throughout the year to offer a variety of safety, technical, and interpersonal learning opportunities for employees.

Responsible: Financial Rating Upgrade

Our efforts to strengthen our financial rating were rewarded in 2006 by Moody's Investors Service. Our underlying bond rating was upgraded from Aa3 to Aa2. According to Moody's, the upgrade is based on RPU's strong financial performance, good liquidity, and the diminishing threat of retail regulation.

Strengths cited in the bond rating upgrade include:

- RPU is a well-established enterprise with a long, stable operating history and good liquidity.
- RPU's service area is economically sound with growing employment.
- The likelihood of deregulation in Minnesota is low. RPU has exclusive rights in its service territory.
- RPU has local rate-setting autonomy (City Council approval is required) with no state oversight. Base rates have been adjusted periodically during the last five years.





we pledge, we deliver

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Connecting with the Community



Teaching: Electric Safety Presentations for Local Schools

Each year, we commit significant money and time toward educating local students about electric safety. The public and private schools of Rochester continue to see the value in utilizing RPU's electricity safety presentation. In fact, this past year alone we were invited to speak to over 1,100 students.

As the landscape of the electric utility industry changes, we have targeted our presentation to touch on new, emerging topics in the industry including energy conservation and renewable energy.

Facility Tours

Education is an important part of our commitment to the community. Instrument, control and results technician,

Jay Button, has been giving tours of the Silver Lake Plant for over 25 years. He gives more than 30 tours a year, educating people on what electricity is, how it works, its environmental impacts and even the basics of how it gets to their house. Jay's tours of the 100 MW coal-fired power plant attract audiences ranging from local youth groups to groups of advanced electrical and mechanical engineers.

"I really enjoy giving tours of the Silver Lake Plant because after the tour people always mention that they learned something that they didn't know before. It's rewarding to know that people have a different, informed view of RPU and the plant after their tour."

– Jay Button



Involved: Tree Planting

We respect the environment and safety. So when the city, the Park and Recreation Department, and RPU had to remove trees that were growing into power lines as a safety measure we wanted to give something back to the community.

Our employees and their families volunteered their time to help plant trees throughout Rochester. Over 200 trees

were planted in three boulevard locations during a one-day planting event in partnership with the city of Rochester and NeighborWoods of Rochester. The tree's planted have a maximum growth that falls below the power lines, ensuring their safety long into the future.

RPU contributed \$5,000 toward purchasing the trees.



Rewarding: Environmental Achievement Awards

Recognizing those who make a positive impact on the environment can go a long way in convincing others to make positive environmental contributions in the community. For this reason, RPU partnered with the Olmsted County Environmental Commission to present the 2006 Environmental Achievement Awards.

The goal of the awards is to promote and encourage innovative approaches to environmental and conservation challenges and to develop an environmental and conservation ethic within our community and county. The awards honor individuals, families, youth, organizations, or businesses that have made a significant contribution towards environmental quality in any of the following categories: renewable efforts, conservation, energy, water, agriculture, education and other.

The 2006 recipients were:

1. Andy Hart
2. High Point Condominiums Association
3. Sam Bailey
4. Olmsted County Elections and Purchasing Department
5. Rochester Area Builders and Zumbro Land Conservancy
6. Intercultural Mutual Assistance Association (IMAA)
7. Olmsted County Youth Commission





Community: Economic Impact

In 2006, Rochester Area Economic Development Inc. (RAEDI) evaluated RPU's Economic Impact on the community. They found:

- RPU's total economic impact on Rochester in 2006 was \$259 million. This figure is derived through analysis of the total revenue generated and the impact on other Rochester area industries.
- RPU directly affects local employment. At the time of the study, RPU employed 193 people and an additional 400 jobs were sustained through RPU's local operation.
- RPU has an impact on local taxes. Each year RPU transfers money to the city of Rochester via in lieu of taxes. In 2006, approximately \$8 million was transferred to the city, which represents \$8 million less that needs to be generated through the levying of local property taxes.



1/30/07
Date

Rochester Public Utilities Leadership



General Manager
Larry Koshire



Director of Core Services
Walter Lorber



Director of Corporate Services
Curt Kraft



Director of Customer Relations
Jim Walters



Director of Field Services
Joe Hensel



Director of Power Resources
Walter Schlink

Utility Board



Board President
Richard Landwehr
Director of Business Development
Weis Builders Inc.



Board Member and City Council Liaison
Dennis Hanson
City Council President
City of Rochester
Director of Business Development
Kruse Lumber



Board Member
Mark Utz
Attorney & Shareholder
Wendland, Utz, Stahl,
and Mintz, Ltd.



Board Member
John (Jack) Jibben
Vice Chair of Campus Planning/
Project Coordination
Mayo Clinic



Board Member
Susan Parker
Controller
Olmsted County Public Works

Rochester Public Utilities

4000 East River Road NE
Rochester, MN 55906-2813
800-778-3421 • 507-280-1500
www.rpu.org

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Success in What Matters

2006 Financial Statements



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Management Discussion & Analysis

The following discussion and analysis of the financial results of Rochester Public Utilities (RPU or the Utility) provides an overview of the utility's financial activities for the year ended December 31, 2006. This discussion is designed to be used in conjunction with the financial statements and notes, which follow this section.

Rochester Public Utilities is a municipal utility governed by a five-member board under the authority of the Rochester City Council. Rochester Public Utilities is comprised of two separate utilities, the Electric Utility and the Water Utility.

Overview of the Financial Statements

Consolidated Financial Statements

The Consolidated Statements of Net Assets present the Utility's assets and liabilities, with the difference between the two reported as net assets. The Statement of Net Assets provides information about the nature and amount of investments in resources (assets), and the obligations to creditors (liabilities). Net assets increase when revenues exceed expenses. The Consolidated Statements of Revenues, Expenses, and Changes in Net Assets report the revenues and expenses during the periods indicated. The Consolidated Statements of Cash Flows provide information about the Utility's cash receipts and payments from operations, as well as funds provided and used in investing and financing activities.

Notes to Consolidated Financial Statements

The notes to consolidated financial statements provide additional information that is essential to a full understanding of the amounts provided in the consolidated financial statements.

Electric Utility Highlights

- Due to the City of Rochester's continued growth, 847 new electric customers were added in 2006.
- The hot summer weather had a positive impact on revenues and demand. Retail kilowatt-hour sales were slightly over budget, with an increase of 2.3% over 2005. A record annual peak demand of 288.3 megawatts was set in July 2006, which represented a 9.3% increase over the previous record of 263.8 megawatts set in August 2005.
- A rate increase of 5.0% was approved by the Utility Board in December 2005, and went into effect January 2006. An additional rate increase of 8.5% was approved by the Utility Board in March 2006, and went into effect April 2006.
- Rates for power purchased from SMMPA (Southern Minnesota Municipal Power Agency) increased 5.2% in January 2006, with another increase of 16.9% in May 2006. Purchased power costs represented 59% of electric operating expenses for 2006.
- The cost to RPU of providing health insurance coverage to its employees increased 12% over 2005.
- RPU's bond rating was upgraded to Aa2 by Moody's, and continued to be rated A+ by Fitch.
- The electric utility transferred approximately \$8.0 million to the City's general fund in the form of in-lieu-of-tax payments.
- In the summer of 2006, a contract was awarded and engineering began on installing emissions control equipment at the Silver Lake Plant. This project is expected to be completed in 2008, and will improve air quality by reducing harmful emissions such as sulfur dioxide, NO_x, and particulate matter.
- In April 2006, RPU, in addition to selling energy from the Silver Lake Plant, began selling energy generated from the Cascade Creek gas turbine into the MISO (Midwest Independent System Operators) market. Then, in June 2006, RPU began purchasing power through the MISO market for all power needs above the Contract Rate of Delivery limit of 216 megawatts provided by SMMPA. Previously, this power had been self-generated by RPU. The financial statements for 2006 show a positive impact on net income as a result of the change.
- RPU continues to be involved in Capacity Expansion by 2020, or CapX 2020 project. Specifically, RPU is involved with four other utilities, Xcel Energy, Dairyland Power Cooperative, SMMPA, and Wisconsin Public Power Inc., in the future construction of a 345-kilovolt transmission line coming from the Twin Cities down to Rochester, and over to LaCrosse.
- RPU surpassed its Aggressive Demand-Side Management (DSM) goal for 2006 of 9,855 megawatt hours in energy savings. Actual energy savings of 10,405 megawatt hours were achieved through helping commercial and residential customers install energy efficient equipment and technologies. This represents a 36% increase over the previous year's energy savings.

Water Utility Highlights

- Due to the City of Rochester's continued growth, 766 new water customers were added in 2006.
- Retail water sales (ccf) were up 5.8% in 2006 due to a warm summer and below-average rainfall.
- A new record monthly peak pumpage of 743.9 million gallons occurred in July 2006. The daily peak pumpage record of 29.8 million gallons that was set in July 2005 still stands.
- A rate increase of 5.0% was approved by the Board in December 2005, and went into effect January 2006.
- The water utility transferred approximately \$370,000 to the City's general fund in the form of in-lieu-of-tax payments.

Financial Analysis – Electric Utility

The following discussion provides analysis of the 2006 and 2005 comparative financial information provided in the following table.

Condensed Financial Information - Electric Utility

December 31, 2006 and 2005 (In millions)

Statement of Revenues, Expenses, & Changes in Net Assets

	<u>2006</u>	<u>2005</u>	<u>Change</u>
Operating Revenues	\$ 130.7	\$ 112.4	\$ 18.3
Operating Expenses	116.3	95.6	20.7
Operating Income	14.4	16.8	(2.4)

Transfers Out			
(In-Lieu-Of-Tax Payments)	(7.9)	(7.5)	(0.4)
Other Income & Expense	2.3	.6	1.7
Interest Charges	(2.3)	(2.2)	(0.1)
Change in Net Assets	6.5	7.7	(1.2)

Net Assets - Beginning of Year	114.6	106.9	7.7
Net Assets - End of Year	\$ 121.1	\$ 114.6	\$ 6.5

Statement of Net Assets

	<u>2006</u>	<u>2005</u>	<u>Change</u>
Cash	\$ 16.3	\$ 17.5	\$ (1.2)
Other Current Assets	21.6	19.1	2.5
Capital Assets, Net	138.3	135.2	3.1
Other Noncurrent Assets	7.6	6.1	1.5
Total Assets	183.8	177.9	5.9

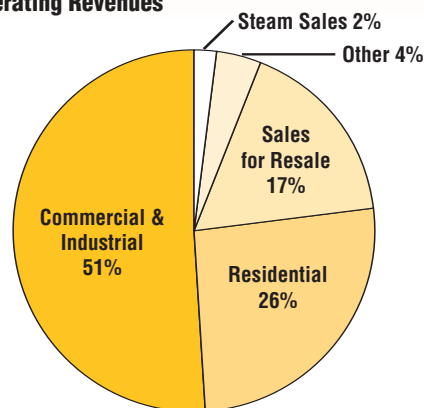
Current Liabilities	15.4	14.2	1.2
Long-Term Debt	45.2	47.1	(1.9)
Other Long-Term Liabilities	2.1	2.0	0.1
Total Liabilities	62.7	63.3	(0.6)

Invested in Capital Assets,			
Net of Related Debt	95.4	90.6	4.8
Restricted	1.9	0.6	1.3
Unrestricted	23.8	23.4	0.4
Net Assets	\$ 121.1	\$ 114.6	\$ 6.5

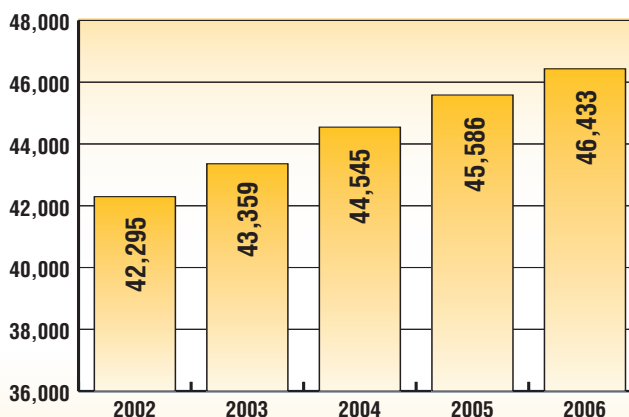
Operating Revenues

Operating revenues increased \$18.3 million (16.3%) in 2006. This was due in part to rate increases of 5.0% and 8.5%, as well as an increase in retail kilowatt-hour sales and wholesale revenues.

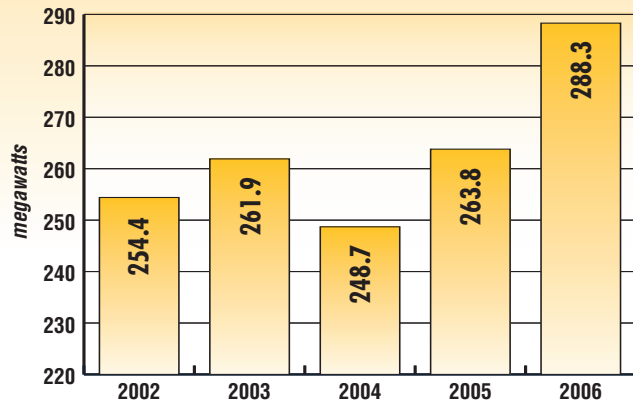
Electric Operating Revenues



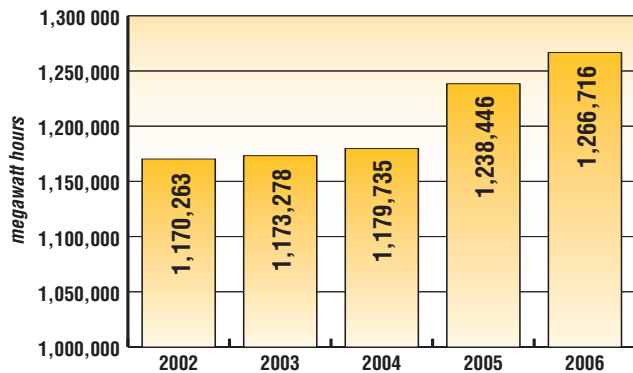
Number of Electric Customers



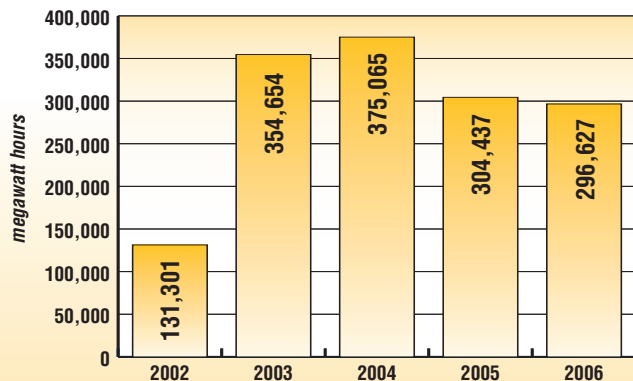
Electric Peaks



Electric Retail Sales



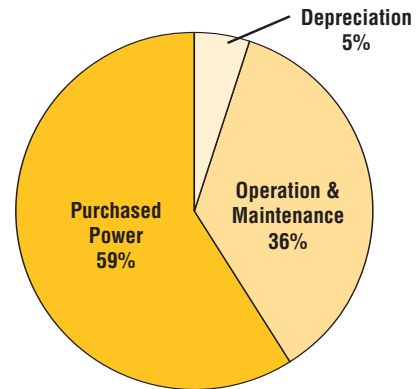
Wholesale Sales



Operating Expenses

Operating expenses increased \$20.7 million (21.7%) in 2006, due to increases in fuel purchases and purchased power costs. The primary driver of operating expenses for the Electric Utility continues to be purchases of power from SMMPA, which comprised 59% of total Utility operating expenses.

Electric Operating Expenses



In-Lieu-of-Tax Payments

The Electric Utility transfers an amount to the City of Rochester's General Fund each month based on the amount of retail kilowatt-hours sold. Due to the increased kilowatt-hour sales because of the hot summer, as well as an increase in the in-lieu-of-tax rate of 3.4%, payments to the City increased by \$425,000.

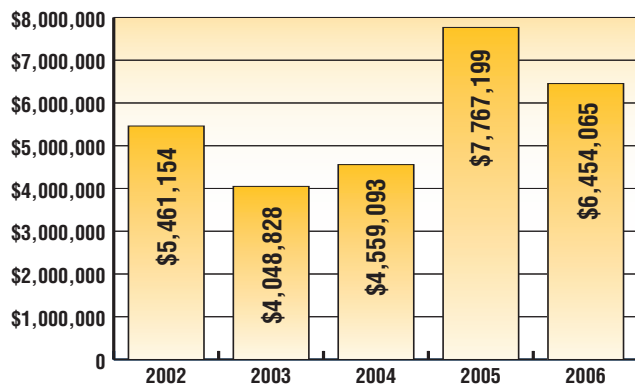
Other Income and Expense

Other income increased \$1.7 million (283%) in 2006. This was due to the fact that RPU sold more excess SO₂ allowances in 2006 than in 2005. These SO₂ allowances are provided each year to the Electric Utility by the federal government at no cost, under provisions of the Clean Air Act.

Change in Net Assets

The increase in net assets for 2006 was \$6.5 million, \$1.2 million (15.6%) less than in 2005. While operating revenue increased because of rate increases, higher retail kilowatt-hour sales and increased wholesale revenues; operating expenses increased at a higher rate due to increases in fuel and purchased power costs.

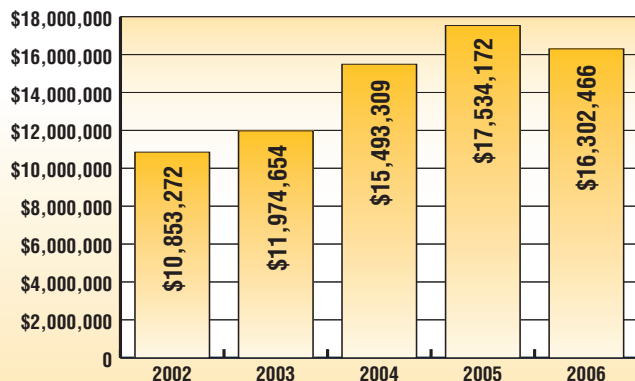
Change in Net Assets



Cash and Other Assets

The ending cash balance for 2006 was \$16.3 million, \$1.2 million below the cash balance at the end of 2005. This is primarily due to higher operating costs and required deposits into the service territory escrow for city annexations.

Unrestricted Cash – Electric



Other current assets for 2006 were \$21.6 million, \$2.5 million higher than at the end of 2005. This increase was due primarily to more receivables outstanding at the end of 2006, as well as an increase in fuels inventory due to higher fuel prices and build-up of generation fuel inventory.

Other noncurrent assets increased by \$1.5 million due to a slight increase in the debt service reserve, and a larger increase in the service territory escrow fund.

Liabilities

Current liabilities increased \$1.2 million in 2006, primarily due to increased accounts payable related to purchased power from SMMPA at the end of the year.

Net Assets

Net assets invested in capital assets, net of related debt, increased \$4.8 million. This increase reflects additions to capital assets, a decrease in outstanding debt and a slight increase in cash restricted for debt service. Capital expenditures are funded through rate-based revenues, fees from customers, and debt proceeds.

Restricted net assets increased by \$1.3 million. This represents resources that are subject to external restrictions, such as bond covenants or third-party contractual agreements. Specifically, restricted net assets for the Electric Utility consist of amounts placed in escrow for future acquisition of service territory from People's Cooperative Services. See Note 4 to the financial statements for additional details regarding this amount.

Unrestricted net assets are not subject to any constraints established by debt covenants or other legal requirements. In 2006, unrestricted net assets increased \$.4 million due to the results of operations.

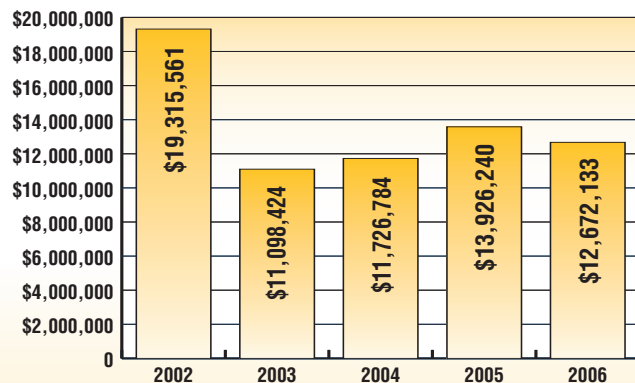
CAPITAL ASSETS

At December 31, 2006, the Electric Utility had \$138.3 million invested in a broad range of utility capital assets, including a coal-burning steam generation plant, two gas turbines, a hydroelectric power generation plant, two diesel generators, equipment related to providing Mayo Clinic's Prospect Plant with steam, electric transmission and distribution lines, buildings and equipment. Capital assets increased \$8.9 million in 2006, reflecting investments in the distribution and transmission systems, as well as construction associated with the growth of the City and general facilities of the Electric Utility. One item included in the increase is a land purchase of \$1 million that is planned for a future site of another gas turbine. This increase in capital assets was partially offset by a \$5.8 million increase in accumulated depreciation. Additional details regarding the Utility's total assets (electric and water) may be found in Note 6 to the financial statements. Capital and major maintenance expenses decreased by \$1.2 million in 2006, due to a lower dollar amount budgeted for capital projects in 2006.

LONG-TERM DEBT

At the end of 2006, the Utility had \$42.4 million in revenue bonds and a \$5.0 million revenue note outstanding. No new debt was issued during the year, and \$1.8 million was retired in 2006. The Utility was upgraded to an Aa2 bond rating from Moody's in 2006, and maintained an A+ bond rating from Fitch on its revenue bonds. Additional details regarding the Utility's long-term debt may be found in Note 5 to the financial statements.

Capital and Major Maintenance Expenditures



Financial Analysis – Water Utility

The following discussion provides analysis of the 2006 and 2005 comparative financial information provided in the following table.

Condensed Financial Information - Water Utility

December 31, 2006 and 2005 (In millions)

Statement of Revenues, Expenses, & Changes in Net Assets

	2006	2005	Change
Operating Revenues	\$ 7.7	\$ 7.0	\$ 0.7
Operating Expenses	6.8	6.1	0.7
<i>Operating Income</i>	0.9	0.9	-
Transfers Out			
(In-Lieu-Of-Tax Payments)	(0.4)	(0.3)	(0.1)
Other Income & Expense	0.1	-	0.1
Interest Charges	(0.03)	-	(0.03)
Capital Contributions	2.3	2.6	(0.3)
<i>Change in Net Assets</i>	2.9	3.2	(0.3)

Net Assets - Beginning of Year	77.7	74.5	3.2
<i>Net Assets - End of Year</i>	<u>\$ 80.6</u>	<u>\$ 77.7</u>	<u>\$ 2.9</u>

Statement of Net Assets

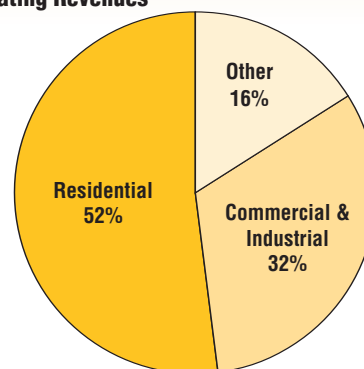
	2006	2005	Change
Cash	\$ 1.8	\$ 1.5	\$ 0.3
Other Current Assets	1.0	1.0	-
Capital Assets, Net	79.6	76.6	3.0
Other Noncurrent Assets	1.5	-	1.5
<i>Total Assets</i>	83.9	79.1	4.8
Current Liabilities	2.0	1.3	0.7
Long-Term Debt	1.2	-	1.2
Other Long-Term Liabilities	0.1	0.1	-
<i>Total Liabilities</i>	3.3	1.4	1.9

Invested in Capital Assets, Net of Related Debt	78.0	76.6	1.4
Restricted	1.5	-	1.5
Unrestricted	1.1	1.1	-
<i>Net Assets</i>	<u>\$ 80.6</u>	<u>\$ 77.7</u>	<u>\$ 2.9</u>

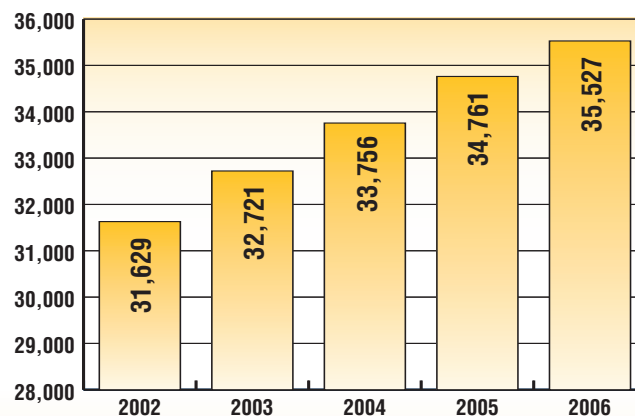
Operating Revenues

Operating revenues increased \$700,000 (10.0%) in 2006. Some of this was due to a rate increase of 5.0%, as well as an increase in sales volume of 5.8%. Antenna site rental revenues also increased \$70,000.

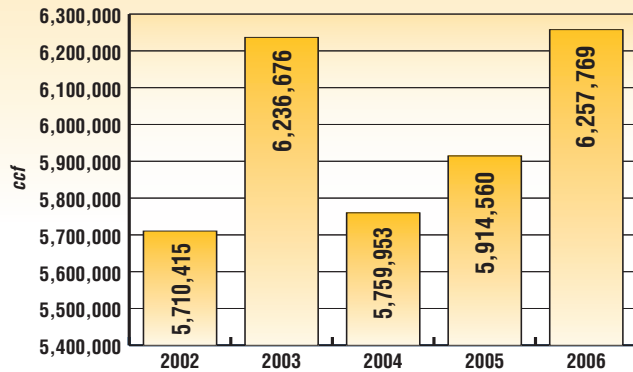
Water Operating Revenues



Number of Water Customers



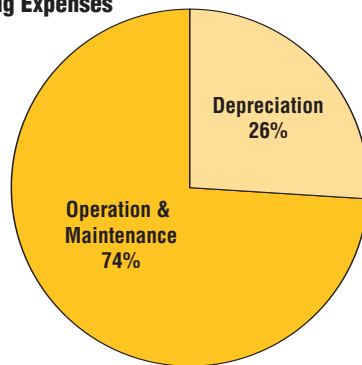
Water Retail Sales



Operating Expenses

Operating expenses increased by \$700,000 (11.5%) in 2006. This was primarily due to an increase in electricity expense as well as an increase in payments for outside services.

Water Operating Expenses



In-Lieu-of-Tax Payments

The Water Utility transfers an amount to the City of Rochester's General Fund each month based on the amount of retail ccf (hundred cubic feet) sold. Due to the increase in ccf sold in 2006, as well as an increase in the in-lieu-of-tax rate of 3.4%, payments to the City increased by approximately \$31,000.

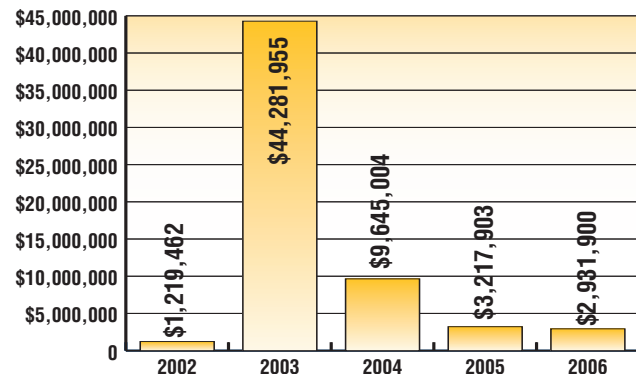
Capital Contributions

Capital contributions decreased \$380,000 in 2006. These are assets, primarily water mains and fire hydrants, which are contributed to the Water Utility from both the City and developers. These assets are valued using a costing database that estimates the approximate construction costs associated with these assets.

Change in Net Assets

The increase in net assets for 2006 was \$2.9 million, \$300,000 lower than in 2005. This is primarily due to the decrease in reported capital contributions in 2006.

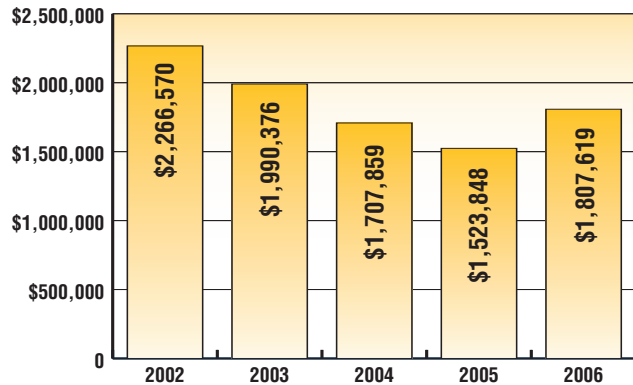
Change in Net Assets



Cash and Other Assets

The ending cash balance for 2006 was \$1.8 million, \$300,000 higher than at the end of 2005 due to an increased amount of cash provided by operations in 2006 over 2005.

Unrestricted Cash – Water



Other current assets for 2006 were \$1.0 million. These consisted of accounts receivable, inventory, and accrued revenues.

Liabilities

Current liabilities increased \$700,000 in 2006 due to an increased amount owed to the City at the end of 2006 related to capital projects as well as an amount owed for debt service on the \$1.5 million borrowing that occurred in 2006.

Net Assets

Net assets invested in capital assets, net of related debt, increased \$1.4 million. This increase reflects additions to capital assets and an increase in outstanding debt. Capital expenditures for the Water Utility are funded through rate-based revenues, fees from customers and debt proceeds.

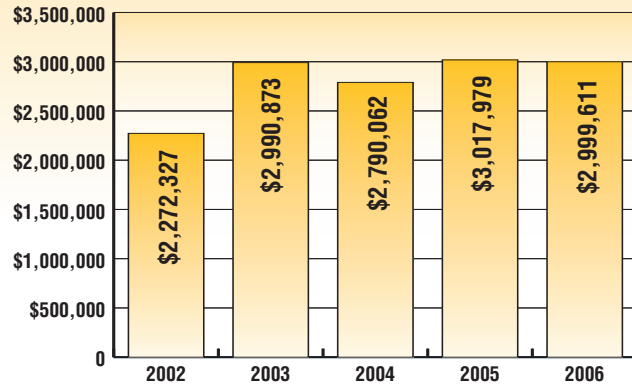
Restricted net assets increased by \$1.5 million. This represents resources that are subject to external restrictions, such as bond covenants or third-party contractual agreements. Specifically, restricted net assets for the Water Utility consist of note proceeds that are required by the note agreement to be spent on certain capital projects. See Note 4 to the financial statements for additional details regarding this amount.

Unrestricted net assets are not subject to any constraints established by debt covenants or other legal requirements.

CAPITAL ASSETS

At December 31, 2006, the Water Utility had \$79.6 million invested in a broad range of utility capital assets, including 18 water storage facilities, 33 wells, water mains, pump station facilities, buildings, and equipment. Capital assets increased \$4.9 million in 2006, reflecting capital contributions as well as construction associated with the growth of the City and general facilities of the Water Utility. This increase in capital assets was partially offset by a \$1.9 million increase in accumulated depreciation. Additional details regarding the Utility's total assets (electric and water) may be found in Note 6 to the financial statements. Capital and major maintenance expenses decreased slightly in 2006. Some of the major components of capital spending in 2006 were City and developer projects, new wells, water storage facility maintenance and spending on water meters and automated meter reading.

Capital and Major Maintenance Expenditures



LONG-TERM DEBT

At the end of 2006, the Utility had a \$1.5 million revenue note outstanding. In August of 2006, the Utility Board and City Council authorized borrowing approximately \$1.5 million through the Minnesota Consortium of Municipal Utilities at a fixed interest rate. The closing on this loan occurred in August of 2006. This money is being used by the Water Utility to construct and maintain wells and water mains, as well as other ongoing projects. No debt was retired in 2006.

Miscellaneous Information

ECONOMIC FACTORS

The City Council has approved Electric and Water rate increases for three consecutive years. In 2004 and 2005 the Electric Utility had 3.0% increases each year followed by increases of 5.0% and 8.5% in January 2006, and April 2006, respectively. In 2004 the Water Utility had a 3.0% increase followed by 5.0% increases each year in 2005 and 2006. These overall increases will help strengthen RPU's financial stability by meeting the expected increased costs to operate each Utility, improve system reliability, and build liquidity by increasing cash reserves.

In addition to inflation, management continually plans for and identifies issues or potential contingencies that could impact future rates, such as system expansion, infrastructure needs, accelerated debt payments, future supply costs, regulatory changes, and others.

2007 REVENUE BOND ISSUE

In March 2007, the Utility Board and City Council authorized the issuance of approximately \$76 million in

revenue bonds. Roughly \$46 million of the proceeds will be used to finance the emission reduction project at the Silver Lake Plant, as well as transmission and substation work and distribution expansion. The rest of the bond issue (approximately \$30 million) will be used to refund, in advance, a portion of the 2000 bond issue due to the lower interest rate that the 2007 issue will carry. The advance refunding is required because the 2000 bonds are not callable until 2010. Due to positive financial changes instituted in recent years, RPU was very pleased to receive an upgrade in its bond rating from Fitch prior to the bond issue, going from an A+ to AA-.

REQUESTS FOR INFORMATION

The consolidated financial statements, notes, and management discussion and analysis are designed to provide a general overview of RPU's finances. Questions concerning any of the information provided in this report should be directed to RPU at 4000 E River Rd NE, Rochester, MN 55906. The phone number is (507) 280-1500. Additional information regarding RPU may also be found on its website at www.rpu.org.

2006 Financial Statements

Consolidated Statements of Revenues, Expenses, and Changes in Net Assets

	Years Ended December 31	
	2006	2005
Operating Revenues:		
Electric	\$130,723,369	\$112,432,402
Water	7,747,855	7,047,596
Total Operating Revenues	138,471,224	119,479,998
Operating Expenses:		
Purchased Power	68,444,307	55,780,898
Operations and Maintenance	46,268,718	37,918,061
Depreciation	8,442,545	8,026,868
Total Operating Expenses	123,155,570	101,725,827
Operating Income	15,315,654	17,754,171
Nonoperating Income (Expenses):		
Investment Income	1,230,243	719,188
Interest Expense	(2,331,336)	(2,170,778)
Miscellaneous, Net	1,215,734	(116,827)
Total Nonoperating Income (Expenses)	114,641	(1,568,417)
Income Before Transfers/Capital Contributions	15,430,295	16,185,754
Transfers Out	(8,340,824)	(7,884,443)
Capital Contributions	2,296,494	2,683,791
Change in Net Assets	9,385,965	10,985,102
Net Assets, Beginning of Year	192,273,547	181,288,445
Net Assets, End of Year	\$201,659,512	\$192,273,547

See Notes to Consolidated Financial
Statements Found on Pages 43-47

Income by Segments of Business

2006	Electric	Water	Total
Operating Revenues	\$130,723,369	\$7,747,855	\$138,471,224
Operating Expenses	116,338,775	6,816,795	123,155,570
Operating Income	14,384,594	931,060	15,315,654
Nonoperating Income (Expense)	40,710	73,931	114,641
Income Before Transfers/Capital Contributions	14,425,304	1,004,991	15,430,295
Transfers Out	(7,971,240)	(369,584)	(8,340,824)
Capital Contributions	0	2,296,494	2,296,494
Change in Net Assets	\$6,454,064	\$2,931,901	\$9,385,965

2005	Electric	Water	Total
Operating Revenues	\$112,432,402	\$7,047,596	\$119,479,998
Operating Expenses	95,582,269	6,143,558	101,725,827
Operating Income	16,850,133	904,038	17,754,171
Nonoperating Income (Expense)	(1,543,204)	(25,213)	(1,568,417)
Income Before Transfers/Capital Contributions	15,306,929	878,825	16,185,754
Transfers Out	(7,546,050)	(338,393)	(7,884,443)
Capital Contributions	6,321	2,677,470	2,683,791
Change in Net Assets	\$7,767,200	\$3,217,902	\$10,985,102

See Notes to Consolidated Financial
Statements Found on Pages 43-47

Consolidated Statements of Net Assets

	December 31	
	2006	2005
ASSETS:		
Current Assets:		
Cash and Cash Equivalents (Note 3)	\$18,110,086	\$19,058,019
Accounts Receivable and Accrued Utility Revenues	13,055,589	11,855,196
Fossil Fuel Inventory	4,650,345	3,338,326
Materials and Supplies Inventory	4,801,849	4,764,596
Other Current Assets	89,130	177,641
Total Current Assets	40,706,999	39,193,778
Non-Current Assets:		
Restricted Assets (Note 4):		
Cash and Cash Equivalents	5,753,242	4,201,995
Amounts Held in Escrow	1,944,564	660,387
Total Restricted Assets	7,697,806	4,862,382
Deferred Charges:		
Unamortized Bond Issuance Costs	597,484	629,828
Other	885,936	559,812
Total Deferred Charges	1,483,420	1,189,640
Capital Assets:		
Construction Work in Progress	11,060,617	14,553,576
Land and Land Rights	3,175,326	2,117,874
Depreciable Assets, Net (Note 6)		
Electric	128,050,490	120,447,123
Water	75,493,900	74,636,721
Net Capital Assets	217,780,333	211,755,294
Total Non-Current Assets	226,961,559	217,807,316
Total Assets	\$267,668,558	\$257,001,094

See Notes to Consolidated Financial
Statements Found on Pages 43-47

	December 31	
	2006	2005
LIABILITIES:		
Current Liabilities:		
Accounts Payable	\$10,445,379	\$9,597,032
Due to Other Funds	2,290,787	1,794,163
Accrued Compensated Absences	1,592,217	1,743,272
Customer Deposits	489,146	421,225
Interest Payable	172,726	177,195
Current Maturities of Long Term Debt (Note 5)	2,195,000	1,750,000
Deferred Credits	181,395	82,962
Total Current Liabilities	17,366,650	15,565,849
Non-Current Liabilities:		
Accrued Compensated Absences	1,299,215	1,096,006
Accrued Claims	110,000	123,000
Revenue Bonds and Notes Payable (net of unamortized discount) (Note 5)	46,385,707	47,058,798
Unearned Lease Revenues	847,475	883,895
Total Non-Current Liabilities	48,642,397	49,161,699
Commitments and Contingencies (Note 10)		
Total Liabilities	\$66,009,047	\$64,727,548
NET ASSETS:		
Invested in Capital Assets, Net of Related Debt	\$173,410,724	\$167,148,490
Restricted (Note 4)	3,467,373	660,387
Unrestricted Net Assets	24,781,415	24,464,670
Total Net Assets	\$201,659,512	\$192,273,547

See Notes to Consolidated Financial
Statements Found on Pages 43-47

Consolidated Statements of Cash Flows

	Years Ended December 31	
	2006	2005
Cash Flows From Operating Activities:		
Cash Received from Customers	\$135,197,839	\$118,837,596
Cash Paid to Suppliers and Employees	(114,904,085)	(99,475,478)
Internal Activity – Payments From Other Funds	4,181,568	3,882,976
Net Cash Provided By Operating Activities	24,475,322	23,245,094
Cash Flows From Noncapital Financing Activities:		
Operating Transfers to Other Funds	(8,321,148)	(7,851,502)
Cash Flows From Capital and Related Financing Activities:		
Additions to Utility Plant and Other Assets	(12,386,619)	(14,164,066)
Service Territory Acquisition	(597,875)	(582,343)
Payments on Bonds and Notes Payable Obligations	(4,114,437)	(4,155,847)
Proceeds from Issuance of Note Payable	1,525,000	5,765,000
Net Cash (Used In) Capital and Related Financing Activities	(15,573,931)	(13,137,256)
Cash Flows From Investing Activities:		
Interest Received	1,307,248	703,822
Service Territory Escrow Payments	(1,284,177)	(418,780)
Net Cash Provided By Investing Activities	23,071	285,042
Net Increase in Cash and Cash Equivalents	603,314	2,541,378
Cash and Cash Equivalents, Beginning of Year	23,260,014	20,718,636
Cash and Cash Equivalents, End of Year	\$23,863,328	\$23,260,014
Classified As:		
Current Assets	\$18,110,086	\$19,058,019
Restricted Assets	5,753,242	4,201,995
Total Cash and Cash Equivalents, End of Year	\$23,863,328	\$23,260,014
Reconciliation of Operating Income to Net Cash Provided by Operating Activities:		
Operating Income	\$15,315,654	\$17,754,171
Adjustments to Reconcile Operating Income to Net Cash Provided by Operating Activities:		
Depreciation	8,442,545	8,026,868
Other	1,371,055	70,758
(Increase) Decrease In:		
Accounts Receivable and Accrued Utility Revenues	(1,250,393)	(2,373,166)
Inventories	(1,349,272)	(1,257,806)
Prepaid and Other Current Assets	(19,426)	(99,604)
Increase (Decrease) In:		
Accrued Liabilities and Accounts Payable	1,835,225	1,186,402
Customer Deposits	67,921	67,407
Unearned Lease Revenues	(36,420)	(36,419)
Other	98,433	(93,517)
Net Cash Provided by Operating Activities	\$24,475,322	\$23,245,094
Non-Cash Capital and Related Financing Activities:		
Additions to Utility Plant and Other Assets Contributed by the City's Governmental Funds	\$330,141	\$506,946
Additions to Utility Plant and Other Assets Contributed by Developers	\$1,966,353	\$2,176,845

See Notes to Consolidated Financial Statements Found on Pages 43-47

Notes to Consolidated Financial Statements

NOTE 1: Organization and Summary of Significant Accounting Policies

Organization and Accounting Method

Rochester Public Utilities ("Utility") is a municipal utility. The Electric Utility is engaged in the generation, transmission, and distribution of electric power and energy, and related activities. The Water Utility is engaged in the supply, purification, and distribution of water, and related activities. The equity of the Utility is vested in the City of Rochester, Minnesota. The Utility is comprised of two proprietary funds, the Electric and the Water Enterprise Funds of the City of Rochester, Minnesota. Activities are accounted for using the flow of economic resources measurement focus and the accrual basis of accounting. The Utility prepares its financial statements as a business-type activity in conformity with accounting practices prescribed for regulated enterprises by the applicable pronouncements of the Governmental Accounting Standards Board (GASB). Pursuant to GASB Statement No. 20, the Utility has elected to apply the provisions of all relevant pronouncements of the Financial Accounting Standards Board (FASB) that were issued on or before November 30, 1989, to the extent they do not conflict with or contradict GASB pronouncements. Interfund transactions are not eliminated for purposes of the consolidated financial statements.

Revenues

Meters are read through a series of monthly cycles. Accounts are billed based on a combination of fixed charges and charges for actual usage. Utility tariffs for electric service include a power supply adjustment under which electric rates charged to customers are adjusted to reflect changes in power supply costs. Other activities are billed according to contractual arrangements and fees, or fees for services provided. Utility revenues are recognized on the accrual basis of accounting and include estimated amounts for service rendered but not billed.

Accounts Receivable

The Utility provides an allowance for losses on receivables, as needed, for accounts considered uncollectible.

Capital Assets, Depreciation and Amortization

Electric and water capital assets are recorded at original cost. Additions to utility plant and significant replacements are recorded at cost. Cost includes components of labor, materials and overhead. Depreciation expense is recorded using the straight-line method over the expected useful life of the asset, which ranges from five years to seventy-five years. Purchased service territory rights are amortized over a forty-year period on a straight-line basis.

Contributions in Lieu of Taxes

Contributions in Lieu of Taxes are paid by the Utility to the General Fund of the City of Rochester based upon the monthly commodity sales billed by the electric and water utilities, and are reported as Transfers Out in the Statement of Revenues, Expenses and Changes in Net Assets.

Inventories

Inventories consist of materials, supplies, and fossil fuels used in Utility operations. Materials and supplies inventory is valued at a moving average cost or market. Fossil fuel inventory is valued at cost, using the last-in, first-out method.

Compensated Absence Benefits

Vacation pay, which is payable upon termination, is accrued as it is earned by employees.

The Utility's sick leave liability is estimated based on the Utility's past experience of making termination payments for sick leave. Employees are compensated upon termination for forty percent of their unused sick leave, after meeting certain qualifications.

Amortization of Bond Issuance Costs and Bond Discount

Bond issuance costs, bond discount and bond premium are amortized over the terms of the related bond issues using the interest method.

Taxes

In accordance with certain provisions of the United States Internal Revenue Code and related federal and state governing laws and regulations, the Utility is exempt from federal and state income taxes, and local property taxes.

Use of Estimates

The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the period. Actual results could differ from the estimates.

Reclassifications

Certain reclassifications have been made to the 2005 financial statements to conform to the 2006 presentation.

Concentration of Credit Risk

Financial instruments which expose the Utility to a concentration of credit risk consist primarily of cash equivalents and accounts receivable.

Cash equivalents are primarily comprised of the Utility's equity in the City of Rochester cash and investment pool. Credit risk factors associated with the cash and investment pool are disclosed in Note 3.

The Utility's accounts receivable are generally due from a large number of residential and business retail customers who are concentrated geographically in or near the City of Rochester.

NOTE 2: Revenues

Revenue, consisting primarily of billings to customers for Utility services, includes accrued Utility revenue amounts of \$3,175,803 and \$2,754,244 for the years ended December 31, 2006 and 2005, respectively.

Sales to the Utilities single largest retail customer were \$13,656,633 and \$11,862,381 in 2006 and 2005, respectively. During the year ended December 31, 2006, no other customer accounted for more than 10% of operating revenues. Sales to other funds of the City of Rochester were \$3,553,628 and \$3,244,401 for the years ended December 31, 2006 and 2005, respectively.

Wholesale sales revenue totaled \$22,481,255 and \$18,413,450 for the years ended December 31, 2006 and 2005, respectively.

NOTE 3: Cash and Cash Equivalents

The Utility considers all temporary cash investments, including the Utility's equity in the City of Rochester investment pool, to be cash and cash equivalents. Generally, cash equivalents are highly liquid investments. The majority of the Utility's cash and cash equivalents are held in the City of Rochester cash and investment pool or the Utility's checking account and related investment sweep account. The investment sweep account automatically invests excess checking account funds at competitive market rates under the terms of a sweep repurchase agreement.

After all debit and credit transactions have posted at the end of each business day, excess balances are automatically invested in the sweep account overnight in order to maximize the use of idle funds, including the cash float from outstanding checks. The investments of this account consist of direct obligations or those that are fully guaranteed as to the principal and interest by the U.S. Government or its agency and are collateralized at 100% of market value.

All deposits are insured or collateralized by securities held by the City of Rochester or its agents in the City's name.

The Utility's equity in the City of Rochester cash and investment pool is based on actual cash receipts and disbursements and a monthly allocation of investment earnings on a pro-rata basis.

Investments held in the investment pool are disclosed in the notes to the City of Rochester's basic financial statements included in the City's 2006 Comprehensive Annual Financial Report.

NOTE 4: Restricted Assets

Restricted Cash and Cash Equivalents

Under the provisions of the 2000A and 2002A revenue bonds, the Electric Utility is required to fund a debt service account in an amount equal to the following year's bond principal and interest payments at least by the date the debt service payments are due each year. In addition to the debt service account, bond provisions require that \$4,230,433 of the bond proceeds be deposited in a reserve account to be used to pay bond principal and interest payments if funds in the debt service account are insufficient. In 2006, the Water Utility borrowed \$1,525,000 to fund the construction and maintenance of wells and water mains, as well as other ongoing projects. Under the provisions of the revenue note, unspent proceeds are placed in a construction fund until capital expenditures are made.

Restricted Cash and Cash Equivalents are summarized as follows:

	2006	2005
Reserve Account	\$ 4,230,433	\$ 4,201,995
Construction Fund	1,522,809	-
Total Restricted Cash and Cash Equivalents	\$ 5,753,242	\$ 4,201,995

Restricted Amounts Held in Escrow

In accordance with a territorial rights agreement with People's Cooperative Services, the Utility deposits funds in an escrow account managed by a fiscal agent upon annexation of areas in service territories assigned to People's Cooperative Services. Upon agreement of compensation for the transfer of the service territory rights to the Utility, the funds in escrow are returned to the Utility. The service territory escrow fund totaled \$1,944,564 and \$660,387 at December 31, 2006 and 2005 respectively.

NOTE 5: Long-Term Debt

At December 31, 2006 and 2005, long-term debt consisted of the following:

	2006	2005
Revenue Bonds,	\$ 8,965,000	\$ 9,605,000
Series 2002A		
3.00% - 4.50%		
due each December 1		
through 2017		
Revenue Bonds,	33,410,000	34,135,000
Series 2000A		
4.75% - 5.25%		
due each December 1		
through 2030		
Revenue Note Payable,	5,035,000	5,420,000
principal due each		
December 1 through		
2014, interest due each		
June 1 and December 1 at		
variable rate, currently 3.95%		
Revenue Note Payable 3.80%,	1,525,000	-
principal due each		
December 1 through		
2010, interest due monthly		
Less: Unamortized Discount	394,225	408,228
Plus: Unamortized Premium	39,932	57,026
Less: Current Maturities	2,195,000	1,750,000
TOTAL	\$ 46,385,707	\$ 47,058,798

The revenue bonds and notes are secured by all funds and revenues of the Utility derived from the ownership and operation of the electric and water Utility systems. The bond issuance costs, bond discount and bond premium are amortized over the terms of the bond issues.

The annual requirements to amortize all debt outstanding as of December 31, 2006, including interest payments of \$29,501,549 are as follows:

	Revenue Bonds	Notes Payable
2007	\$ 3,487,706	\$ 1,096,057
2008	3,495,394	1,109,650
2009	3,493,656	1,143,772
2010	3,492,606	1,174,216
2011	3,491,919	780,372
Thereafter	53,085,279	2,585,921
Total	\$ 70,546,560	\$ 7,889,988

NOTE 6: Capital Assets

Major classes of depreciable assets and total accumulated depreciation as of December 31, 2006 and 2005 are as follows:

	2006	2005
Intangible Plant Assets	\$ 8,568,095	\$ 7,970,220
Buildings, Structures,		
and Improvements	34,496,875	27,179,831
Installations, Equipment,		
and Fixtures	272,618,170	263,927,824
Total Depreciable Assets	315,683,140	299,077,875
Less: Accumulated		
Depreciation	112,138,750	103,994,031
Net Depreciable Assets	\$ 203,544,390	\$ 195,083,844

In 2006 capital assets totaling \$330,141 were contributed to the Utility by the City of Rochester, and \$1,966,353 were contributed to the Utility by others.

NOTE 7: Southern Minnesota Municipal Power Agency

The Utility is a voting member of the Southern Minnesota Municipal Power Agency (SMMPA). The Utility has entered into a power purchase contract with SMMPA, whereby SMMPA will provide all Utility power requirements up to 216 megawatts, the contract rate of delivery. This contract expires in the year 2030. In 1999, the Utility and SMMPA agreed to a contract rate of delivery (CROD) that began in 2000. The CROD caps the amount of power SMMPA must supply to the Utility under the power purchase contract. The Utility is responsible for acquiring its power needs above the CROD. The Utility purchased 1,276,555,301 and 1,258,723,258 kilowatt hours totaling \$68,848,823 and \$57,293,036 from SMMPA during the years ended December 31, 2006 and 2005, respectively.

The Utility was reimbursed \$1,846,299 and \$1,958,485 for the years ended December 31, 2006 and 2005 respectively, for its share of previous SMMPA charges. These reimbursed charges are reported as offsets to purchased power costs.

The Utility leases a portion of its electrical transmission system, known as the North Loop, to SMMPA under a non-cancelable operating lease through the year 2030. The Utility is responsible for all operating and maintenance costs. The Utility received a lump sum payment of \$1,500,000 in 1989 and lease revenues are being recognized ratably over the lease term.

NOTE 8: Pension Plans

The Utility participates in a statewide retirement plan administered by the Public Employees Retirement Association (PERA) of Minnesota. PERA administers the Public Employees Retirement Fund (PERF) which is a cost sharing, multiple employer retirement plan. PERA provides retirement benefits as well as disability benefits to members and benefits to survivors upon death of eligible members. Benefits and annual contributions are established by State statute. Total required contributions made during the year ended December 31, 2006 were \$1,480,321 of which \$772,913 was made by the Utility and \$707,408 was made by the Utility's employees.

PERA does not make separate measurements of assets and pension benefit obligations for individual employers participating in the plan. PERA issues a publicly available financial report that includes financial statements and required supplementary information for PERF. That report may be obtained by writing to PERA, 60 Empire Dr. # 200, St. Paul, Minnesota, 55103-2088 or by calling (651) 296-7460 or 1-800-652-9026.

The Utility had maintained an unqualified supplemental pension plan. The plan was unfunded and was discontinued in 1968. Funds have been deposited with a plan administrator to fund the estimated benefits due under the plan. The pension reserve deposit as of December 31, 2006 and 2005 was \$87,708 and \$95,884, respectively. Payments under the plan for 2006 and 2005 were \$12,080 and \$14,279, respectively.

NOTE 9: Legal Matters

The Utility continues to pursue the acquisition of certain electric service rights from People's Cooperative Services, a rural Utility system. At times this involves proceedings before the Minnesota Public Utilities Commission and the Minnesota courts, and negotiation of various settlement agreements with People's Cooperative Services.

In 2005, the City of Rochester brought a claim against Southern Minnesota Municipal Power Agency (SMMPA) its primary wholesale power supplier, seeking a declaratory judgment that by virtue of the establishment of a "contract rate of delivery (CROD)" in 1999 under Rochester's contract with SMMPA, Rochester is not obligated to pay the capital costs of new generating resources. Rochester also alleged breach of contract related to the process by which SMMPA establishes its rates and the possibility that SMMPA might have overcollected costs through rates charged to RPU (and others) under the Power Sales Contract since 2003. In 2006, Rochester amended and supplemented its claims. With respect to the CROD-related count, Rochester amended the requested judgment to state that SMMPA cannot charge Rochester for the capital costs of generating facilities exceeding the 216 MW CROD. With respect to the breach of contract issues regarding rates, Rochester amended and supplemented the count to argue that SMMPA has not followed correct ratemaking procedures and may have undercollected important costs in past years.

SMMPA has filed a counterclaim alleging that RPU's steam sale agreement with the Mayo Clinic represents a breach of a 1992 "Settlement Agreement" concerning the use of RPU's Silver Lake Plant. SMMPA also filed counterclaims for declaratory judgment on issues relating to the nature of RPU's obligations under the Power Sales Contract. Early in 2007, SMMPA added a counterclaim requesting a judgment declaring, among other things, that the SMMPA Board has virtually unlimited discretion in setting rates under the Power Sales Contract with Rochester.

No provision for gain or loss related to RPU's claims or SMMPA's counterclaims have been recorded in the accompanying financial statements as it is not possible to predict or determine the outcome of this litigation.

NOTE 10: Commitments and Contingencies

Risk Management Program

The City of Rochester has established a self-insurance program for group health coverage and workers' compensation. Rochester Public Utilities participates in this self-insurance program. The group health program is limited to losses of \$225,000 per claim with a variable annual aggregate, and the workers' compensation coverage is limited to \$780,000 per occurrence, both through the use of stop-loss policies. The City recognizes a liability on individual claims when a loss is probable and the amount can be reasonably estimated. In addition, the City recognizes an estimated liability on unreported claims that are incurred but not yet reported. The Utility recognized an estimated liability for workers' compensation claims of \$40,000 and \$43,000 at December 31, 2006 and 2005, respectively. No actuarial studies have been performed by independent actuaries.

Power Sales Agreement

The Utility has entered into two agreements with the Minnesota Municipal Power Agency (MMPA) to sell a maximum 100 megawatts of power annually from its Silver Lake Plant to MMPA. Under the terms of the agreements, 100 megawatts of power is sold at fixed rates for providing the

availability of generating capacity. The Utility is reimbursed for the fuel-related costs of generating power for half of the energy production. The remaining half of the energy produced is sold into the Midwest Independent System Operator (MISO) market at market-based rates adjusted for SO₂ allowance consumption under a margin-sharing arrangement. The Utility has an additional agreement with MMPA to market energy from its Cascade Creek combustion turbines (approximately 82 megawatts) into the MISO market, also under a margin-sharing arrangement.

Revenue under these agreements for the years ended December 31, 2006 and 2005 was as follows:

	2006	2005
kWh provided	281,570,153	293,114,000
Payments for availability	\$ 3,514,433	\$ 4,583,350
Reimbursed generation costs	\$ 5,879,340	\$ 10,626,679
Market-based sales	\$ 12,854,608	\$ 2,318,289

Service Territory Settlements

In connection with the acquisitions of certain electric service rights from People's Cooperative Services (PCS), the Utility is required to make payments to PCS based upon the amount of electricity sold in specific territories over a ten-year term. The payment varies by each settlement agreement and ranges from 5.7 mills (tenths of a cent) per kWh to 14.5 mills per kWh. These commitments expire over various periods through 2012. Costs are recognized under these agreements as service is provided.

NOTE 11: Subsequent Event

In March 2007, the Utilities issued \$76 million in revenue bonds to finance emissions control improvements at the Silver Lake plant, substation work, and the expansion of the transmission and distribution system, as well as refund the 2000 revenue bonds at a lower interest rate.

Report of Independent Auditors

*To the Public Utility Board
City of Rochester, Minnesota*

We have audited the consolidated statements of net assets of Rochester Public Utilities as of December 31, 2006 and 2005 and the related consolidated statements of revenues, expenses and changes in net assets, and cash flows for the years then ended. These financial statements are the responsibility of Rochester Public Utilities' management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

As discussed more fully in Note 1, the consolidated financial statements present only the Electric and Water Funds and are not intended to present fairly the financial position of the City of Rochester and the results of its

operations and the cash flows of its proprietary fund types in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Rochester Public Utilities as of December 31, 2006 and 2005, and the changes in its net assets and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

The management's discussion and analysis on pages 28 through 37 is not a required part of the basic financial statements, but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Smith Schafer and Associates, LLC

Smith, Schafer and Associates, Ltd.
Certified Public Accountants
March 14, 2007
Rochester, Minnesota

Operating and Financial Statistics (unaudited)

ELECTRIC	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>1997</u>
Retail Customers:						
Residential	41,926	41,179	40,329	39,244	38,259	32,663
General Service	4,501	4,401	4,210	4,109	4,030	3,371
Industrial / Commercial	2	2	2	2	2	19
Other	4	4	4	4	4	4
Total Retail Customers	46,433	45,586	44,545	43,359	42,295	36,057
Retail Sales: (kWh)						
Residential	333,685,036	327,161,549	300,108,426	304,653,325	302,755,054	233,340,476
General Service	623,562,494	608,760,469	592,690,358	601,393,595	608,230,284	331,622,126
Industrial / Commercial	292,580,435	286,246,138	270,939,006	250,347,096	243,121,084	335,269,091
Other	16,888,011	16,277,635	15,997,702	16,883,613	16,156,452	14,322,275
Total Retail Sales (kWh)	1,266,715,976	1,238,445,791	1,179,735,492	1,173,277,629	1,170,262,874	914,553,968
Retail Revenue:						
Residential	\$33,537,874	\$29,724,751	\$26,391,940	\$25,876,051	\$25,569,567	\$18,776,032
General Service	49,559,854	43,813,580	41,172,242	40,375,839	40,155,746	22,192,832
Industrial / Commercial	17,183,144	15,484,581	14,536,253	13,281,822	13,093,886	19,388,149
Other	2,088,066	1,857,280	1,756,415	1,722,054	1,650,037	1,354,774
Total Retail Revenue	\$102,368,938	\$90,880,192	\$83,856,850	\$81,255,766	\$80,469,236	\$61,711,787
Steam Sales (MLBs)	165,676	17,934				
Steam Revenues	\$2,617,899	\$281,966				
Annual Peak (Megawatts)	288.3	263.8	248.7	261.9	254.4	197.5
Total kWh Generated	304,571,154	317,898,898	383,245,906	361,726,670	144,260,682	205,819,400
Total kWh Purchased	1,287,671,577	1,262,309,983	1,208,354,664	1,194,543,798	1,179,943,696	935,739,663
Year End Cash Balance	\$22,477,464	\$22,396,555	\$19,252,385	\$18,652,198	\$23,532,042	\$17,386,703
WATER	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>1997</u>
Retail Customers:						
Residential	32,143	31,477	30,622	29,663	28,684	23,975
Industrial / Commercial	3,384	3,284	3,134	3,058	2,945	2,628
Total Retail Customers	35,527	34,761	33,756	32,721	31,629	26,603
Retail Sales: (ccf)						
Residential	3,176,005	3,002,546	2,751,441	3,314,437	2,829,508	2,427,163
Industrial / Commercial	3,081,764	2,912,014	3,008,512	2,922,239	2,880,907	2,929,908
Total Retail Sales (ccf)	6,257,769	5,914,560	5,759,953	6,236,676	5,710,415	5,357,071
Retail Revenue:						
Residential	\$4,017,533	\$3,677,305	\$3,303,751	\$3,423,496	\$3,003,346	\$2,104,064
Industrial / Commercial	2,643,985	2,392,942	2,275,949	2,141,201	2,049,770	1,653,771
Public Fire Protection	494,712	450,215	429,228	401,055	324,105	222,464
Total Retail Revenue	\$7,156,230	\$6,520,462	\$6,008,928	\$5,965,752	\$5,377,221	\$3,980,299
Total Pumped (gallons)	5,072,853,720	4,708,567,996	4,591,078,140	5,011,304,421	4,560,177,918	4,296,149,784
Year End Cash Balance	\$3,330,428	\$1,523,848	\$1,707,859	\$1,990,376	\$2,266,570	\$2,080,162

General Information

Rochester Public Utilities Leadership

General Manager	Larry Koshire
Director of Core Services	Walter Lorber
Director of Corporate Services	Curt Kraft
Director of Customer Relations	Jim Walters
Director of Field Services	Joe Hensel
Director of Power Resources	Walter Schlink

Utility Board

Board President	Richard Landwehr <i>Director of Business Development, Weis Builders Inc.</i>
Board Member	Mark Utz <i>Attorney and Shareholder, Wendland, Utz, Stahl, and Mintz, Ltd.</i>
Board Member	John (Jack) Jibben <i>Vice Chair of Campus Planning/ Project Coordination, Mayo Clinic</i>
Board Member	Susan Parker <i>Controller, Olmsted County Public Works</i>
Board Member and City Council Liaison	Dennis Hanson <i>City Council President, City of Rochester</i> <i>Director of Business Development, Kruse Lumber</i>

Advisors and Consultants

Independent Auditors	Smith, Schafer and Associates, Ltd.
Bond Counsel	Briggs & Morgan
Financial Advisors	Springsted Public Finance Advisors

Headquarters

Rochester Public Utilities
4000 East River Road NE
Rochester, MN 55906-2813
800-778-3421
507-280-1500
www.rpu.org

