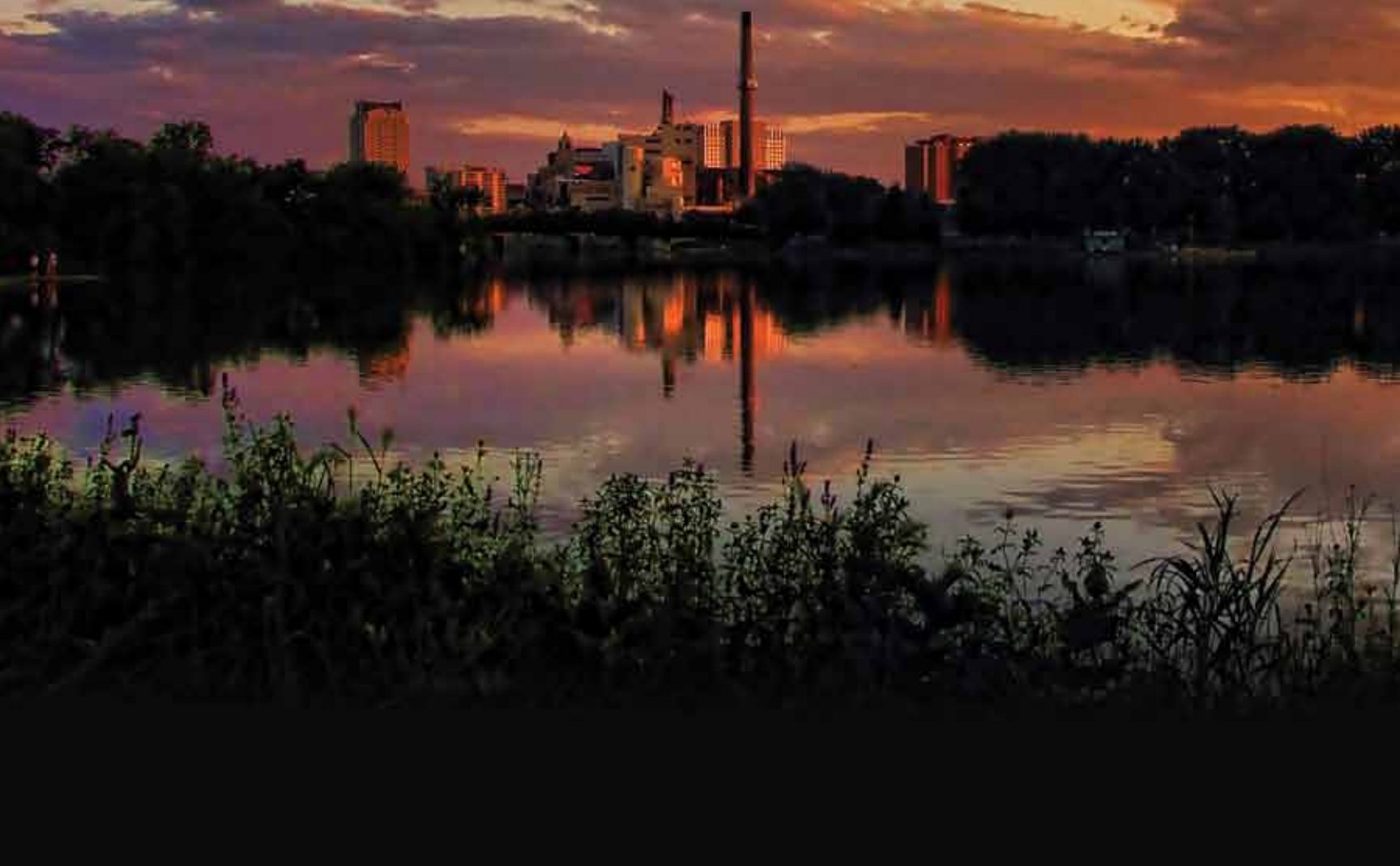


REFLECTIONS

ANNUAL REPORT 2012



REFLECTIONS





rpu 
we pledge. we deliver[®]

REFLECTIONS

ANNUAL REPORT 2012

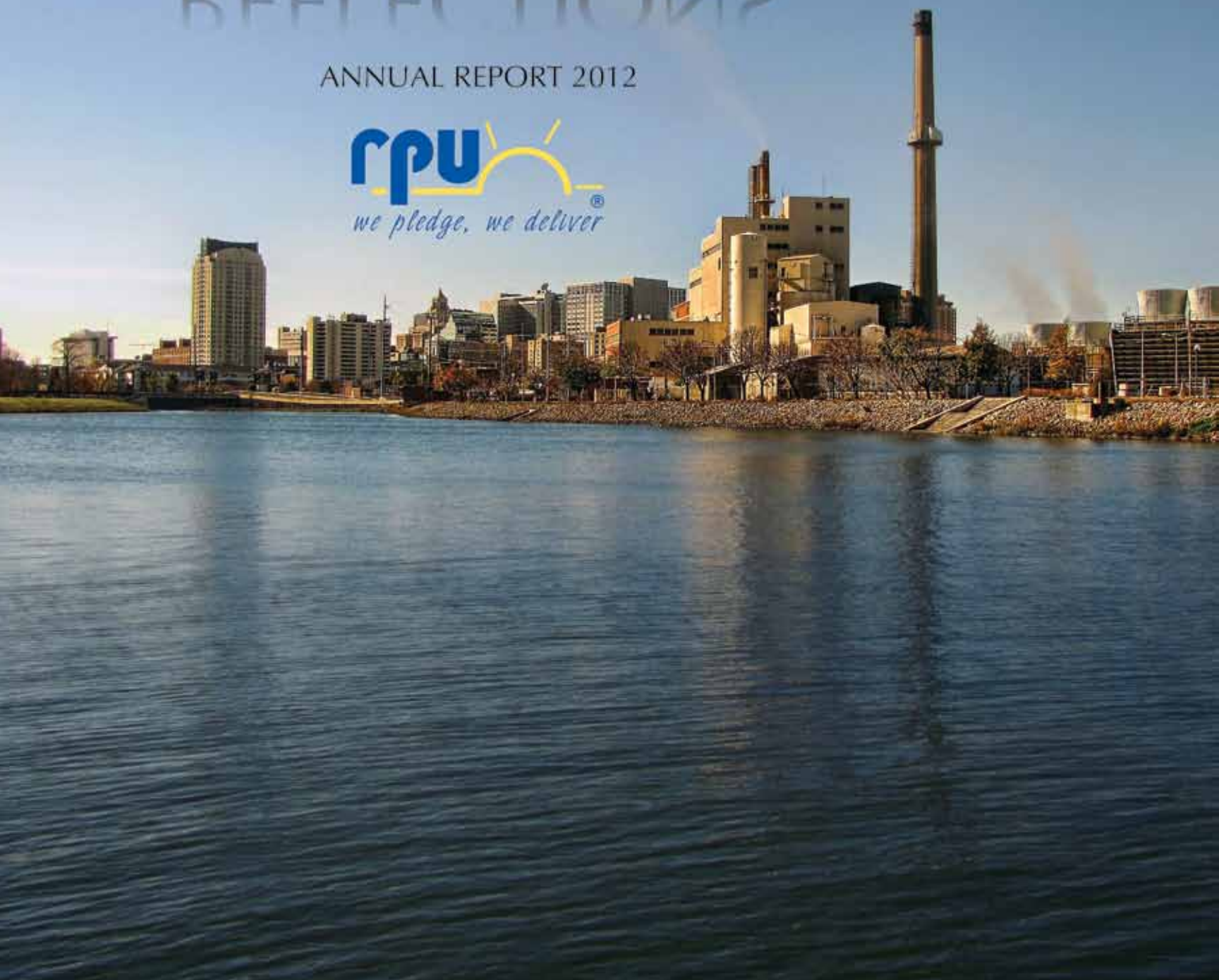


TABLE OF CONTENTS

THANK YOU TO OUR PHOTO CONTRIBUTORS:

Chad Johnson

www.flickr.com/photos/johnson7/

Josh Banks

www.banksphotos.com

Letter from Management | 7

Core Values | 13

Outage Response | 27

Decommissioning of the Silver Lake Plant | 29

Adding Needed Water Storage | 31

Supporting Local Educational Opportunities | 35

Recognition | 36

Leadership & Utility Board Members | 38

Utility Headquarters & Advisors/Consultants | 67

2012 FINANCIAL STATEMENTS

Report of Independent Auditors | 40

Management Discussion & Analysis | 42

Consolidated Statements of Revenues,
Expenses and Changes in Net Position | 54

Income by Segments of Business | 55

Consolidated Statements of Net Position | 56

Consolidated Statements of Cash Flows | 58

Notes to Consolidated Financial Statements | 60

Operating and Financial Statistics | 65

General Information | 66



LETTER FROM MANAGEMENT

Reflecting back on another year provides great insight into what a strong organization Rochester Public Utilities (RPU) truly is. There were many successes and milestones set this year, ensuring that 2012 will go down as a historic time in history for RPU.

It is our job and responsibility as the Board and General Manager to make the difficult decisions and to lead RPU with an unwavering focus. This leadership is not provided without a great deal of support from more than 200 RPU employees.

RPU has six core values which provide a framework for all to work from. Our core values are always used in decision-making and are never compromised, ensuring that our customers and stakeholders always get the best from RPU.

We have dedicated a great deal of time and space in this year's annual report to clearly outline each core value and to show how each helps to guide RPU business on a daily basis.

This year turned out to be a strong year for sales both in the water and electric utility. Both utilities rely heavily on the weather with regards to sales. As it happened, the past summer turned out to be hot and dry, which produced steady sales throughout the summer months. Along with strong sales, there was also great participation in our conservation efforts.

The conservation goals for 2012 were to save 18,785,066 kilowatt-hours (kWh) and 9,564,220 gallons of water. We are very proud to announce that we met our electric goal again this year, but unfortunately fell short of meeting our water goal.

OUR MISSION

We provide the highest quality services and products for our customers. With our experience and resources, we enrich people's lives, help businesses prosper, and promote the community's welfare.

OUR VISION

We will set the standard for service.

OUR CORE VALUES

SAFETY

Protect every individual

INTEGRITY

Demonstrate honesty, respect, and good faith

SERVICE

Leave every individual with a positive impression

STEWARDSHIP

Protect our environment through the wise use of resources

ACCOUNTABILITY

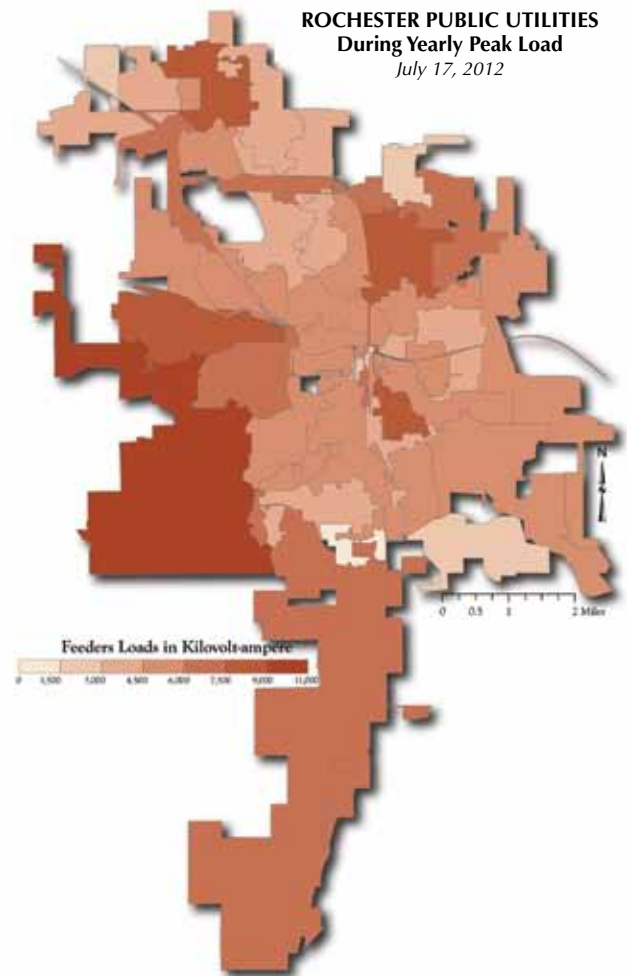
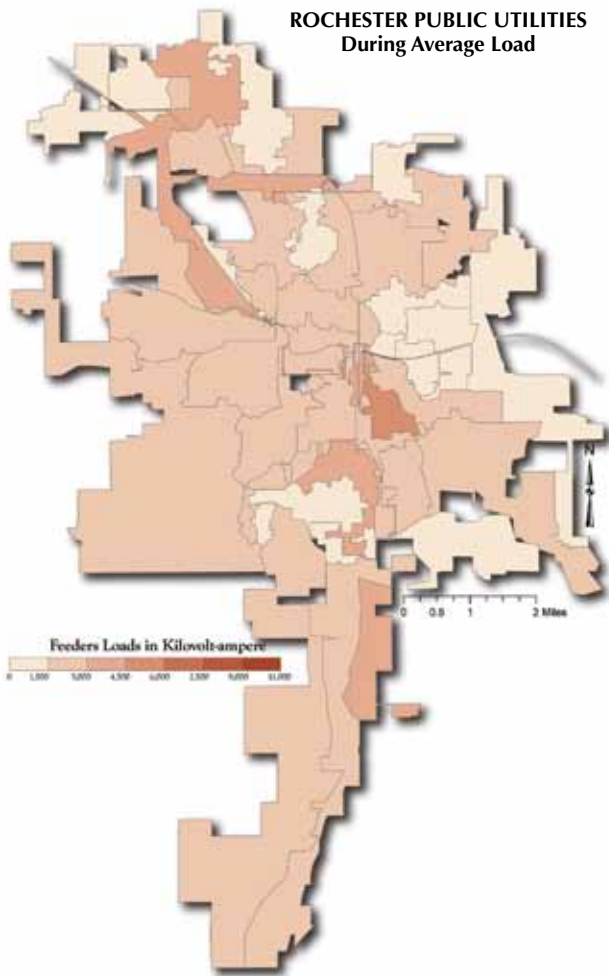
Take ownership and responsibility for actions and outcomes

SKILL

Improve our own and others' abilities and knowledge

Though electric and water usage were steady this year, a peak was not set in either utility. The electric utility usage peaked at 288 megawatts (MW) this year back on July 17, short of the all-time peak set in 2011 at 292 MW. The peak water pumpage was on July 11 at 26.9 million gallons, over 3 million gallons short of the all-time peak of 30.2 million gallons in 2007.

This past year was the third straight year without a rate increase in the electric utility and the fifth straight year for water. While we are very proud of staff's fiscal management, this certainly is not a reflection of a slowed economic situation in the city of Rochester. Rochester actually has been showing economic growth and vitality. According



to RAEDI's (Rochester Area Economic Development Inc) Quarterly Report from third quarter 2012, Rochester's unemployment rate was at 4.4% which was substantially lower than the state and national levels of 5.3% and 7.6% respectively.

RAEDI

Rochester Area Economic Development, Inc.

RPU's fiscal health didn't go unnoticed this past year. Our AA- bond rating was reaffirmed by Fitch Rating back in March giving credence to RPU's financial strength.

This past year didn't go by without its fair share of challenges. The weather was favorable for sales, but caused substantial problems resulting in a number of weather related outages.

Storms brought lightning and wind through the area, knocking power out to thousands of RPU customers in the summer and early fall. The results of the storms were broken poles, downed power lines, and vegetation tearing into overhead services across town. For the second time in RPU history, a mutual aid response was necessary back in September calling for additional help from other utilities because of the amount of damage caused. Thankfully crews from Owatonna Public Utilities and Austin Utilities were able to provide needed support.

As a result of Hurricane Sandy that devastated the east coast, we were able to be on the other side of mutual aid when we sent a crew to Long Island, New York. Crews from RPU along with eight other Minnesota municipal utilities traveled to Long Island for two weeks to help restore power to more than 800,000 affected Long Island Power Authority customers.



With a great deal of consideration and evaluation, the RPU Board voted to decommission the Silver Lake Plant (SLP) on or before December 31, 2015. The three main drivers which drove our decision were enforcement, environmental, and economics. The ongoing discussions with the Environmental Protection Agency (EPA) with regards to potential litigation regarding enforcement of the New Source Review section of the Clean Air Act will not go away, but with this proactive decision to decommission SLP, we will provide a good faith step in the direction that the EPA is heading while discussions continue. Environmental regulations also continue to emerge and to define what electric generation will need to look like in the future. Coal-fired generation continues to look like a costly option for generation and we

do not feel that passing along large expenditures to greater reduce coal-based emissions is in the best interest of our customers. With a strong mix of gas-fired and renewable energy (Lake Zumbro hydro) we feel we are and will continue to be in a good position for generation sales in the Midwest Independent System Operators (MISO) market. Lastly, the economics of keeping SLP open just doesn't make sound financial sense. With the slowed energy market, SLP is not competitive in the MISO market. We plan to continue using SLP to provide steam to the Mayo Clinic campus by utilizing the existing boilers through burning natural gas. We will rollout a comprehensive plan for the decommissioning of SLP in early 2013.



Progress continued to be made this year on the CapX2020 transmission project. RPU is a 9 percent participant in the project along with four other Minnesota utilities. Together we will construct a much needed and more robust transmission system to better ensure reliability to the Rochester area for many years to come. When RPU goes to the bond market to secure financing for CapX2020, it is projected to be the single largest expenditure to date for RPU, at an estimated cost of \$49 million.

After many meetings and discussions with customers and stakeholders, we finally were able to come to a decision on locating a new 3.5 million gallon water reservoir to be built in 2013. The open dialogue and discussion were extremely valuable for the board and staff to come up with the best location for all parties. In the end, the replacement for the 4th Street SE reservoir will be built on an existing RPU site along 4th St SW and 10th Ave SW.

This year we lost an integral part of our Utility Board, City Council Liaison Dennis Hanson. During the seven years he served on the RPU Board, Denny Hanson was a valued board member of the RPU family. As the liaison from the City Council to the board, Denny was actively involved in several significant decisions throughout the years, including keeping rates low with minimal or no increase, environmental improvement efforts such as the Emission Reduction Project at the Silver Lake Plant, reaffirmation of RPU's already strong bond rating in the AA category and others.

These accomplishments and many others would not have been possible without the support and oversight of Denny




Dennis Hanson

and the rest of the board. Denny's level-headed approach and good listening skills always benefited the board and customers alike. His hard work and joy for service that he brought to the board and the organization will not be forgotten.

It is with fond remembrance of the past and great anticipation for the future that we share our 2012 annual report.

Sincerely,

	
Larry Koshire	Jerry Williams
General Manager	Board President



CORE VALUES

The guiding principles for sound, professional decision-making lie squarely in RPU's core values. As the largest municipal utility in the state of Minnesota, RPU is looked at to be a leader among municipals and other utilities across Minnesota and the nation. The core values provide a framework for employees and the Utility Board to make business decisions and to operate as an ethical business entity.

RPU prides itself as an industry leader not afraid to work with transparency and integrity in everything it does.

CORE VALUE: Safety

PROTECT EVERY INDIVIDUAL

Safety is part of everything we do and is the responsibility of every worker whether in a bucket truck, a well house, the Silver Lake Plant, or behind a desk. Using proper safety procedures and equipment not only keeps our employees safe but helps to ensure the safety of our customers and the community as well. On average, every RPU employee attends over 15 hours of safety training each year. In certain cases safety training can top 30 hours annually.

Safety was never of higher importance than when storms swept through Rochester and much of southeastern Minnesota back in September. The winds of speeds over 70 mph caused a large amount of damage to vegetation and infrastructure, taking power out to some customers for a number of days.

CORE VALUE: Integrity

DEMONSTRATE HONESTY, RESPECT, AND GOOD FAITH

As a city-owned municipal utility governed by a mayor-appointed Utility Board, integrity in all facets of RPU business and decision-making can clearly be seen.

An important decision for RPU this past year was the decision on where to construct the new water reservoir to replace the existing water reservoir on 4th St SE. From the first board discussion on the reservoir replacement, board president Jerry Williams stated that the board would take a slow, listening approach to choosing a location. The decision, in fact, was slow taking a course of more than six months to come. In the course of that time, many local stakeholders were consulted, homeowners shared their concerns and additional meetings were held by CUDE (Committee on Urban Design and Environment).

The respect and need for input from all parties wasn't an option, it was always stated as a necessity to reach the best decision for everyone.





CORE VALUE: Service

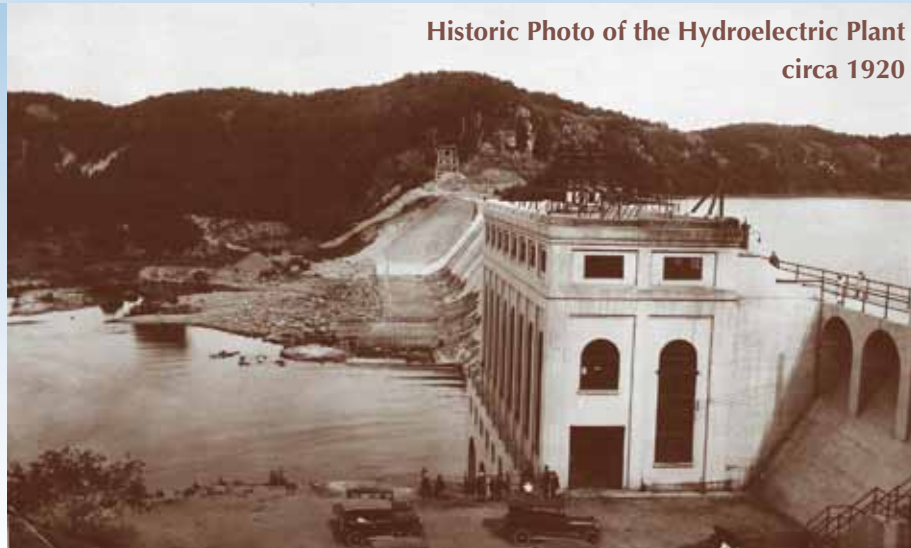
LEAVE EVERY INDIVIDUAL WITH A POSITIVE IMPRESSION

This year marked the third straight year for the electric utility and fifth straight year for the water utility without a rate increase. Keeping rates level for another year while still providing a high level of customer service took a great deal of work from RPU staff. Planning and coordination started mid-year to provide adequate time to ensure that maintaining a level budget for another straight year was a feasible option. Much of the behind-the-scenes work goes unnoticed, but sound fiscal management is a service that all RPU customers can appreciate and be proud of.

CORE VALUE: Stewardship

PROTECT OUR ENVIRONMENT THROUGH THE WISE USE OF RESOURCES

Since 1920, the Lake Zumbro hydroelectric plant has been a reliable source of renewable energy. The historically significant powerhouse set along the bank of Lake Zumbro houses two turbines with an output rating of 2.6 megawatts. This year, the hydro produced 7,548,089 kilowatt-hours of energy, which is equivalent to the average annual usage of 968 houses in Rochester.







CORE VALUE: Accountability

TAKE OWNERSHIP AND RESPONSIBILITY FOR ACTIONS AND OUTCOMES

Rochester is a beautiful community that loves trees, both the mature trees and the thousands of seedlings planted each year. With many mature trees lining roadways and backyards, comes growth and sometimes overgrowth of vegetation. As with any vegetation around overhead lines, if it is not constantly attended to, it can become a factor in outages and interruptions in service.

RPU constantly evaluates its vegetation management program, and this year made the decision to substantially increase its efforts in vegetation management. This meant a larger budget for tree pruning efforts, additional time committed to addressing areas of overgrowth, and setting in place a more aggressive tree pruning plan for the future.

CORE VALUE: Skill

IMPROVE OUR OWN AND OTHERS' ABILITIES AND KNOWLEDGE

Science, Technology, Engineering, and Math (STEM) are all areas of emphasis in many jobs at RPU. In order to increase interest about STEM careers and industries, RPU sponsored and participated in the STEM Summit hosted by the Rochester Area Chamber of Commerce.

At the daylong event, RPU employees spoke with and shared different facets of STEM careers at RPU with more than 2,000 students in attendance.



REFLECTIONS







RPU SERVICE TRUCKS
caravan over 1,200 miles
to provide mutual aid to
Long Island, New York, after
Hurricane Sandy left more than
800,000 people without power.

OUTAGE RESPONSE

The Midwest got hit with its fair share of wind and storms this past year. Back in June, a wind storm swept through the area leaving behind broken trees, downed power lines, and even broken distribution and transmission poles for RPU crews to deal with. In all of the mess, thousands of RPU customers lost power. Then a similar storm event followed later in September.

RPU's outage response was tested this year and again the adversity was met head on. The intricate coordination necessary to safely restore power to thousands of customers starts with dedicated employees.

Employees were called in the late night hours to help answer customer calls and all available line workers were called in as well. As employees made their way into the RPU service center, it was clear that the outages were of substantial size. Over 5,000 customers were affected in June's outage and over 10,000 were affected in September. The outage in September was so severe that after restoration efforts by crews rotating around the clock, it was determined that a call for mutual aid was going to have to be made. This marked the second time in history that RPU had to reach out to other utilities for aid. Fortunately, Austin Utilities and Owatonna Public Utilities had crews to send to Rochester to help.

With the uncertainty of weather, a utility never knows when a call for mutual aid is necessary for help or when a call might come in from somewhere else needing help. After Hurricane Sandy hit the east coast, over 800,000 Long Island Power Authority (LIPA) customers were left without electricity. Through the Minnesota Municipal Utilities Association (MMUA) mutual aid agreement with LIPA,

RPU along with eight other utilities answered the call for additional help and headed to Long Island, NY.

The Minnesota crews ended up being away for two weeks offering a hand wherever needed. Initial work included clearing away vegetation and ensuring that the area was safe and clear of debris before work on the distribution system could take place.

When the crews arrived it was estimated that there were over 300,000 LIPA customers without power. During the time the crews were working in NY, a large snow storm came through the east coast and knocked out service to additional customers bringing the total back to over 800,000 customers.

By the time the crews left New York to return to Minnesota, 99% of the LIPA customers had power restored.

Minnesota Municipal Utilities Association crews that went to Long Island, NY

- Rochester Public Utilities
- Austin Utilities
- St. Peter Electric Utilities
- Brainerd Public Utilities
- Willmar Utilities
- Grand Rapids Public Utilities
- Chaska Electric Department
- Owatonna Public Utilities
- Hutchinson Utilities



ANNOUNCEMENT OF THE DECOMMISSIONING OF THE SILVER LAKE PLANT

After being an electric generating facility located in the heart of downtown Rochester for 63 years, the RPU Utility Board approved the decommissioning of the Silver Lake Plant (SLP) before or by December 31, 2015. This will end the burning of coal and electric generation at the plant, but could still leave the option for SLP to be a steam producing facility after 2015 by burning natural gas.

The decision came after significant consideration and discussion, with the Utility Board identifying three main drivers for the decision: enforcement of regulation, environmental laws, and economic realities. As a coal-fired power plant, SLP and many other power plants have been under tighter scrutiny regarding stack emissions. It is unknown what the future regulated emission levels will be, adding an additional level of uncertainty if SLP remained a generating facility in the future. The economics of the decision are hard facts based on today's energy market. The market consistently has an excess of energy which is driving the price for energy down to record lows. SLP is not positioned to be a viable option for future generation without significant and costly improvements to some or all of the four units on site. The decommissioning of SLP is a better decision for RPU ratepayers.

An internal team has been put in place to handle the planning and coordination for the decommissioning starting with the plan itself. No decisions have been made regarding the future of the physical structure or property on the SLP site. A comprehensive plan will be presented to the Utility Board by the second quarter of 2013.

Built in 1949, SLP was initially built with one modestly sized 7.5 megawatt (MW) Westinghouse turbine generator. Paid for in cash, at the time, SLP cost \$2.2 million dollars. Just three years later an additional turbine generator was added bringing the total capacity of the facility to 19 MW. By 1969 SLP had added two more turbine generators giving SLP a total generating capacity of 100 MW.

SLP has ordered its last shipment of coal to the site and will operate using the existing pile of coal or natural gas for future fuel needs. The last shipment will be completed by May 31, 2013.



Historic Photo of the Silver Lake Plant



ADDING NEEDED WATER STORAGE

After a long decision process comprised of many opportunities for engagement with customers and the community, the RPU Utility Board voted unanimously, in November, to place the new 3.5 million gallon water reservoir in the existing leased space of the 1.5 million gallon reservoir located at 4th St. and 10th Ave. SW. The 1.5 million gallon reservoir was built in 1930 on land leased to the city of Rochester by the Saint Mary's Hospital.

The new reservoir is necessary to replace the aging reservoirs at Saint Mary's and 4th Street SE, and to provide adequate water storage for future growth in the downtown Rochester area. The existing 4th Street SE reservoir was built in 1916 and has a capacity of 500,000 gallons. Approaching 100 years old, the reservoir is at the end of its life cycle and would not be able to be maintained without substantial costly improvements. No plans have been made for the space that will be freed up once the new reservoir goes into service.

RPU relies on the inclusion of others and transparency in decision-making. Home owners, business owners, stakeholders, and downtown business groups were all invited to be a part of the decision-making process. Two independent public meetings were also held and hosted by the Committee on Urban Design and Environment (CUDE). Now finally through all of the meetings, RPU looks forward to beginning work on the new water reservoir in 2013 with an in service date sometime in 2014.



- Existing 1.5 MG Reservoir (65' Diameter)
- Proposed 3.5 MG Reservoir (97' Diameter)
- Current Lease Area Boundary
- Current Revocable Permit Area for a Private Drive

REFLECTIONS







SUPPORTING LOCAL EDUCATIONAL OPPORTUNITIES

Every RPU employee was inspired at one point in time, by watching or speaking with someone in their field of study. That opportunity is what RPU wanted to help provide students at the 54th Rochester Regional Science Fair. RPU was the main sponsor of the event with a fitting theme of “Water: Our Natural Resource.” RPU staff gave their time to speak with the students, help organize the event, and served as judges at the science fair.

RPU has been a long-time supporter of the Rochester Regional Science Fair.

“Rochester Public Utilities support during this past year and previous years have been marked by a willingness to support the youth of Rochester. Because of the support of RPU the Rochester Regional Science Fair continued to represent the achievements of some of the best research in the country. It has been a willingness to field alternative energy sources and support the development of solutions to global energy principles that have helped to make the Rochester Fair one of the best. Organizations and companies give donations but RPU also gave employees the time to volunteer to make the fair successful.”

– Roger Larsen
Rochester Regional Science Fair Director



RECOGNITION

RPU was honored to receive a prestigious award for excellence in safe and reliable electric service and to receive a distinguished recognition this year for educational outreach. Additionally, RPU's efforts in the water utility received an equal amount of praise and recognition.

The American Public Power Association's (APPA) Reliable Public Power Provider Program (RP3) encourages public power utilities to operate an efficient and reliable distribution

system by demonstrating proficiency in four important disciplines: reliability, safety, work force development, and system improvement. In addition, the RP3 designation recognizes municipal utilities nationwide who are leading the way in those areas of discipline. RPU received the Platinum Level recognition this year for demonstrating excellence in the years of 2011 and 2012. Previously, RPU was recognized three straight times at the Diamond Level.

RPU was equally honored to receive the Minnesota Municipal Utilities Association's System Innovation Award for its involvement in the Cascade Meadow Wetlands and Environmental Science Center.

The award is given for leadership and innovation in customer service, energy efficiency, renewable energy or technology use, which has improved service to the utility's community and enhanced public power's prestige. RPU has been an active partner with Cascade Meadow since the early planning stages of the facility. Today, Cascade Meadow is a regional resource for learning about energy and water conservation, wetlands and water quality.

RPU leases space for five interactive, educational exhibits for all ages and has a staff person on site as a resource for visitors. In addition, RPU also installed the on-site wind and solar power systems, supporting the effort to build Cascade Meadow as a Leadership in Energy and Environmental Design (LEED) certified building.

More than 7,500 people visited Cascade Meadow in 2012.



RPU's General Manager Larry Koshire receives the Minnesota Municipal Utilities Association's System Innovation Award for RPU's involvement in the Cascade Meadow Wetlands and Environmental Science Center.

During Governor Dayton's proclamation of Safe Drinking Water Week in Minnesota for 2012, Lt. Governor Yvonne Prettner Solon presented certificates to four Minnesota communities including Rochester. The Source Water Protection Leadership Community certificates are designated by the Minnesota Department of Health. The communities received recognition for serving as an example to other communities of utility involvement with land owners, community residents, businesses and local government can lead to innovative and effective implementation of source water protection efforts.

As a result of being a leading municipal water provider, RPU's must ensure that the water supply is clean, safe and has a good taste to it. The Minnesota Chapter of the American Water Works Association (AWWA) awarded RPU with the designation as having the "Best Tasting Water" in southeast Minnesota. A component of having the "Best Tasting Water" is to maintain a safe level of fluoridation at all times. RPU was awarded the Water Fluoridation Quality Award by the Centers for Disease Control and Prevention for its consistent and professional adjustment of fluoride content to the optimum level for oral health in 2012. Consistent, high-quality water fluoridation practice is a safe and effective method to prevent tooth decay, improving the oral health of Rochester residents of all ages.



Lt. Governor Yvonne Prettner Solon (right) presents one of four Source Water Protection Leadership Community certificates to RPU Director of Field Services Joe Hensel (left) and RPU Environmental Analyst Todd Osweiler.

LEADERSHIP & UTILITY BOARD MEMBERS



ROCHESTER PUBLIC UTILITIES LEADERSHIP *(from left to right)*

Mark Kotschevar | **Director of Core Services** || Walter Schlink | **Director of Power Resources**
Larry Koshire | **General Manager** || Joe Hensel | **Director of Field Services** || Susan Parker | **Director of Corporate Services**



UTILITY BOARD *(from left to right)*

Michael Wojcik | **Board Member & City Council Liaison** | Owner, Elite Consulting, Inc.
Dave Reichert | **Board Member** | Project Manager, Facilities Engineering Manager, IBM
Mark Browning | **Board Member** | Project Manager, Facilities Project Services, Mayo Clinic
Roger Stahl | **Board Member** | Owner and Attorney, RMS Law Firm, PLLC
Jerry Williams | **Board President** | Retired

REFLECTIONS

REFLECTIONS

FINANCIAL STATEMENTS 2012



REPORT OF INDEPENDENT AUDITORS

To the Public Utility Board City of Rochester, Minnesota

We have audited the consolidated statements of net position of Rochester Public Utilities as of December 31, 2012 and 2011 and the related consolidated statements of revenues, expenses and changes in net position, and cash flows for the years then ended, which collectively comprise Rochester Public Utilities' basic financial statements as listed in the table of contents, and the related notes to the financial statements.

As discussed more fully in Note 1, the consolidated financial statements present only the Electric and Water Funds and do not purport to, and do not, present fairly the financial position of the City of Rochester as of December 31, 2012 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.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting principles used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

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, 2012 and 2011, and the changes in its net position and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Other Matters

Accounting principles generally accepted in the United States of America require that the Management's Discussion & Analysis information on pages 42 through 53 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing

the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Our audit was conducted for the purpose of forming an opinion on the financial statements that collectively comprise Rochester Public Utilities' financial statements as a whole. The Operating and Financial Statistics are presented on page 65 for purposes of additional analysis and are not a required part of the financial statements. The Operating and Financial Statistics have not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we do not express an opinion or provide any assurance on them.



Smith, Schafer and Associates, Ltd.

Certified Public Accountants

April 2, 2013

Rochester, Minnesota

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, 2012. 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 FINANCIAL STATEMENTS

Consolidated Financial Statements

The Consolidated Statements of Net Position present the Utility's assets and liabilities, with the difference between the two reported as net position. The Statement of Net Position provides information about the nature and amount of investments in resources (assets), and the obligations to creditors (liabilities). Net position increases when revenues exceed expenses. The Consolidated Statements of Revenues, Expenses, and Changes in Net Position 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.

HIGHLIGHTS

- Rochester continued to grow with 583 new electric customers and 398 new water customers added in 2012. Factoring out the electric customers added from a single large city service territory annexation in 2011, growth for the Electric Utility more than doubled from 2011, while growth for the Water Utility showed a 25% increase over the prior year.
- Retail revenues and kilowatt-hour sales stayed relatively flat from 2011. Demand also remained relatively flat. The annual peak demand of 288 megawatts was set in July, which is a decrease of 1.5% from the record demand of 292 megawatts set in July 2011.
- Retail water sales (ccf) were up 5.1% in 2012 due in part to a 12.7% decrease in rainfall May through September 2012 from 2011.
- Since 2009, cost reduction measures have been in place with the goal of keeping rates steady. Also contributing to this goal has been the fact that RPU's main power supplier, SMMPA, has not had a rate increase since 2010. As a result, RPU has succeeded in keeping Electric and Water rates steady each year since 2009 and did so in 2012 as well.
- Rates for power purchased from SMMPA (Southern Minnesota Municipal Power Agency) remained steady in 2012, with no increase. Purchased power costs from SMMPA and the MISO market represented 70% of electric operating expenses for 2012.
- The Electric Utility transferred approximately \$8.3 million, and the Water Utility transferred \$374,000 to the City of Rochester's General Fund in the form of in-lieu-of-tax payments.
- In November 2012, after a long decision process, the RPU Board voted unanimously on placing a new 3.5 million gallon water reservoir in the existing leased space of the 1.5 million gallon reservoir located at 4th St SW and 10th Ave SW. The new reservoir is necessary to provide adequate water storage for existing and future water demands in the downtown Rochester area. The new reservoir will also replace the existing 4th St SE reservoir, which was constructed in 1916.
- In November 2012 a two-person line crew from RPU, along with crews from eight other Minnesota utilities made the long trip to Long Island, NY to help with restoration efforts after Hurricane Sandy took out power to more than 300,000 Long Island Power Authority (LIPA) customers. The crews worked to help restore power in New York for ten days. By the time they left, 99% of the LIPA customers had power restored.
- RPU has been investing in smart grid technologies with regards to its electric distribution system for several years. This included installing an automated meter reading (AMR) system, which allows meter readers to collect data remotely via wireless connection and utilizing Geographic Information System (GIS) software in the outage management system. RPU is exploring other uses for these technologies that will allow them to better serve their customers. To that end, in 2012 RPU focused on installing a fiber backbone to all substations for future smart grid communication needs. A pilot program that RPU began in 2011 that involved sending a free Home Energy Report to a group of 25,000 customers was expanded to include all residential electric customers. The report provides customers information on their energy use and offers easy, personalized energy saving tips.

- RPU continues to sell energy from the Silver Lake Plant and the Cascade Creek gas turbine into the MISO (Midwest Independent System Operators) market, as well as purchase power through the MISO market for all power needs above the Contract Rate of Delivery limit of 216 megawatts provided by SMMPA. However, in August 2012, the RPU Board made a decision to direct staff to develop, implement and execute a plan to decommission the Silver Lake Power Plant by December 31, 2015 or sooner. They further clarified “decommission” to mean cease coal burning and electric generation, while retaining the potential to generate steam for the Mayo Clinic using natural gas until 2025. The Board based this decision on a number of factors, including the economics of selling into the MISO market, current potential or threatened litigation by the EPA and future restrictive environmental regulations. As a result of the Board’s August 2012 action, an asset impairment of \$35.5 million was recorded, which had a negative impact on the change in net position.
- RPU continues to be involved in the 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 from just south of the Twin Cities to Rochester, and then on to LaCrosse, as well as two 161-kilovolt transmission lines specific to the Rochester area. In December 2012, the RPU Board approved various contracts that allowed RPU to move into the next phase of the project, giving RPU a 9% interest in the project and authorizing the start of construction on the 161-kilovolt lines.
- In the fall of 2012 RPU completed a remodel of the service center lobby, which was originally constructed in 1988. The redesigned lobby is more functional for RPU staff and visitors, and better defines the large space to provide quality service to RPU customers. The lobby space also utilizes more natural light and relies on energy-efficient LED lighting rather than the traditional fluorescent lights.
- RPU surpassed its Aggressive Demand-Side Management (DSM) goal for 2012 of 18,785 megawatt hours in energy savings. Actual energy savings of 23,248 megawatt hours were achieved through helping commercial and residential customers install energy efficient equipment and technologies. This represents an estimated 23,248 tons of carbon reduction. The energy savings also represents 1.9% of annual retail energy sales. RPU almost surpassed its goal of 9.5 million gallons of water saved. Actual savings of 9.3 million gallons were achieved through the implementation of water conservation rates in 2010, customer education, leak detection and offering rebates on clothes washers, high efficiency toilets, rain barrels and other items.
- RPU receives all power up to its maximum Contract Rate of Delivery (“CROD”) of 216 megawatts from SMMPA. SMMPA’s primary source of energy is its 41% ownership of the 900 MW SHERCO 3 coal fired unit near Becker, MN. In November 2011, during start up from a scheduled overhaul, SHERCO 3 experienced significant equipment failure in the turbine and generator. Repairs are now well underway. The unit is expected to return to service in 2013. With the exception of a \$0.6 million deductible and the Agency’s share of unreimbursed capital improvements made while the plant is offline, nearly all of the repair costs are covered by insurance. In the interim, SMMPA has procured replacement power supply from the MISO market at a net cost slightly higher than SHERCO 3 production costs. SMMPA does not anticipate a revenue adjustment in 2013 as a result of the outage repairs or interim power supply arrangements.

FINANCIAL ANALYSIS – Electric Utility

The following discussion provides analysis of the 2012 and 2011 comparative financial information provided in the following table.

Condensed Financial Information - Electric Utility

December 31, 2012 and 2011

(In millions)

Statement of Revenues, Expenses, & Changes in Net Position

	<u>2012</u>	<u>2011</u>	<u>Change</u>
Operating Revenues	\$ 142.6	\$ 142.4	\$ 0.2
Operating Expenses	126.2	125.4	0.8
Operating Income	16.4	17.0	(0.6)
Transfers Out (In-Lieu-Of-Tax Payments)	(8.3)	(8.4)	0.1
Other Income & Expense	—	0.2	(0.2)
Interest Expense	(3.8)	(3.9)	0.1
Capital Contributions	0.5	—	0.5
Nonoperating Income (Expense)	(11.6)	(12.1)	0.5
Income Before Special Item	4.8	4.9	(0.1)
Special Item	(35.5)	—	(35.5)
Change in Net Position	(30.7)	4.9	(35.6)
Net Position - Beginning of Year	152.5	147.6	4.9
Net Position - End of Year	\$ 121.8	\$ 152.5	\$ (30.7)

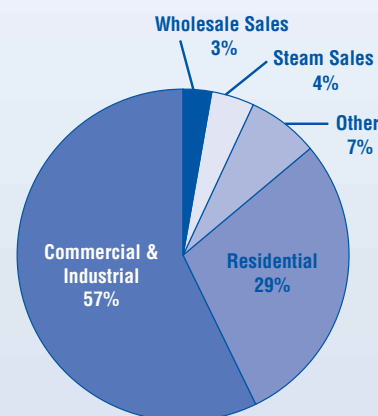
Statement of Net Position

	<u>2012</u>	<u>2011</u>	<u>Change</u>
Cash and Investments	\$ 43.2	\$ 42.5	\$ 0.7
Other Current Assets	19.5	20.4	(0.9)
Capital Assets, Net	155.9	189.5	(33.6)
Other Noncurrent Assets	3.1	3.1	—
Total Assets	221.7	255.5	(33.8)
Current Liabilities	19.0	18.0	1.0
Long-Term Debt	78.8	82.9	(4.1)
Other Long-Term Liabilities	2.1	2.1	—
Total Liabilities	99.9	103.0	(3.1)
Invested in Capital Assets, Net of Related Debt	75.1	105.1	(30.0)
Unrestricted	46.7	47.4	(0.7)
Net Position	\$ 121.8	\$ 152.5	\$ (30.7)

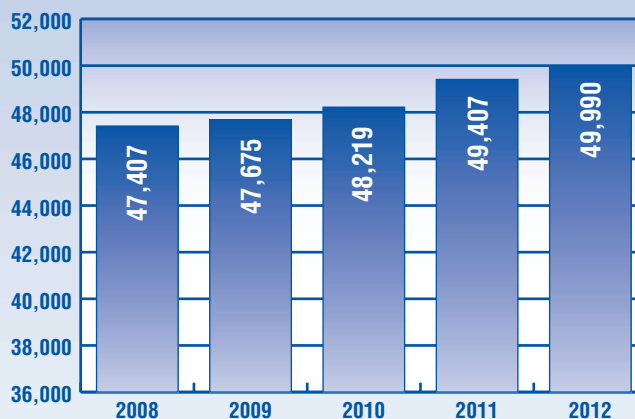
Operating Revenues

Operating revenues increased \$0.2 million (0.1%) in 2012. This was due primarily to an increase in wholesale revenues of \$1.4M or 52.2%, offset by a decrease in retail revenues of \$1.2M or 0.9%.

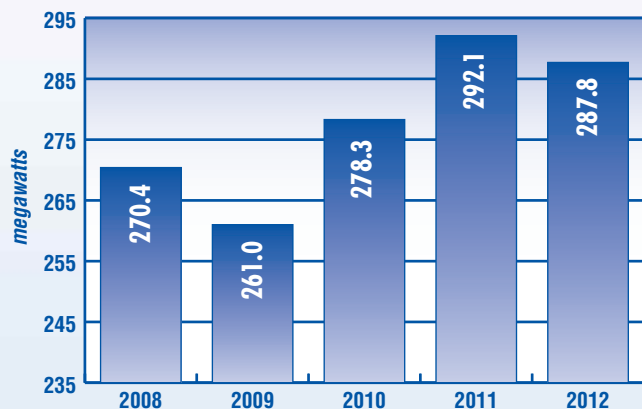
Electric Operating Revenues



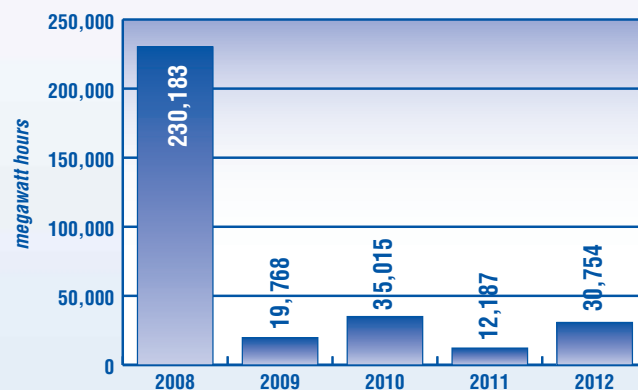
Number of Electric Customers



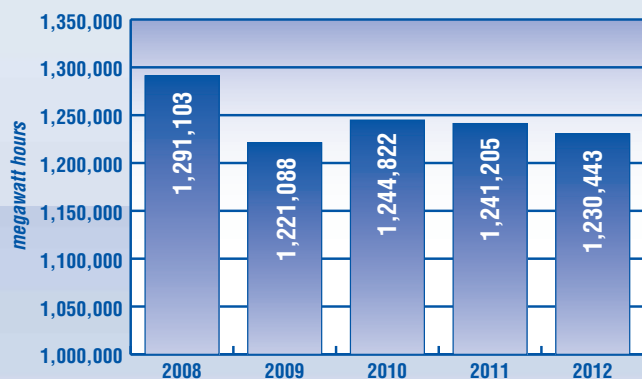
Electric Peaks



Wholesale Sales



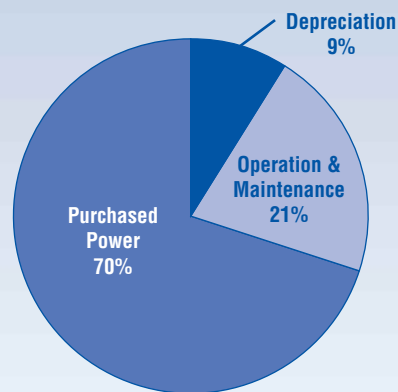
Electric Retail Sales



Operating Expenses

Operating expenses increased \$0.8 million (0.6%) in 2012, due primarily to an increase in generation fuel costs and purchased power. The primary driver of operating expenses for the Electric Utility continues to be purchases of power from SMMPA and from the MISO market, which comprised 70% of total 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 a slight decrease in kilowatt-hour sales the payment to the City decreased by approximately \$73,000.

Capital Contributions

Capital contributions increased \$0.5 million in 2012. This amount represents the City's portion of the geothermal system that serves both RPU and the Rochester Public Works Operations Center.

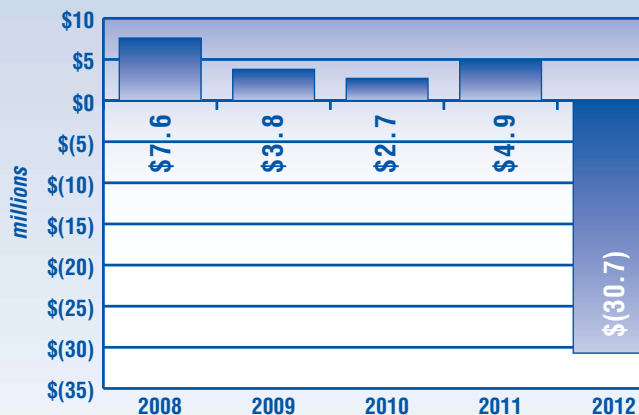
Special Items

This amount was the result of recording the asset impairment of affected Silver Lake Plant assets due to the decision to decommission the plant by December 31, 2015.

Change in Net Position

The decrease in net position for 2012 was \$30.7 million, \$35.6 million less than the \$4.9 million increase recorded in 2011. This is primarily due to the impact of recording the asset impairment to the Silver Lake Plant assets as a result of the decision to decommission the plant by December 31, 2015.

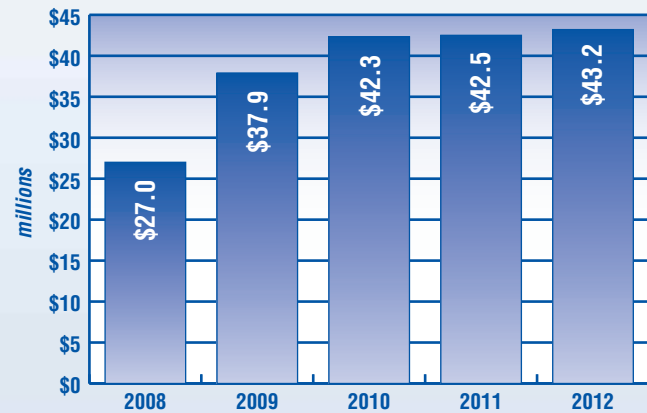
Change in Net Position



Cash, Investments and Other Assets

The ending unrestricted cash and investments balance for 2012 was \$43.2 million, \$0.7 million higher than 2011.

Unrestricted Cash and Investments – Electric



Other current assets for 2012 were \$19.5 million, \$0.9 million lower than at the end of 2011. This decrease was due primarily to a decrease in accounts receivable.

Liabilities

Current liabilities increased \$1.0 million in 2012, primarily due to an increase in the amount owed to the City for sewer and stormwater revenues collected, as well as an increase in the current portion of long-term debt.

Net Position

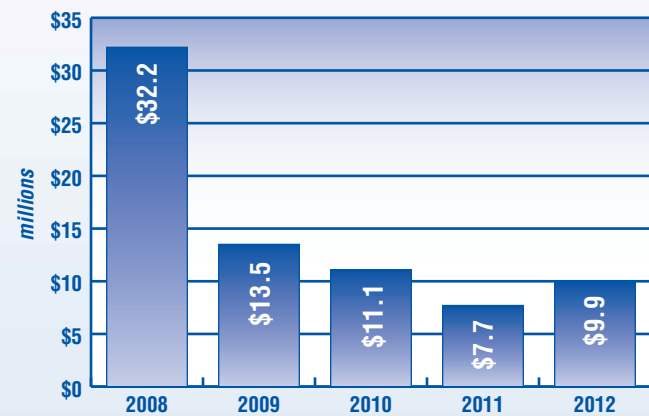
Net position invested in capital assets, net of related debt, decreased \$30 million. This decrease reflects additions to capital assets funded through rate-based revenues and fees from customers. It also reflects the impact of recording the asset impairment of affected Silver Lake Plant assets.

Unrestricted net position is not subject to any constraints by debt covenants or other legal requirements. In 2012, unrestricted net position decreased \$0.7 million due to the results of operations.

CAPITAL ASSETS

At December 31, 2012, the Electric Utility had \$155.9 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, emission reduction equipment, electric transmission and distribution lines, buildings and equipment. Capital assets increased \$10.5 million in 2012, reflecting investments in the distribution and transmission systems, and general facilities of the Electric Utility. This increase in capital assets was offset by a \$44.1 million increase in accumulated depreciation. The large increase in accumulated depreciation was the result of the current year depreciation expense and recording impaired assets due to the decommissioning of the Silver Lake Plant. Additional details regarding the Utility's total assets (electric and water) may be found in Note 7 to the financial statements. Capital and major maintenance expenses increased by \$2.1 million in 2012, due to increased development activity and some larger projects.

Capital and Major Maintenance Expenditures



LONG-TERM DEBT

At the end of 2012, the Utility had \$77.8 million in revenue bonds and \$4.4 million in revenue notes outstanding. No new debt was issued during the year and \$4.0 million was retired in 2012.

The Utility maintained an AA- bond rating from Fitch. In December 2012 the Utility's bond rating from Moody's went down slightly from an Aa2 to an Aa3. Additional details regarding the Utility's long-term debt may be found in Note 8 to the financial statements.

FINANCIAL ANALYSIS – Water Utility

The following discussion provides analysis of the 2012 and 2011 comparative financial information provided in the following table.

Condensed Financial Information - Water Utility

December 31, 2012 and 2011

(In millions)

Statement of Revenues, Expenses, & Changes in Net Position

	<u>2012</u>	<u>2011</u>	<u>Change</u>
Operating Revenues	\$ 8.6	\$ 8.3	\$ 0.3
Operating Expenses	8.2	8.1	0.1
<i>Operating Income</i>	<u>0.4</u>	<u>0.2</u>	<u>0.2</u>
Transfers Out			
(In-Lieu-Of-Tax Payments)	(0.4)	(0.3)	(0.1)
Other Income & Expense	0.1	0.1	—
Capital Contributions	0.9	1.3	(0.4)
Nonoperating Income (Expense)	0.6	1.1	(0.5)
<i>Change in Net Position</i>	<u>1.0</u>	<u>1.3</u>	<u>(0.3)</u>
Net Position - Beginning of Year	92.8	91.5	1.3
<i>Net Position - End of Year</i>	<u>\$ 93.8</u>	<u>\$ 92.8</u>	<u>\$ 1.0</u>

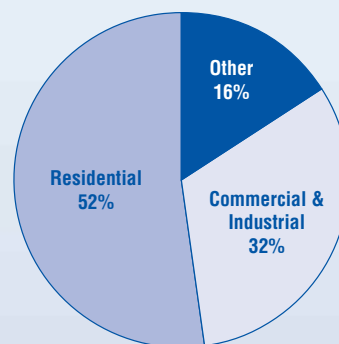
Statement of Net Position

	<u>2012</u>	<u>2011</u>	<u>Change</u>
Cash and Investments	\$ 8.0	\$ 6.5	\$ 1.5
Other Current Assets	0.7	0.7	—
Capital Assets, Net	87.2	87.0	0.2
<i>Total Assets</i>	<u>95.9</u>	<u>94.2</u>	<u>1.7</u>
Current Liabilities	1.9	1.2	0.7
Other Long-Term Liabilities	0.2	0.2	—
<i>Total Liabilities</i>	<u>2.1</u>	<u>1.4</u>	<u>0.7</u>
Invested in Capital Assets, Net of Related Debt	87.2	87.0	0.2
Unrestricted	6.6	5.8	0.8
<i>Net Position</i>	<u>\$ 93.8</u>	<u>\$ 92.8</u>	<u>\$ 1.0</u>

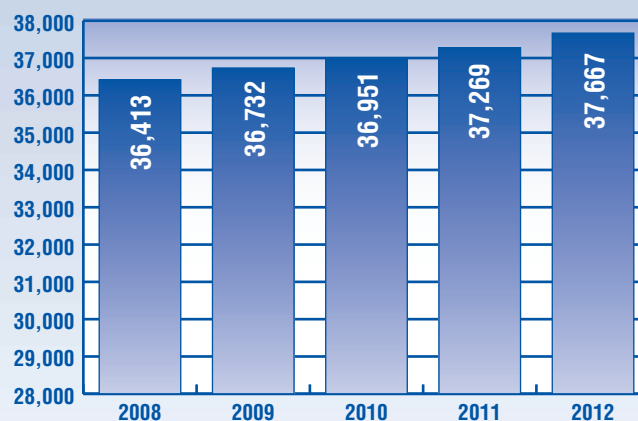
Operating Revenues

Operating revenues increased by \$0.3 million (3.6%) in 2012. Rates from 2011 were not changed. Sales volume increased by 5.1%, however, utility service revenues increased by only 4.1%. This is due to the rate structure where approximately 45% of utility service revenue comes from a fixed customer charge that doesn't vary with sales volume.

Water Operating Revenues



Number of Water Customers



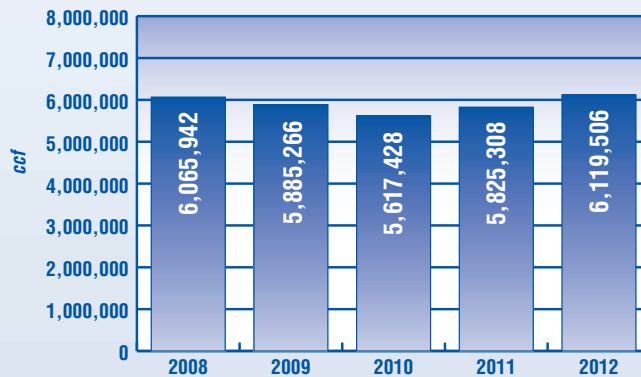
Operating Expenses

Operating expenses increased by \$0.1 million (1.4%) in 2012. This was primarily due to increases in depreciation, salaries expense and outside services, offset by a decrease in materials and supplies expense.

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 2012, payments to the City increased by approximately \$18,000.

Water Retail Sales



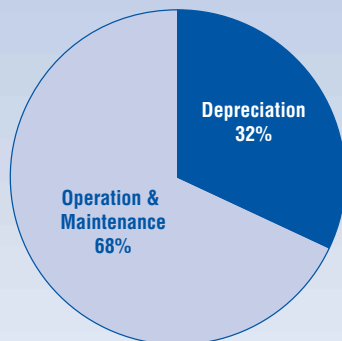
Capital Contributions

Capital contributions decreased \$0.4 million in 2012. These are assets, primarily water towers, 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.

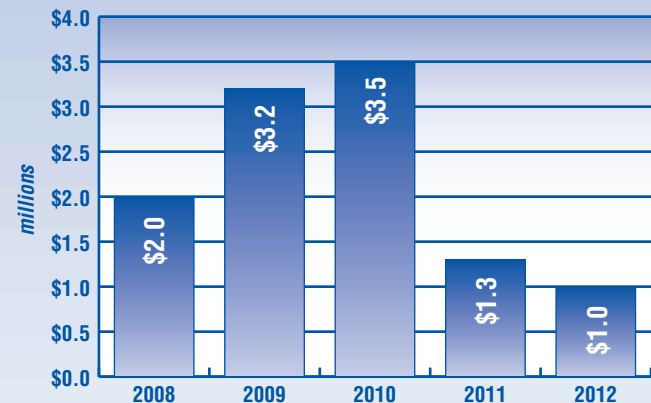
Change in Net Position

The increase in net position for 2012 was \$1.0 million, \$0.3 million lower than in 2011. This is primarily due to a decrease in reported capital contributions in 2012.

Water Operating Expenses



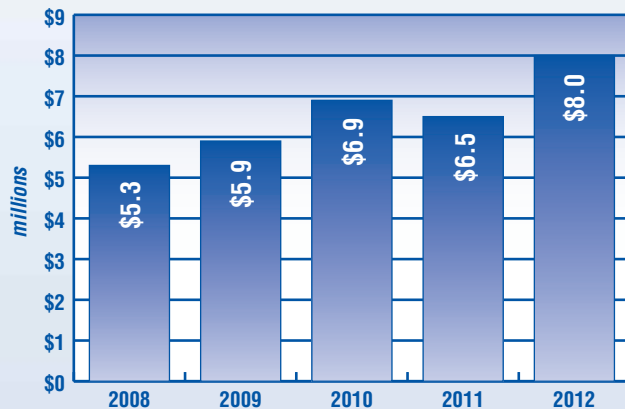
Change in Net Position



Cash, Investments and Other Assets

The ending unrestricted cash and investments balance for 2012 was \$8.0 million, \$1.5 million higher than 2011 due to an increase in cash provided by operations.

Unrestricted Cash and Investments – Water



Liabilities

Current liabilities increased \$0.7 million in 2012, mainly due to an increase in the amount owed to the City at the end of 2012.

Net Position

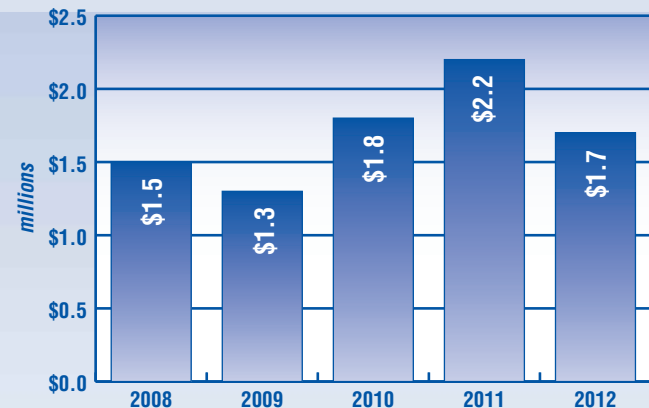
Net position invested in capital assets, net of related debt, increased \$0.2 million. This increase reflects additions to capital assets. Capital expenditures for the Water Utility are funded through rate-based revenues and fees from customers.

Unrestricted net position is not subject to any constraints established by debt covenants or other legal requirements. In 2012, unrestricted net position increased \$0.8 million due to the results of operations.

CAPITAL ASSETS

At December 31, 2012, the Water Utility had \$87.2 million invested in a broad range of utility capital assets, including 20 water storage facilities, 31 wells, water mains, pump station facilities, buildings, and equipment. Capital assets increased \$2.7 million in 2012, 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 \$2.5 million increase in accumulated depreciation. Additional details regarding the Utility's total assets (electric and water) may be found in Note 7 to the financial statements. Capital and major maintenance expenses decreased by \$0.5 million in 2012, due to less work being completed in 2012. Some of the major components of capital spending in 2012 were City projects, design of a new well, water storage facility maintenance, well maintenance, a new vehicle and spending on water meters and automated meter reading.

Capital and Major Maintenance Expenditures



MISCELLANEOUS INFORMATION

ECONOMIC FACTORS

The City Council has approved Electric and Water rate increases as needed to support the Utility on a cost of service basis. In December 2011, the Utility Board voted to have no rate increase for 2012 for both the Electric and Water Utilities. The Electric Utility had rate increases in 2008 and 2009, followed by three years of no rate increases. The Water Utility has had not had a rate increase since 2007. For the Electric Utility, the fact that SMMPA has not had a rate increase since 2010 has been a major contributing factor in allowing RPU to accomplish this. For both Utilities, this has also been the result of careful planning and continued aggressive cost control measures, and has been a way for RPU to support the Rochester community during difficult economic conditions.

The table below compares historical electric and water rate increases with the annual inflation rate, as well as an average for the last five years.

Rochester Public Utilities
Electric and Water Rate Change Versus Inflation

Year	Inflation	Electric Rates	Water Rates
2013*	2.0%	0.0%	0.0%
2012	2.1%	0.0%	0.0%
2011	3.2%	0.0%	0.0%
2010	1.7%	0.0%	0.0%
2009	(0.4%)	5.0%	0.0%
Annualized Average	1.7%	1.0%	0.0%

*Estimated Yearly Values

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. Growth of the city directly affects several of these factors.

As the housing market has begun to pick up, growth of the city has increased as well. In 2012 there were 312 building permits totaling \$68.2 million issued for single-family homes as compared to 208 permits totaling \$42.1 million in 2011. While the number of commercial building permits issued decreased from 2011, the dollar value increased significantly. Commercial permits numbered 40 for 2012 totaling \$95.8 million as compared to 47 commercial permits valued at \$62.6 million in 2011.

According to the US Department of Labor Bureau of Labor Statistics, the December 2012 unemployment rate of 4.5% for the area remains well below the state and national rates of 5.5% and 7.8%, respectively. The employment data shows that, on average, there were slightly more people working in the Rochester area than the previous year. During the past 12 months, the average unemployment rate for Rochester was 4.8%.

After examining all of these factors in the budgeting process, RPU has projected both electric and water rates to increase modestly over the next five years. However, taking into account the current economic conditions and the effect it has had on customers, management has felt it prudent to recommend no electric rate increase for 2013 as it did in 2010 through 2012. RPU management and employees were able to make this possible by continuing to hold costs down. SMMPA contributed to this as well by not increasing rates in 2011 through 2013.

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.

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

See Notes to Consolidated
Financial Statements
Found on Pages 60–64

	Years Ended December 31	
	2012	2011
Operating Revenues:		
Electric:		
Retail	\$129,480,259	\$130,698,001
Wholesale	4,058,764	2,666,088
Other	9,063,734	9,048,830
Water	8,619,875	8,320,952
Total Operating Revenues	151,222,632	150,733,871
Operating Expenses:		
Purchased Power	88,282,511	87,915,718
Operations and Maintenance	32,558,866	32,700,100
Depreciation	13,532,825	12,897,099
Total Operating Expenses	134,374,202	133,512,917
Operating Income	16,848,430	17,220,954
Nonoperating Income (Expenses):		
Investment Income	451,351	639,208
Interest Expense	(3,763,297)	(3,902,584)
Miscellaneous, Net	(420,877)	(386,838)
Total Nonoperating Income (Expenses)	(3,732,823)	(3,650,214)
Income Before Transfers/Capital Contributions and Special Item	13,115,607	13,570,740
Transfers Out	(8,679,453)	(8,734,117)
Capital Contributions	1,489,781	1,262,600
Income Before Special Item	5,925,935	6,099,223
Special Item - Impairment Loss (Note 4)	(35,536,828)	—
Change in Net Position	(29,610,893)	6,099,223
Net Position, Beginning of Year	245,251,593	239,152,370
Net Position, End of Year	\$215,640,700	\$245,251,593

Income by Segments of Business

See Notes to Consolidated
Financial Statements
Found on Pages 60–64

2012	Electric	Water	Total
Operating Revenues:			
Retail	\$129,480,259	\$7,890,123	\$137,370,382
Wholesale	4,058,764	–	4,058,764
Other	9,063,734	729,752	9,793,486
Total Operating Revenues	142,602,757	8,619,875	151,222,632
Operating Expenses	126,180,724	8,193,478	134,374,202
Operating Income	16,422,033	426,397	16,848,430
Nonoperating Income (Expense)	(3,783,184)	50,361	(3,732,823)
Income Before Transfers, Capital Contributions and Special Item	12,638,849	476,758	13,115,607
Transfers Out	(8,305,490)	(373,963)	(8,679,453)
Capital Contributions	585,129	904,652	1,489,781
Income Before Special Item	4,918,488	1,007,447	5,925,935
Special Item - Impairment Loss (Note 4)	(35,536,828)	–	(35,536,828)
Change in Net Position	(\$30,618,340)	\$1,007,447	(\$29,610,893)

2011	Electric	Water	Total
Operating Revenues:			
Retail	\$130,698,001	\$7,580,968	\$138,278,969
Wholesale	2,666,088	–	2,666,088
Other	9,048,830	739,984	9,788,814
Total Operating Revenues	142,412,919	8,320,952	150,733,871
Operating Expenses	125,429,806	8,083,111	133,512,917
Operating Income	16,983,113	237,841	17,220,954
Nonoperating Income (Expense)	(3,729,524)	79,310	(3,650,214)
Income Before Transfers/Capital Contributions	13,253,589	317,151	13,570,740
Transfers Out	(8,378,132)	(355,985)	(8,734,117)
Capital Contributions	–	1,262,600	1,262,600
Change in Net Position	\$4,875,457	\$1,223,766	\$6,099,223

Consolidated Statements of Net Position

See Notes to Consolidated
Financial Statements
Found on Pages 60–64

	December 31	
	2012	2011
ASSETS:		
Current Assets:		
Cash and Cash Equivalents (Note 5)	\$7,511,488	\$7,022,031
Investments	43,699,113	42,034,903
Accounts Receivable and Accrued Utility Revenues	12,038,300	13,376,934
Fossil Fuel Inventory	2,925,430	2,374,245
Materials and Supplies Inventory	5,132,125	5,261,529
Other Current Assets	131,230	84,353
Total Current Assets	71,437,686	70,153,995
Non-Current Assets:		
Restricted Assets (Note 6):		
Investments	2,508,848	2,504,517
Deferred Charges:		
Unamortized Bond Issuance Costs	533,673	618,916
Capital Assets:		
Construction Work in Progress	11,258,617	9,948,367
Land and Land Rights	4,135,424	3,995,924
Depreciable Assets, Net (Note 7):		
Electric	144,157,517	178,251,726
Water	83,574,931	84,246,253
Net Capital Assets	243,126,489	276,442,270
Total Non-Current Assets	246,169,010	279,565,703
Total Assets	\$317,606,696	\$349,719,698

	December 31	
	2012	2011
LIABILITIES:		
Current Liabilities:		
Accounts Payable	\$9,644,908	\$9,556,085
Due to Other Funds	3,363,266	2,460,113
Accrued Compensation and Compensated Absences	2,383,930	2,260,316
Customer Deposits	539,613	523,920
Interest Payable	296,357	303,007
Current Maturities of Long Term Debt (Note 8)	4,503,032	4,029,714
Deferred Credits	150,835	241,362
Total Current Liabilities	20,881,941	19,374,517
Non-Current Liabilities:		
Accrued Compensated Absences	1,608,723	1,535,700
Accrued Claims	27,000	35,000
Long-Term Debt (Note 8)	78,819,377	82,857,513
Unearned Lease Revenues (Note 9)	628,955	665,375
Total Non-Current Liabilities	81,084,055	85,093,588
Commitments and Contingencies (Note 12)		
Total Liabilities	\$101,965,996	\$104,468,105
NET POSITION:		
Invested in Capital Assets, Net of Related Debt	\$162,313,293	\$192,059,560
Unrestricted	53,327,407	53,192,033
Total Net Position	\$215,640,700	\$245,251,593

Consolidated Statements of Cash Flows

See Notes to Consolidated
Financial Statements
Found on Pages 60–64

	Years Ended December 31	
	2012	2011
Cash Flows From Operating Activities:		
Cash Received from Customers	\$147,127,595	\$143,947,327
Cash Paid to Suppliers and Employees	(122,045,297)	(119,912,419)
Internal Activity – Payments From Other Funds	5,654,282	5,509,558
Net Cash Provided By Operating Activities	30,736,580	29,544,466
Cash Flows From Noncapital Financing Activities:		
Operating Transfers to Other Funds	(8,682,222)	(8,798,802)
Cash Flows From Capital and Related Financing Activities:		
Additions to Utility Plant and Other Assets	(12,771,449)	(13,630,813)
Service Territory Acquisition	(608,580)	(650,272)
Payments on Bonds and Notes Payable Obligations	(7,249,076)	(7,685,899)
Net Cash (Used In)		
Capital and Related Financing Activities	(20,629,105)	(21,966,984)
Cash Flows From Investing Activities:		
Interest Received	732,746	1,047,994
(Increase) Decrease in Investments	(1,668,541)	334,388
Net Cash Provided by (Used In) Investing Activities	(935,795)	1,382,382
Net Increase in Cash and Cash Equivalents	489,458	161,062
Cash and Cash Equivalents, Beginning of Year	7,022,031	6,860,969
Cash and Cash Equivalents, End of Year	\$7,511,489	\$7,022,031

	Years Ended December 31	
	2012	2011
Reconciliation of Operating Income to Net Cash Provided by Operating Activities:		
Operating Income	\$16,848,430	\$17,220,954
Adjustments to Reconcile Operating Income to		
Net Cash Provided by Operating Activities:		
Depreciation	13,532,825	12,897,099
Bad Debts	143,947	310,977
Other	(421,780)	(388,305)
(Increase) Decrease In:		
Accounts Receivable and Accrued Utility Revenues	1,194,689	(2,173,106)
Inventories	(421,781)	448,617
Prepaid and Other Current Assets	(41,744)	68,744
Increase (Decrease) In:		
Accrued Liabilities and Accounts Payable	13,248	1,181,791
Customer Deposits	15,693	30,910
Unearned Lease Revenues	(36,420)	(36,420)
Other	(90,527)	(16,795)
Net Cash Provided by Operating Activities	\$30,736,580	\$29,544,466

Non-Cash Capital and Related Financing Activities:

Additions to Utility Plant and Other Assets Contributed By:		
City's Governmental Funds	\$1,008,522	\$842,218
Developers	\$481,259	\$420,382
Equipment Purchases in Accounts Payable	\$1,951,340	\$1,062,614
Silver Lake Plant Capital Asset Impairment	\$35,536,828	—

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 proprietary fund in conformity with the applicable pronouncements of the Governmental Accounting Standards Board (GASB). Interfund transactions are not eliminated for purposes of the consolidated financial statements.

Operating 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 Position.

Inventories

Inventories consist of materials, supplies, and fossil fuels used in Utility operations. Materials and supplies inventory is valued at the lower of 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/Premium

Bond issuance costs, bond discounts and bond premiums 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 2011 financial statements to conform to the 2012 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 and investments 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 5.

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: New Accounting Pronouncements

GASB 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*, implemented this year provides financial reporting guidance for deferred outflows of resources and deferred inflows of resources. The Statement of Net Assets is renamed the Statement of Net Position and includes four components: assets, deferred outflows of resources, liabilities and deferred inflows of resources. The Utility has determined they have no deferred outflows or inflows as defined by this standard.

GASB 65, *Items Previously Reported as Assets and Liabilities*, will be effective for the Utility beginning with its year ending December 31, 2013. This statement requires certain items that are currently reported as assets and liabilities to be reclassified as deferred outflows resources, deferred inflows of resources, or current-period outflows and inflows. Management does not anticipate that the statement will have a significant impact on the Utility's financial statements.

NOTE 3: Revenues

Revenue, consisting primarily of billings to customers for Utility services, includes accrued Utility revenue amounts of \$4,787,308 and \$4,867,158 for the years ended December 31, 2012 and 2011, respectively.

Sales to the Utilities single largest customer were \$21,826,252 (\$16,398,833 retail and \$5,427,419 other) and \$22,183,485 (\$16,671,153 retail and \$5,512,332 other) in 2012 and 2011, respectively. During the year ended December 31, 2012, no other customer accounted for more than 10% of operating revenues. Sales to other funds of the City of Rochester were \$4,737,680 and \$4,917,455 for the years ended December 31, 2012 and 2011, respectively.

NOTE 4: Special Item

In August 2012, the Public Utilities Board passed a resolution directing Utility staff to develop, implement and execute a plan to decommission the Silver Lake Plant for purposes of electrical generation by December 31, 2015 or sooner. That resolution was further clarified to state that portions of the Silver Lake Plant would remain operating to produce steam for sale to the Mayo Clinic using only natural gas as a fuel source. It has been determined that steam boilers for Silver Lake Plant Units 2 and 3 will remain in operation for that purpose. The decommissioning decision was driven by wholesale market factors and also current and upcoming regulations issued by the U.S. Environmental Protection Agency that impact coal-fired generating facilities. Additionally two new transmission lines are projected to be in service by the end of 2015 which will address reliability concerns of having less generation within the Electric Utility's service area. An impairment loss of \$35,536,828 has been reported as a special item in 2012 which represents the estimated undepreciated book value of impaired capital assets at the anticipated decommissioning date of December 31, 2015.

NOTE 5: Cash and Cash Equivalents

The Utility considers all temporary cash investments, including the Utility's equity in the cash portion of the City of Rochester investment pool, to be cash equivalents. Generally, cash equivalents are highly liquid investments.

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 2012 Comprehensive Annual Financial Report.

NOTE 6: Restricted Assets

Under the provisions of the 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 \$2,508,848 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.

NOTE 7: Capital Assets

Major classes of depreciable assets and total accumulated depreciation as of December 31, 2012 and 2011 are as follows:

	2012	2011
Intangible Plant Assets	\$ 15,006,468	\$ 14,042,587
Buildings, Structures, and Improvements	52,379,729	49,010,544
Installations, Equipment, and Fixtures	367,523,164	360,044,243
Total Depreciable Assets	434,909,361	423,097,374
Less: Accumulated Depreciation	207,176,913	160,599,394
Net Depreciable Assets	\$ 227,732,448	\$ 262,497,980

In 2012, capital assets totaling \$1,008,522 were contributed to the Utility by other funds of the City of Rochester, and \$481,259 were contributed to the Utility by others. Accumulated depreciation as of December 31, 2012 includes an impairment loss reserve of \$35,536,828 as described in Note 4.

NOTE 8: Long-Term Debt

At December 31, 2012 and 2011, long-term debt consisted of the following:

	2012	2011
Revenue Bonds, Series 2007C 4.00% - 5.00%, due each December 1 through 2030	\$ 73,180,000	\$ 74,370,000
Revenue Bonds, Series 2002A 3.00% - 4.50%, due each December 1 through 2017	4,595,000	5,400,000
Revenue Note Payable, principal due each December 1 through 2014, interest at variable rate, currently 0.15%, ongoing line of credit fees and administrative fees due each June 1 and December 1	1,675,000	2,390,000
Revenue Note Payable, principal due each December 1 through 2014, interest at variable rate, currently 0.15%, ongoing line of credit fees and administrative fees due each June 1 and December 1	2,805,000	4,120,000
Capital lease obligations	518,410	12,505
Less: Unamortized Discount	146,243	159,857
Less: Unamortized Deferred Amount on Refunding	1,382,772	1,515,371
Plus: Unamortized Premium	2,078,014	2,269,950
Less: Current Maturities	4,503,032	4,029,714
Total Long-Term Debt	\$ 78,819,377	\$ 82,857,513

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

In March 2007, the Electric Utility issued \$76.2 million in Revenue Bonds, Series 2007C, to finance the emission reduction project at Silver Lake Plant, transmission and substation work, and distribution system expansion, and to advance refund the majority of the outstanding Series 2000A Bonds. This advance refunding resulted in a difference between the reacquisition price and net carrying amount of the old debt of \$2,172,658. This difference, reported in the financial statements as a deduction from revenue bonds payable, is being amortized and charged to operations over the bond term using the interest method. The unamortized balance at December 31, 2012 and 2011 was \$1,382,772 and \$1,515,371 respectively. The Utility completed the advance refunding to reduce its total debt service payments over the subsequent 23 years by \$3.1 million and to obtain an economic gain (difference between the present values of the old and the new debt service payments) of \$2.0 million.

The annual requirements to amortize all debt outstanding as of December 31, 2012, including interest payments of \$39,416,474 are as follows:

	Revenue Bonds	Notes Payable
2013	\$ 5,631,281	\$ 2,312,165
2014	5,633,281	2,364,734
2015	6,605,788	—
2016	6,606,650	—
2017	6,608,900	—
Thereafter	85,908,675	—
Total	\$ 116,994,575	\$ 4,676,899

NOTE 9: 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 1,258,605,881 and 1,252,131,977 kilowatt hours totaling \$87,384,202 and \$87,012,687 from SMMPA during the years ended December 31, 2012 and 2011, respectively.

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 10: Pension Plans

The Utility participates in a statewide retirement plan administered by the Public Employees Retirement Association (PERA) of Minnesota. PERA administers the General Employees Retirement Fund (GERF) 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 the death of eligible members. Benefits and annual contributions are established by State statute. Total required contributions made during the year ended December 31, 2012 were \$2,024,531 of which \$1,094,588 was made by the Utility and \$929,943 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 GERF. That report may be obtained by writing to PERA, 60 Empire Drive #200, St. Paul, Minnesota, 55103-2088 or on the internet at www.mnpera.org 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, 2012 and 2011 was \$45,618 and \$51,831, respectively.

NOTE 11: Legal Matters

In November 2010, the City of Rochester/Rochester Public Utilities received a request for information from the U.S. Environmental Protection Agency (EPA) regarding the four units at the Silver Lake Power Plant. The information request was made under the provisions of Section 114 of the Clean Air Act. In previous cases involving other utilities, the information requests have been followed by EPA allegations of Clean Air Act violations which, in turn, have resulted in litigation or settlements resolving those allegations. The EPA has indicated that this request would result either in a settlement or in litigation between Rochester and the EPA. Currently, the parties continue to discuss a possible settlement of this matter however the timing and amount of potential settlement costs are unknown at this time. Management believes any likely resolution would not have a material adverse effect on the Utilities' financial statements.

NOTE 12: 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 \$275,000 per claim with a variable annual aggregate, and the 2012 workers' compensation coverage is limited to \$920,000 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.

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 one quarter of the energy production. The remaining three quarters 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. These agreements expire October 31, 2015.

Revenue under these agreements for the years ended December 31, 2012 and 2011 was as follows:

	2012	2011
kWh provided	30,655,054	12,048,787
Payments for availability	\$ 1,651,366	\$ 1,701,292
Reimbursed generation costs	\$ 182,405	\$ 102,819
Market-based sales	\$ 2,125,168	\$ 827,318

Service Territory Settlements

Under an agreement with People's Cooperative Services (PCS), the Utility is required to make payments to PCS related to the acquisitions of certain electric service rights from PCS. The agreement is valid until December 31, 2012. The payment varies by each settlement agreement and ranges from 8.5 mills (tenths of a cent) per kWh to 15.68 mills per kWh. These commitments expire over various periods as determined by the length of the term for each annexation. Costs are recognized under these agreements as service is provided.

NOTE 13: Subsequent Events

In preparing these financial statements, Rochester Public Utilities has evaluated events and transactions for potential recognition or disclosure through April 2, 2013, the date the financial statements were available to be issued.

OPERATING AND FINANCIAL STATISTICS (unaudited)

ELECTRIC	2012	2011	2010	2009	2008	2003
Retail Customers:						(10 years ago)
Residential	45,244	44,700	43,614	43,123	42,861	39,244
General Service	4,740	4,701	4,599	4,546	4,540	4,109
Industrial / Commercial	2	2	2	2	2	2
Other	4	4	4	4	4	4
Total Retail Customers	49,990	49,407	48,219	47,675	47,407	43,359
Retail Sales: (mWh)						
Residential	342,986	346,088	345,076	325,400	328,030	304,653
General Service	634,692	642,712	643,998	633,700	640,711	601,394
Industrial / Commercial	236,566	236,880	240,438	246,180	306,828	250,347
Other	16,199	15,525	15,310	15,808	15,534	16,884
Total Retail Sales (mWh)	1,230,443	1,241,205	1,244,822	1,221,088	1,291,103	1,173,278
Retail Revenue:						
Residential	\$41,924,195	\$42,565,163	\$41,706,952	\$39,405,261	\$37,790,777	\$25,876,051
General Service	62,452,007	62,924,479	61,730,430	60,130,384	57,912,677	40,375,839
Industrial / Commercial	19,405,820	19,455,536	19,389,007	18,984,349	21,159,879	13,281,822
Other	5,698,237	5,752,823	5,154,490	4,573,021	4,544,124	1,722,054
Total Retail Revenue	\$129,480,259	\$130,698,001	\$127,980,879	\$123,093,015	\$121,407,457	\$81,255,766
Steam Sales (MLBs)	447,579	459,491	453,280	438,810	346,449	—
Steam Revenues	\$5,427,419	\$5,512,332	\$5,555,370	\$5,178,145	\$3,771,825	\$0
Annual Peak (Megawatts)	287.8	292.1	278.3	261.0	270.4	261.9
Total mWh Generated	38,210	25,375	44,640	66,726	231,848	361,727
Total mWh Purchased	1,273,851	1,263,798	1,260,920	1,235,082	1,324,665	1,194,544
Year End Restricted / Unrestricted Cash & Investment Balance	\$45,760,328	\$45,025,194	\$44,813,640	\$46,566,146	\$40,265,406	\$18,652,198
WATER	2012	2011	2010	2009	2008	2003
Retail Customers:						(10 years ago)
Residential	34,213	33,827	33,547	33,337	33,044	29,663
Industrial / Commercial	3,454	3,442	3,404	3,395	3,369	3,058
Total Retail Customers	37,667	37,269	36,951	36,732	36,413	32,721
Retail Sales: (ccf)						
Residential	3,170,446	2,931,422	2,817,200	3,007,600	3,070,783	3,314,437
Industrial / Commercial	2,949,060	2,893,886	2,800,228	2,877,666	2,995,159	2,922,239
Total Retail Sales (ccf)	6,119,506	5,825,308	5,617,428	5,885,266	6,065,942	6,236,676
Retail Revenue:						
Residential	\$4,526,267	\$4,290,475	\$4,170,552	\$4,202,344	\$4,221,429	\$3,423,496
Industrial / Commercial	2,808,702	2,741,479	2,672,797	2,680,653	2,750,233	2,141,201
Public Fire Protection	555,154	549,014	545,114	541,544	536,193	401,055
Total Retail Revenue	\$7,890,123	\$7,580,968	\$7,388,463	\$7,424,541	\$7,507,855	\$5,965,752
Total Pumped (billion gallons)	4.8	4.5	4.5	4.7	4.8	5.0
Year End Restricted / Unrestricted Cash & Investment Balance	\$7,959,122	\$6,536,257	\$6,921,137	\$5,869,010	\$5,332,076	\$1,990,376

GENERAL INFORMATION



ROCHESTER PUBLIC UTILITIES LEADERSHIP

Larry Koshire | **General Manager**
Mark Kotschevar | **Director of Core Services**
Susan Parker | **Director of Corporate Services**
Joe Hensel | **Director of Field Services**
Walter Schlink | **Director of Power Resources**

UTILITY BOARD

Jerry Williams | **Board President** | Retired
Dave Reichert | **Board Member** | Project Manager, Facilities Engineering Manager, IBM
Mark Browning | **Board Member** | Project Manager, Facilities Project Services, Mayo Clinic
Roger Stahl | **Board Member** | Owner and Attorney, RMS Law Firm, PLLC
Michael Wojcik | **Board Member & City Council Liaison** | Owner, Elite Consulting, Inc.

ADVISORS AND CONSULTANTS

Smith, Schafer and Associates, Ltd. | **Independent Auditors**
Kennedy & Graven | **Bond Counsel**
Springsted Public Finance Advisors | **Financial Advisors**

UTILITY HEADQUARTERS

Rochester Public Utilities
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Rochester, MN 55906-2813
800.778.3421 | 507.280.1500
www.rpu.org

RPU UTILITY HEADQUARTERS



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