MINNESOTA MUNICIPAL POWER AGENCY

Financial Statements

December 31, 2011 and 2010

(With Independent Auditors' Report Thereon)

MINNESOTA MUNICIPAL POWER AGENCY

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KPMG LLP
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Independent Auditors' Report

The Board of Directors
Minnesota Municipal Power Agency:

We have audited the accompanying financial statements of the business-type activities and the discretely presented component unit of Minnesota Municipal Power Agency (the Agency) as of December 31, 2011 and 2010, as listed in the table of contents. These financial statements are the responsibility of the Agency's 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 audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Agency's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Minnesota Municipal Power Agency and the discretely presented component unit as of December 31, 2011 and 2010, and the changes in financial position and cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

U.S. generally accepted accounting principles require that the management's discussion and analysis of pages 2 through 7 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.

KPMG LLP

May 17, 2012

Financial Statements Overview

This discussion and analysis of Minnesota Municipal Power Agency's (the Agency) financial performance provides an overview of the Agency's activities for the fiscal years ended December 31, 2011 and 2010. The information presented should be read in conjunction with the financial statements and the accompanying notes to the financial statements.

The Agency follows the Uniform System of Accounts prescribed by the Federal Energy Regulatory Commission. The basic financial statements are prepared on the accrual basis of accounting in accordance with U.S. generally accepted accounting principles. The Agency's basic financial statements include the balance sheets, the statements of revenues, expenses, and changes in net assets, the statements of cash flows, and notes to the financial statements.

The balance sheets provide information about the nature and amount of assets and obligations (liabilities) of the Agency as of the end of each year reported. The statements of revenues, expenses, and changes in net assets report revenues and expenses. The statements of cash flows report cash receipts, cash payments, and net changes in cash resulting from operating, capital and related financing activities, and investing activities.

Financial Highlights

Comparison of 2011 with 2010

The following table summarizes the financial position of the Agency (excluding the discretely presented component unit) as of December 31:

Condensed Balance Sheets

	2011	2010	Dollar change	Percentage change
Capital assets, net	$ 267,396,382	231,544,627	35,851,755	15.5%
Current assets	37,853,482	29,067,585	8,785,897	30.2
Other noncurrent assets	54,632,008	90,225,038	(35,593,030)	(39.4)
Total assets	$ 359,881,872	350,837,250	9,044,622	2.6
Current liabilities	$ 26,689,639	21,501,633	5,188,006	24.1%
Long-term liabilities	303,243,748	303,382,513	(138,765)	—
Total liabilities	329,933,387	324,884,146	5,049,241	1.6
Net assets:				
Invested in capital assets, net of related debt	6,618,366	6,031,347	587,019	9.7
Restricted	6,695,254	3,922,647	2,772,607	70.7
Unrestricted	16,634,865	15,999,110	635,755	4.0
Total net assets	29,948,485	25,953,104	3,995,381	15.4
Total liabilities and net assets	$ 359,881,872	350,837,250	9,044,622	2.6

(Continued)

Condensed balance sheet highlights are as follows:

- The assets of the Agency exceeded its liabilities at the close of 2011 by approximately $29.9 million (net assets) as compared with $26.0 million at the end of 2010. Net assets provide necessary liquidity to the Agency and support its investment-grade credit rating.
- Current assets increased by $8.8 million from 2010 to 2011, primarily the result of increased cash and cash equivalents. Current assets include cash and cash equivalents, accrued interest receivable, and short-term investments. Current assets also include power sales receivables, which increased by approximately $0.3 million from 2010 to 2011.
- Other noncurrent assets, which include restricted cash and cash equivalents, prepaid expenses, and deferred costs, decreased by approximately $35.6 million from 2010 to 2011, primarily the result of construction funds from the Series 2010 bond issue being spent and a $3.2 million increase in future recoverable costs related to the levelization of depreciation and bond interest. Restricted cash and cash equivalents are used for operations, maintenance, working capital, and construction needs of the Agency.
- Capital assets, net increased by approximately $35.9 million during 2011 primarily due to the increase in electric plant in service associated with the Oak Glen Wind Farm project, partially offset by depreciation on capital assets in place.
- Current liabilities increased by approximately $5.2 million from 2010 to 2011 primarily due to the increase of retainage payable associated with the Oak Glen Wind Farm project, accrued interest payable, and bonds due within one year.
- Long-term liabilities did not materially change from 2010 to 2011, as the decrease in long-term debt was offset by the increase in the Agency's rate stabilization account. The Agency contributed $6.5 million to its rate stabilization account in 2011. Long-term liabilities consist of the bonds issued for construction of the Agency's generating facilities and deferred revenue in the Agency's rate stabilization account.

(Continued)

Comparison of 2010 with 2009

The following table summarizes the financial position of the Agency (excluding the discretely presented component unit) as of December 31:

Condensed Balance Sheets

	2010	2009	Dollar change	Percentage change
Capital assets, net	$ 231,544,627	185,581,370	45,963,257	24.8%
Current assets	29,067,585	29,069,155	(1,570)	—
Other noncurrent assets	90,225,038	23,811,391	66,413,647	278.9
Total assets	$ 350,837,250	238,461,916	112,375,334	47.1
Current liabilities	$ 21,501,633	19,056,273	2,445,360	12.8%
Long-term liabilities	303,382,513	197,635,228	105,747,285	53.5
Total liabilities	324,884,146	216,691,501	108,192,645	49.9
Net assets:				
Invested in capital assets, net of related debt	6,031,347	(888,070)	6,919,417	(779.2)
Restricted	3,922,647	3,645,402	277,245	7.6
Unrestricted	15,999,110	19,013,083	(3,013,973)	(15.9)
Total net assets	25,953,104	21,770,415	4,182,689	19.2
Total liabilities and net assets	$ 350,837,250	238,461,916	112,375,334	47.1

Condensed balance sheet highlights are as follows:

- The assets of the Agency exceeded its liabilities at the close of 2010 by approximately $25.9 million (net assets) as compared with $21.8 million at the end of 2009. Net assets provide necessary liquidity to the Agency and support its investment-grade credit rating.
- Current assets did not materially change from 2009 to 2010. Current assets include cash and cash equivalents, accrued interest receivable, and short-term investments. Current assets also include power sales receivables, which increased by approximately $0.9 million from 2009 to 2010.
- Other noncurrent assets, which include restricted cash and cash equivalents, prepaid expenses, and deferred costs, increased by approximately $66.5 million from 2009 to 2010, primarily the result of unspent construction funds related to the Series 2010 bond issue and a $3.3 million increase in future recoverable costs related to the levelization of depreciation and bond interest. Restricted cash and cash equivalents are used for operations, maintenance, working capital, and construction needs of the Agency.
- Capital assets, net increased by approximately $46.0 million during 2010 primarily due to the increase in construction work in progress associated with the Oak Glen Wind Farm project, partially offset by depreciation on capital assets in place.

(Continued)

- Current liabilities increased by approximately $2.4 million from 2009 to 2010 primarily due to the increase of accounts payable and accrued liabilities offset by a decrease in bonds due within one year because of the Agency retiring its note payable. Current liabilities also include accrued interest payable and short-term bonds payable.
- Long-term liabilities increased by approximately $105.8 million from 2009 to 2010 primarily due to the issuance of the Series 2010 bonds, partially offset by principal payments on Agency bonds and the retirement of the Agency's note payable. The Agency also contributed $3.0 million to its rate stabilization account in 2010. Long-term liabilities consist of the bonds issued for construction of the Faribault Energy Park power-generating plant and deferred revenue in the Agency's rate stabilization account.

The following table summarizes the changes in financial position of the Agency (excluding the discretely presented component unit) for the years ended December 31, 2011 and 2010:

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

	2011	2010	Dollar change	Percentage change
Operating revenues, power sales	$ 97,094,061	87,632,693	9,461,368	10.8%
Other nonoperating revenues	889,737	636,998	252,739	39.7
Total revenues	97,983,798	88,269,691	9,714,107	11.0
Operating expenses	86,541,773	77,795,523	8,746,250	11.2
Other nonoperating expenses	10,611,568	9,356,963	1,254,605	13.4
Total expenses	97,153,341	87,152,486	10,000,855	11.5
Future recoverable costs	3,164,924	3,065,484	99,440	3.2
Change in net assets	3,995,381	4,182,689	(187,308)	(4.5)
Beginning net assets	25,953,104	21,770,415	4,182,689	19.2
Ending net assets	$ 29,948,485	25,953,104	3,995,381	15.4

Condensed statements of revenues, expenses, and changes in net assets highlights are as follows:

- Operating revenues – power sales increased by approximately $9.5 million between 2011 and 2010 primarily due to higher costs. Operating revenues – power sales consist primarily of member power sales revenue, power sales to nonmembers, and other transmission revenue. Operating expenses increased by approximately $8.7 million between 2011 and 2010, primarily as a result of higher purchased power costs.
- Other revenues increased by approximately $0.3 million between 2011 and 2010 as the result of higher investment income.
- Other nonoperating expenses increased by approximately $1.3 million in 2011 primarily due to increased interest expense.

The following table summarizes the changes in financial position of the Agency for the years ended December 31, 2010 and 2009:

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

	2010	2009	Dollar change	Percentage change
Operating revenues, power sales	$ 87,632,693	79,562,477	8,070,216	10.1%
Other nonoperating revenues	636,998	621,931	15,067	2.4
Total revenues	88,269,691	80,184,408	8,085,283	10.1
Operating expenses	77,795,523	70,291,140	7,504,383	10.7
Other nonoperating expenses	9,356,963	9,314,385	42,578	0.5
Total expenses	87,152,486	79,605,525	7,546,961	9.5
Future recoverable costs	3,065,484	3,171,930	(106,446)	(3.4)
Change in net assets	4,182,689	3,750,813	431,876	11.5
Beginning net assets	21,770,415	18,019,602	3,750,813	20.8
Ending net assets	$ 25,953,104	21,770,415	4,182,689	19.2

Condensed statements of revenues, expenses, and changes in net assets highlights are as follows:

- Operating revenues – power sales increased by approximately $8.1 million between 2010 and 2009 primarily due to higher costs. Operating revenues – power sales consist primarily of member power sales revenue, power sales to nonmembers, and other transmission revenue. Operating revenues from sales to counterparties other than members decreased from $0.4 million in 2009 to $0.1 million in 2010 continuing a trend of reduced activity in this area.
- Operating expenses increased by approximately $7.5 million between 2010 and 2009, primarily as a result of higher fuel and purchased power costs.
- Other revenues did not change materially between 2010 and 2009.
- Other nonoperating expenses increased by approximately $0.1 million in 2010 primarily due to increased interest expense.

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Debt Administration

As of December 31, 2011, the Agency had long-term debt outstanding of approximately $295.2 million. On August 25, 2004, the Agency issued two electric revenue bonds: Electric Revenue Bonds Series 2004A in the amount of $50 million and Taxable Electric Revenue Bonds Series 2004B in the amount of $15 million. The bonds were issued for the purpose of constructing a gas-turbine power-generating facility. On September 22, 2005, the Agency issued another electric revenue bond: Electric Revenue Bonds Series 2005 in the amount of $115.18 million. These bonds were issued for the purpose of converting the Faribault Energy Park (FEP) into a combined-cycle power-generating facility. On December 15, 2006, the Agency defeased the outstanding balance of the Taxable Electric Revenue Bonds Series 2004B. On December 1, 2007, the Agency issued Electric Revenue Bonds Series 2007 in the amount of $27 million. The Series 2007 bonds were issued for the purpose of completing the conversion of the FEP into a combined-cycle power-generating facility.

On May 20, 2009, the Agency entered into a Term Loan Agreement in the amount of $10 million. The purpose of the Term Loan Agreement was to finance the purchase of rotable combustion turbine parts for the FEP facility and to finance other capital projects related to the FEP facility. On July 1, 2009, the Agency issued Electric Revenue Bonds Series 2009A in the amount of $5 million. The Series 2009A bonds were issued for the purpose of constructing the Agency's Hometown WindPower projects.

On November 30, 2010, the Agency issued two electric revenue bonds: Electric Revenue Bonds Series 2010A in the amount of $86.595 million and Electric Revenue Bonds Series 2010B in the amount of $27.03 million. The bonds were issued for the purposes of constructing a wind project, developing several other generating projects, and retiring the outstanding balance of the Agency's Term Loan.

On November 30, 2010, the Agency retired the Term Loan entered into on May 20, 2009.

The Agency continued to hold an A3 rating from Moody's in 2011.

MINNESOTA MUNICIPAL POWER AGENCY

Balance Sheets

December 31, 2011 and 2010

	2011			2010		
Assets	**Primary government**	**Component unit**	**Total (Memorandum only)**	**Primary government**	**Component unit**	**Total (Memorandum only)**
Current assets:						
Cash and cash equivalents	$ 21,948,955	980	21,949,935	15,154,407	182,538	15,336,945
Restricted cash and cash equivalents	5,345,034	—	5,345,034	3,933,537	—	3,933,537
Grant receivable	—	65,887	65,887	—	64,169	64,169
Accrued interest receivable	211,991	—	211,991	201,163	—	201,163
Power sales receivables	7,912,709	—	7,912,709	7,564,613	—	7,564,613
Fuel inventory	378,978	—	378,978	390,395	—	390,395
Plant inventory – spares	952,225	—	952,225	775,858	—	775,858
Prepaid expenses	628,290		628,290	991,202	—	991,202
Deferred outflows of resources	475,300	—	475,300	56,410	—	56,410
Total current assets	37,853,482	66,867	37,920,349	29,067,585	246,707	29,314,292
Noncurrent assets:						
Capital assets:						
Equipment	649,670	—	649,670	1,192,910	—	1,192,910
Land	822,655	—	822,655	785,585	—	785,585
Electric plant	285,307,557	—	285,307,557	194,519,060	—	194,519,060
Rotable combustion turbine parts	6,063,531	—	6,063,531	6,063,531	—	6,063,531
Less accumulated depreciation	(33,146,590)	—	(33,146,590)	(26,282,389)	—	(26,282,389)
Property and equipment, net	259,696,823	—	259,696,823	176,278,697	—	176,278,697
Construction in progress	7,699,559	—	7,699,559	55,265,930	—	55,265,930
Total capital assets, net	267,396,382	—	267,396,382	231,544,627	—	231,544,627
Restricted cash and cash equivalents	17,253,810	—	17,253,810	62,926,023	—	62,926,023
Restricted investments	20,518,277	—	20,518,277	13,268,345	—	13,268,345
Investment in component unit	1,000	—	1,000	1,000	—	1,000
Prepaid expenses	653,359	—	653,359	684,064	—	684,064
Deferred costs:						
Future recoverable costs	14,994,581	—	14,994,581	11,829,658	—	11,829,658
Unamortized debt issuance costs	1,210,981	—	1,210,981	1,300,838	—	1,300,838
Total deferred costs	16,205,562	—	16,205,562	13,130,496	—	13,130,496
Deferred outflows of resources	—	—	—	215,110	—	215,110
Total noncurrent assets	322,028,390	—	322,028,390	321,769,665	—	321,769,665
Total assets	$ 359,881,872	66,867	359,948,739	350,837,250	246,707	351,083,957
Net Assets and Liabilities						
Liabilities:						
Current liabilities:						
Accounts payable and accrued liabilities	$ 14,760,033	65,887	14,825,920	14,529,235	245,723	14,774,958
Retainage payable	1,775,477	—	1,775,477	—	—	—
Accrued interest payable	3,560,496	—	3,560,496	2,702,655	—	2,702,655
Long-term debt due within one year	6,118,333	—	6,118,333	4,213,333	—	4,213,333
Derivative instruments – futures	475,300	—	475,300	56,410	—	56,410
Total current liabilities	26,689,639	65,887	26,755,526	21,501,633	245,723	21,747,356
Long-term debt, net	291,743,748	—	291,743,748	298,167,403	—	298,167,403
Deferred revenue – rate stabilization	11,500,000	—	11,500,000	5,000,000	—	5,000,000
Derivative instruments – futures	—	—	—	215,110	—	215,110
Total noncurrent liabilities	303,243,748	—	303,243,748	303,382,513	—	303,382,513
Total liabilities	329,933,387	65,887	329,999,274	324,884,146	245,723	325,129,869
Net assets:						
Invested in capital assets, net of related debt	6,618,366	—	6,618,366	6,031,347	—	6,031,347
Restricted for debt service	6,695,254	—	6,695,254	3,922,647	—	3,922,647
Unrestricted	16,634,865	980	16,635,845	15,999,110	984	16,000,094
Total net assets	29,948,485	980	29,949,465	25,953,104	984	25,954,088
Total liabilities and net assets	$ 359,881,872	66,867	359,948,739	350,837,250	246,707	351,083,957

See accompanying notes to financial statements.

MINNESOTA MUNICIPAL POWER AGENCY

Statements of Revenues, Expenses, and Changes in Net Assets

Years ended December 31, 2011 and 2010

	2011			2010		
	Primary government	**Component unit**	**Total (Memorandum only)**	**Primary government**	**Component unit**	**Total (Memorandum only)**
Operating revenues:						
Power sales	$ 97,094,061	—	97,094,061	87,632,693	—	87,632,693
Total operating revenues	97,094,061	—	97,094,061	87,632,693	—	87,632,693
Operating expenses:						
Production fuel	10,181,080	—	10,181,080	13,525,757	—	13,525,757
Power purchases	46,525,166	—	46,525,166	37,307,996	—	37,307,996
Transmission	8,563,612	—	8,563,612	5,622,621	—	5,622,621
Other operating expenses	13,864,474	580,143	14,444,617	14,540,838	245,739	14,786,577
Depreciation	7,407,441	—	7,407,441	6,798,311	—	6,798,311
Total operating expenses	86,541,773	580,143	87,121,916	77,795,523	245,739	78,041,262
Operating income (loss)	10,552,288	(580,143)	9,972,145	9,837,170	(245,739)	9,591,431
Nonoperating revenues (expenses):						
Amortization of premium and issuance costs on long-term debt, net	197,640	—	197,640	87,977	—	87,977
Interest expense	(10,660,618)	—	(10,660,618)	(9,444,940)	—	(9,444,940)
Investment income	889,737	1	889,738	636,998	—	636,998
Loss on disposition of property	(148,590)	—	(148,590)	—	—	—
Equity contributions from primary government	—	—	—	—	1,000	1,000
Grant revenue	—	580,138	580,138	—	245,723	245,723
Total nonoperating revenues (expenses), net	(9,721,831)	580,139	(9,141,692)	(8,719,965)	246,723	(8,473,242)
Change in net assets before future recoverable costs	830,457	(4)	830,453	1,117,205	984	1,118,189
Future recoverable costs	3,164,924	—	3,164,924	3,065,484	—	3,065,484
Change in net assets	3,995,381	(4)	3,995,377	4,182,689	984	4,183,673
Total net assets, beginning of year	25,953,104	984	25,954,088	21,770,415	—	21,770,415
Total net assets, end of year	$ 29,948,485	980	29,949,465	25,953,104	984	25,954,088

See accompanying notes to financial statements.

MINNESOTA MUNICIPAL POWER AGENCY

Statements of Cash Flows

Years ended December 31, 2011 and 2010

	2011			2010		
	Primary government	**Component unit**	**Total (Memorandum only)**	**Primary government**	**Component unit**	**Total (Memorandum only)**
Cash flows from operating activities:						
Receipts from power sales	$ 103,245,965	—	103,245,965	89,683,370	—	89,683,370
Payments for fuel	(10,169,663)	—	(10,169,663)	(13,525,809)	—	(13,525,809)
Payments for power production and operating expenses	(68,505,204)	(759,979)	(69,265,183)	(53,691,311)	(16)	(53,691,327)
Net cash provided by (used in) operating activities	24,571,098	(759,979)	23,811,119	22,466,250	(16)	22,466,234
Cash flows from noncapital financing activities:						
Grant revenue received	—	578,420	578,420	—	181,554	181,554
Net cash provided by noncapital financing activities	—	578,420	578,420	—	181,554	181,554
Cash flows from capital and related financing activities:						
Construction of capital assets	(37,914,876)	—	(37,914,876)	(53,094,383)	—	(53,094,383)
Proceeds from issuance of long-term debt	—	—	—	113,957,815	—	113,957,815
Principal payments on electric revenue bonds	(4,213,333)	—	(4,213,333)	(12,772,918)	—	(12,772,918)
Payment of interest	(13,520,210)	—	(13,520,210)	(9,027,278)	—	(9,027,278)
Payment of debt issuance costs	(17,824)	—	(17,824)	(741,252)	—	(741,252)
Net cash provided by (used in) capital and related financing activities	(55,666,243)	—	(55,666,243)	38,321,984	—	38,321,984
Cash flows from investing activities:						
Proceeds from sales of investments	15,031,305	—	15,031,305	13,838,933	—	13,838,933
Purchase of investments	(22,281,237)	—	(22,281,237)	(13,331,661)	—	(13,331,661)
Payment (to) from discretely presented component unit	—	—	—	(1,000)	1,000	—
Interest received	878,909	1	878,910	684,011	—	684,011
Net cash (used in) provided by investing activities	(6,371,023)	1	(6,371,022)	1,190,283	1,000	1,191,283
Net change in cash and cash equivalents	(37,466,168)	(181,558)	(37,647,726)	61,978,517	182,538	62,161,055
Cash and cash equivalents, beginning of year	82,013,967	182,538	82,196,505	20,035,450	—	20,035,450
Cash and cash equivalents, end of year	$ 44,547,799	980	44,548,779	82,013,967	182,538	82,196,505
Cash components:						
Cash and cash equivalents	$ 21,948,955	980	21,949,935	15,154,407	182,538	15,336,945
Restricted cash and cash equivalents	22,598,844	—	22,598,844	66,859,560	—	66,859,560
Cash and cash equivalents, end of year	$ 44,547,799	980	44,548,779	82,013,967	182,538	82,196,505
Cash flows from operating activities:						
Operating income (loss)	$ 10,552,288	(580,143)	9,972,145	9,837,170	(245,739)	9,591,431
Adjustments to reconcile operating income (loss) to net cash provided by operating activities:						
Depreciation	7,407,441	—	7,407,441	6,798,311	—	6,798,311
Changes in current assets and liabilities:						
Power sales receivables	(348,096)	—	(348,096)	(949,323)	—	(949,323)
Fuel inventory	11,417	—	11,417	(52)	—	(52)
Plant inventory – spares	(176,367)	—	(176,367)	(141,318)	—	(141,318)
Prepaids	393,617	—	393,617	176,760	—	176,760
Accounts payable and accrued liabilities	230,798	(179,836)	50,962	3,744,702	245,723	3,990,425
Deferred revenue – rate stabilization	6,500,000	—	6,500,000	3,000,000	—	3,000,000
Total adjustments	14,018,810	(179,836)	13,838,974	12,629,080	245,723	12,874,803
Net cash provided by (used in) operating activities	$ 24,571,098	(759,979)	23,811,119	22,466,250	(16)	22,466,234
Supplemental cash flow information and noncash capital and related financing activities:						
Amortization of premium on electric revenue bonds	$ 305,322	—	305,322	123,074	—	123,074
Capital assets in retainage payable	1,775,477	—	1,775,477	—	—	—
Capitalized interest	3,717,433	—	3,717,433	401,585	—	401,585

See accompanying notes to financial statements.

(1) Organization and Significant Accounting Policies

(a) Organization and Operation

Minnesota Municipal Power Agency (the Agency) was created as a municipal corporation and a political subdivision of the State of Minnesota by an agency agreement recorded with the Secretary of the State of Minnesota on May 11, 1992. The Agency's purpose is to secure an adequate, economical, and reliable supply of electric energy for its member municipalities. As of December 31, 2011, the Agency comprises eleven Minnesota municipalities.

The accompanying financial statements present the Agency and its component units, entities for which the Agency is considered to be financially accountable. Blended component units, although legally separate entities, are, in substance, part of the Agency's operations. The discretely presented component unit is reported in a separate column to emphasize that it is legally separate from the Agency and its operations provide services to a different type of customer.

Blended Component Unit: Minnesota Renewable Energy, LLC (formerly known as Oak Glen Holding, LLC) owns 100% of Oak Glen Wind Farm, LLC. Oak Glen Wind Farm, LLC is responsible for the operation of Oak Glen Wind Farm, a 44 megawatt (MW) wind project located in Steele County, Minnesota. The Agency owns 100% of Minnesota Renewable Energy, LLC.

Discretely Presented Component Unit: Hometown GeoPower provides services to residents of the Agency's member municipalities. The Agency owns 100% of Hometown GeoPower, LLC.

Complete financial statements for each of the individual component units may be obtained from the Agency.

The Agency sells power to its members under power sales contracts that extend to October 31, 2040. Under the terms of these contracts, the Agency is obligated to furnish, and each member is obligated to take and pay for, the total power and energy required by each member.

The Agency has entered into agreements with various providers to purchase accredited power and energy during 2011. The power capacity charge for 2011 is approximately $6.0 million. Capacity commitments and charges include 41 MW of capacity purchased pursuant to an agreement with the City of Chaska, a member of the Agency. Under the terms of that agreement and its amendment, the Agency has agreed to make certain payments to the City of Chaska in exchange for the peaking power capacity provided by specified generation facilities owned by the City of Chaska in an amount at least sufficient, together with certain available interest income, to pay the principal of and interest on the bonded indebtedness issued by the City of Chaska for the construction of the generation facility. Energy rates assessed by the Agency vary based on contract terms and production costs. Minimum commitments under the terms of the power sales agreements to purchase power capacity for the next five years are as follows:

	Megawatts
Year ending December 31:	
2012	96
2013	96
2014	86
2015	76
2016	76

The Agency has an agreement with Xcel Energy Corporation (Xcel Energy) to provide transmission services through December 31, 2015. The Agency is obligated to pay for these services at rates established by the Federal Energy Regulatory Commission (FERC), $29.933 per kilowatt per year at December 31, 2011, plus ancillary charges.

The Agency has a long-term contract with the Manitoba Hydro-Electric Board (Manitoba Hydro) that provides for 30 MW of capacity and on-peak energy from May 1, 2009 through April 30, 2012. The Agency also has an agreement with Rochester Public Utilities (RPU) to purchase 25 MW of capacity and energy from November 1, 2010 through October 31, 2015.

The Agency enters into contracts in connection with the generation and sale of electric power to its member cities, the Midwest Independent System Operator or MISO and the wholesale market. A substantial portion of these contracts are for the purchase of natural gas at power plants owned and operated by the Agency and for the physical delivery of power to designated interconnection points on the electric grid as a normal course of business. The Agency also enters into futures or forward contracts to manage exposure to unfavorable trends in the prices of fuel (natural gas) and electric power, which are directly related to the business of the Agency. Open positions at the end of the year are carried at fair value in the Agency’s financial statements with an offsetting deferral amount to reflect the effectiveness of the hedge.

Additionally, the Agency has agreements for dispatching, billing, maintenance services, and other general administration.

(b) Basis of Accounting

The Agency follows the FERC's Uniform System of Accounts and maintains accounting records on an accrual basis in conformity with U.S. generally accepted accounting principles, including the application of the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 980, *Regulated Operations*, as the guidance relates to the deferral of revenues and expenses to future periods in which the revenues are earned or the expenses are recovered through the rate-making process.

The Agency complies with all applicable pronouncements of the Governmental Accounting Standards Board (GASB). In accordance with GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, the Agency has elected not to follow the guidance of Financial Accounting Standards Board (FASB) Statements issued after November 30, 1989.

(c) Capital Assets

Capital assets are recorded at cost, including capitalized interest on borrowed funds during construction. The capitalized interest is recorded as part of the asset to which it relates and is amortized over the asset's estimated useful life. The Agency capitalized interest cost of $3,717,433 and $401,585 for the years ended December 31, 2011 and 2010, respectively.

The Agency follows a preventative and predictive approach to its maintenance of the Faribault Energy Park (FEP) facility. In doing so, it inspects the combustion turbine and performs major maintenance at intervals suggested by the turbine manufacturer. Periodically, one set of combustion parts is removed from the turbine and a replacement set is rotated into the turbine. The parts that have been removed are refurbished and are then ready to be rotated back into the turbine at the next major maintenance cycle. The Agency is depreciating the cost of the combustion turbine spare parts over 30 years. The amount on the balance sheet is the gross acquisition cost, with depreciation associated with the parts included in accumulated depreciation.

Equipment is recorded at cost and consists of telecommunication equipment, transportation equipment, and certain maintenance/testing equipment. Depreciation is provided over the estimated useful lives of the property and equipment by use of the straight-line method. Generally, the estimated useful life for the electric plant is 30 years and 5 years for telecommunications equipment and transportation equipment. Other specialized equipment may differ.

(d) Restricted Cash and Cash Equivalents

The Agency's bond resolution requires the segregation of bond proceeds and prescribes the application of the Agency's revenues. Amounts classified as restricted cash and cash equivalents on the balance sheets represent cash and cash equivalents whose use is restricted by the bond resolution. Investments in U.S. agency obligations that are purchased within one year of maturity are reported at cost, which approximates amortized cost. It is the Agency's policy to use restricted resources first for debt service, and then unrestricted resources as they are needed.

(e) Investments and Short-Term Investments

Investments comprised of federal, state and local bonds which are reported at cost, which approximates fair value, and certificates of deposit having an initial maturity of greater than one year when purchased. Short-term investments comprise certificates of deposit having an initial maturity of less than one year when purchased.

(f) Deferred Costs to Be Recovered in Future Periods

Rates charged to members include amounts sufficient to pay levelized principal and interest payments on long-term debt. For financial reporting purposes, the Agency recognizes depreciation and amortization pertaining to fixed assets and other assets financed by long-term debt in addition to interest paid on such debt. As permitted by the application of the provisions of ASC Topic 980, the Agency defers the current depreciation, amortization, and interest costs in excess of levelized principal and interest costs on long-term debt. These costs will be recovered through rates charged to members in future periods when the levelized costs of principal and interest on long-term debt exceed the then current depreciation and interest costs related to such issues.

(g) Unamortized Debt Issuance Costs and Unamortized Debt Premium/Discount

Debt issuance costs and debt premium/discount are amortized over the repayment period of the related issues using the straight-line method, which approximates the effective-interest method.

(h) Cash Flows

For purposes of the statements of cash flows, cash equivalents are cash and equivalents and investments having an initial maturity of three months or less when purchased.

(i) Power Sales Receivables

Power sales receivables represent power sales for the period between the last billing date and the end of the period that are accrued in the period earned.

(j) Fuel Inventory and Plant Inventory – Spares

Fuel inventory and plant inventory – spares are valued on a cost basis, using the first-in, first-out (FIFO) method, which does not exceed market.

(k) Rates

Rates and charges for providing wholesale power supply are reviewed and adopted by the Agency’s board of directors. Power supply services provided by the Agency are not subject to state or federal regulation.

(l) Revenue Recognition

The Agency recognizes revenue on sales when the electricity is provided to and used by the customers. The Agency reports only the net amount of operating revenues – power sales and power purchases expense resulting from its transactions with counterparties other than Agency members as revenue.

(m) Operating Revenues and Expenses

Operating revenues result from exchange transactions associated with the principal activity of the Agency, the sale of electricity. Reported operating revenues are affected by contributions to or distributions from the rate stabilization account. Operating expenses are defined as expenses directly related to, or incurred in support of, the production and transmission of electricity to the participating members. All other expenses are classified as nonoperating expenses.

(n) Income Taxes

The Agency is exempt from federal and state income taxes as it is a political subdivision of the State of Minnesota.

(o) Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with U.S. 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 reporting period. Actual results could differ from those estimates.

(2) Cash, Cash Equivalents, and Investments

The agency agreement that established the Agency and the bond resolution, under which the Electric Revenue Bonds were issued, provides for the creation and maintenance of certain funds and accounts. The funds and accounts consist principally of deposits and investments in accordance with the agency agreement, bond resolution, and applicable state law. Funds and accounts are reported in the financial statements as follows:

	December 31	
	2011	**2010**
Current assets:		
Cash and cash equivalents	$ 21,948,955	15,154,407
Restricted cash and cash equivalents	5,345,034	3,933,537
Total current assets	27,293,989	19,087,944
Noncurrent assets:		
Restricted cash and cash equivalents	17,253,810	62,926,023
Restricted investments	20,518,277	13,268,345
Total noncurrent assets	37,772,087	76,194,368
Total	$ 65,066,076	95,282,312

At December 31, 2011, all deposits for the Agency were insured or collateralized by securities held by the Agency’s agent in the Agency’s name.

In accordance with its investment policy, the Agency invests in the following types of investments, subject to the limitations and requirements of Minnesota statutes:

- Interest bearing checking accounts
- U.S. treasury bills, bonds, and notes
- U.S. government agencies and instrumentalities securities
- State and local securities
- Minnesota Joint Powers Investment Trusts
- Certificates of deposit
- Money market mutual funds – open-end, no-load
- Guaranteed investment contracts
- Repurchase agreements fully (100%) collateralized by U.S. securities

(a) Interest Rate Risk

Interest rate risk is the risk that the fair value of investments will be adversely affected by a change in interest rates.

The Agency had the following investments and maturities as of December 31, 2011 and 2010:

		December 31, 2011			December 31, 2010		
		Investment maturities (in years)			Investment maturities (in years)		
		Less than one year	Greater than one year	No maturity	Less than one year	Greater than one year	No maturity
Investment type:							
U.S. government agencies	$	7,523,033	6,242,431	—	7,512,243	—	—
U.S. treasuries		—	1,207,217	—	—	—	
Certificates of deposit		—	970,000	—	193,022	970,000	—
State and local bonds		—	4,575,596	—	—	4,593,080	—
Money market accounts		—	—	22,598,844	—	—	66,859,560
Cash and cash equivalents		—	—	21,948,955	—	—	15,154,407
Total	$	7,523,033	12,995,244	44,547,799	7,705,265	5,563,080	82,013,967

(b) Credit Risk

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. Credit risk is measured using credit quality ratings of investments in debt securities as described by nationally recognized rating agencies such as Standard & Poor's and Moody's. The certificates of deposit are FDIC insured. The money market accounts and cash and cash equivalents are invested in short-term U.S. government securities and commercial paper.

The following tables list the credit quality ratings per Standard & Poor's and/or Moody's of the Agency's investments as of December 31, 2011 and 2010:

		December 31, 2011			
			Quality ratings		
		Fair value	AA	AAA	Unrated
Investment type:					
U.S. government agencies	$	13,765,464	13,765,464	—	—
U.S. treasuries		1,207,217	1,207,217	—	—
Certificates of deposit		970,000	—	—	970,000
State and local bonds		4,575,596	4,575,596	—	—
Money market accounts		22,598,844	—	22,598,844	—
Cash and cash equivalents		21,948,955	—	—	21,948,955
Total	$	65,066,076	19,548,277	22,598,844	22,918,955

		December 31, 2010			
			Quality ratings		
		Fair value	AA	AAA	Unrated
Investment type:					
U.S. government agencies	$	7,512,243	—	7,512,243	—
Certificates of deposit		1,163,022	—	—	1,163,022
State and local bonds		4,593,080	914,968	3,678,112	—
Money market accounts		66,859,560	—	—	66,859,560
Cash and cash equivalents		15,154,407	—	—	15,154,407
Total	$	95,282,312	914,968	11,190,355	83,176,989

(c) Custodial Credit Risk

Custodial credit risk is the risk that, in the event of the failure of a counterparty, the Agency will not be able to recover the value of the investments, collateral securities, or deposits that are in the possession of the counterparty. The Agency adopted and revised investment policy addresses, among other things, custodial credit risk. At December 31, 2011 and 2010, all of the Agency's investments are insured and registered and are held by the counterparty's trust department or agent in the Agency's name.

(d) Concentration of Credit Risk

The Agency does not have an investment policy related to investing 5% or more of the Agency's portfolio in the securities of a single issue.

(3) Capital Assets

Capital assets activity was as follows:

	2011			
	Beginning balance	**Additions**	**Retirements/ Transfers**	**Ending balance**
Nondepreciable capital assets:				
Construction work in progress	$ 55,265,930	42,494,746	(90,061,117)	7,699,559
Land	785,585	37,070	—	822,655
Depreciable capital assets:				
Telemetering and telecommunication	1,192,910	—	(543,240)	649,670
Electric plant	194,519,060	727,380	90,061,117	285,307,557
Rotable combustion turbine parts	6,063,531	—	—	6,063,531
Less accumulated depreciation for assets in service	(26,282,389)	(7,407,441)	543,240	(33,146,590)
Capital assets, net	$ 231,544,627	35,851,755	—	267,396,382

	2010			
	Beginning balance	**Additions**	**Retirements/ Transfers**	**Ending balance**
Nondepreciable capital assets:				
Construction work in progress	$ 9,009,183	52,215,667	(5,958,920)	55,265,930
Land	785,585	—	—	785,585
Depreciable capital assets:				
Telemetering and telecommunication	1,197,577	—	(4,667)	1,192,910
Electric plant	187,608,054	545,901	6,365,105	194,519,060
Rotable combustion turbine parts	6,465,049	—	(401,518)	6,063,531
Less accumulated depreciation for assets in service	(19,484,078)	(6,798,311)	—	(26,282,389)
Capital assets, net	$ 185,581,370	45,963,257	—	231,544,627

(4) Long-Term Debt

The Agency has issued the following Electric Revenue Bonds and Taxable Electric Revenue Bonds to finance its construction activities:

		2011	2010
Series 2004A, 3.40% – 5.25%, due October 1, 2010 to 2034	$	48,295,000	49,160,000
Series 2005, 3.50% – 5.00%, due October 1, 2007 to 2035		104,580,000	106,870,000
Series 2007, 4.00% – 5.00%, due October 1, 2007 to 2037		24,945,000	25,435,000
Series 2009A, 1.40%, due October 1, 2009 to 2023		4,000,000	4,333,333
Series 2010A, 3.00% – 5.25%, due October 1, 2011 to 2035		86,360,000	86,595,000
Series 2010B, 4.00%, due October 1, 2013		27,030,000	27,030,000
Total bonds outstanding		295,210,000	299,423,333
Less current maturities		(6,118,333)	(4,213,333)
Add unamortized premium		2,652,081	2,957,403
	$	291,743,748	298,167,403

Electric Revenue Bonds are the major source of financing for the Agency's construction activities. These bonds are secured by a pledge of the net revenues derived from the operation of the system.

During 2010, the Agency issued $86,595,000 of Series 2010A Electric Revenue Bonds and $27,030,000 of Series 2010B Electric Revenue Bonds to finance the construction of Oak Glen Wind Farm, the development of Shell Rock Wind Farm and Hometown BioEnergy, and retire the outstanding balance of the 2009 term loan.

Debt service requirements on the outstanding bonds are as follows:

Year		Principal	Interest	Total
2012	$	6,118,333	14,241,983	20,360,316
2013		33,363,333	14,015,541	47,378,874
2014		6,613,333	12,650,204	19,263,537
2015		6,918,334	12,355,088	19,273,422
2016		7,238,333	12,026,346	19,264,679
2017 – 2021		41,661,667	54,600,067	96,261,734
2022 – 2026		51,716,667	43,432,325	95,148,992
2027 – 2031		67,610,000	29,514,731	97,124,731
2032 – 2036		72,325,000	9,576,600	81,901,600
2037		1,645,000	82,250	1,727,250
	$	295,210,000	202,495,135	497,705,135

Long-term liability activity for the years ended December 31, 2011 and 2010 was as follows:

Long-term liabilities as of December 31, 2011		Beginning balance	Additions	Reductions	Ending balance
Long-term bonds	$	299,423,333	—	(4,213,333)	295,210,000
Less current maturities		(4,213,333)	(6,118,333)	4,213,333	(6,118,333)
Add unamortized premium, net		2,957,403	—	(305,322)	2,652,081
Long-term bonds, net	$	298,167,403	(6,118,333)	(305,322)	291,743,748

Long-term liabilities as of December 31, 2010		Beginning balance	Additions	Reductions	Ending balance
Long-term bonds	$	189,636,667	113,625,000	(3,838,334)	299,423,333
Term loans		8,934,584	—	(8,934,584)	—
Less current maturities		(5,731,905)	(4,213,333)	5,731,905	(4,213,333)
Add unamortized premium, net		2,747,662	332,815	(123,074)	2,957,403
Long-term bonds, net	$	195,587,008	109,744,482	(7,164,087)	298,167,403

(5) Letters of Credit and Credit Facilities

At December 31, 2011, the Agency had an unused standby letter of credit of $850,000 to support energy and capacity purchases from Manitoba Hydro. The agreement provides for interest at the bank's reference rate plus 1%.

The Agency entered into a $5 million credit facility October 1, 2008. This facility was renewed in September 2011. The commitment fee is 0.45% per annum; interest on outstanding balances is tied to the prime rate. The facility can be renewed through July 1, 2013. There were no amounts outstanding as of December 31, 2011 or 2010.

(6) Risk Management

The Agency is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; and natural disasters. The Agency participates in a public entity risk pool to mitigate its exposure to these risks. Liability coverage is provided through a pooled self-insurance plan.

The Agency has a $60,000 deductible per occurrence, with a $200,000 annual maximum for its liability coverage. The Agency carries commercial insurance for its property risk of loss. Settled claims have not exceeded insurance coverage in any of the past three years.

The public entity risk pool has purchased a reinsurance policy to guard against excessive losses.

(7) Contingencies

The Agency is a party to various contracts for the sale, purchase, and transmission of power. In the ordinary course of business, contractual disputes sometimes occur between the Agency and its counterparties. The Agency does not expect the outcome of any existing dispute resolution proceedings to have a material adverse impact on financial position, results of operations, or cash flows.

The Agency is a market participant in the MISO "Day 2" electricity markets. MISO does not provide final settlement results for a trading day until 105 days after a trading day. The financial statements reflect the Agency's best estimates of final settlement results since the commencement of "Day 2" electricity markets on April 1, 2005.

(8) Subsequent Event

During 2012, Oak Glen Wind Farm, LLC received $25,471,916 from the United States Department of the Treasury for Specified Energy Property in Lieu of Tax Credits in accordance with Section 1603 of the American Recovery and Reinvestment Tax Act of 2009. Oak Glen Wind Farm, LLC utilized the federal funding to help finance the construction of the Oak Glen Wind Farm.