MINNESOTA MUNICIPAL POWER AGENCY

Financial Statements

December 31, 2012 and 2011

(With Independent Auditors' Report Thereon)

MINNESOTA MUNICIPAL POWER AGENCY

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KPMG LLP
4200 Wells Fargo Center
90 South Seventh Street
Minneapolis, MN 55402

Independent Auditors' Report

The Board of Directors
Minnesota Municipal Power Agency:

We have audited the accompanying financial statements of Minnesota Municipal Power Agency (the Agency), which comprise the statements of net position as of December 31, 2012 and 2011, and the related statements of revenues, expenses, and changes in net position and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with U.S. generally accepted accounting principles; 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.

Auditors' Responsibility

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 from 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 auditors' 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 policies 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 Minnesota Municipal Power Agency as of December 31, 2012 and 2011, and the results of its operations and its cash flows for the years then ended, in accordance with U.S. generally accepted accounting principles.

Other Matter

U.S. generally accepted accounting principles require that the management's discussion and analysis on pages 3 through 8 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 managements' 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

Minneapolis, Minnesota
April 22, 2013

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, 2012 and 2011. 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 statements of net position, the statements of revenues, expenses, and changes in net position, the statements of cash flows, and notes to the financial statements.

The statements of net position 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 position 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 2012 with 2011

The following table summarizes the financial position of the Agency as of December 31:

Condensed Statements of Net Position

	2012	2011	Dollar change	Percentage change
Capital assets, net	$ 257,842,596	267,396,382	(9,553,786)	(3.6)%
Current assets	50,350,412	37,445,049	12,905,363	34.5
Other noncurrent assets	57,978,614	54,631,008	3,347,606	6.1
Total assets	366,171,622	359,472,439	6,699,183	1.9
Deferred outflows of resources	98,140	475,300	(377,160)	(79.4)
Total assets and deferred outflows	$ 366,269,762	359,947,739	6,322,023	1.8
Current liabilities	$ 29,397,914	26,755,526	2,642,388	9.9
Long-term liabilities	280,223,528	291,743,748	(11,520,220)	(3.9)
Total liabilities	309,621,442	318,499,274	(8,877,832)	(2.8)
Deferred inflows of resources	21,500,000	11,500,000	10,000,000	87.0
Total liabilities and deferred inflows	331,121,442	329,999,274	1,122,168	0.3

(Continued)

Condensed Statements of Net Position

	2012	2011	Dollar change	Percentage change
Net position:				
Net investment in capital assets	$ 25,914,191	6,618,366	19,295,825	291.5
Restricted	5,143,346	6,695,254	(1,551,908)	(23.2)
Unrestricted	4,090,783	16,634,845	(12,544,062)	(75.4)
Total net position	35,148,320	29,948,465	5,199,855	17.4
Total liabilities, deferred inflows, and net position	$ 366,269,762	359,947,739	6,322,023	1.8

Condensed statements of net position highlights are as follows:

- The assets of the Agency exceeded its liabilities at the close of 2012 by approximately $35.1 million (net position) as compared with $29.9 million at the end of 2011. Net position provides necessary liquidity to the Agency and supports its investment-grade credit rating.
- Current assets increased by $12.9 million from 2011 to 2012, 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 $0.4 million from 2011 to 2012.
- Other noncurrent assets, which include restricted cash and cash equivalents, prepaid expenses, and deferred costs, increased by approximately $3.3 million from 2011 to 2012, primarily the result of a $9.4 million increase in future recoverable costs related to the levelization of depreciation and bond interest and costs associated with the Agency's capital lease. This was partially offset by a $5.5 million decrease in restricted cash and cash equivalents related to final expenditures related to the Oak Glen Wind Farm project. Restricted cash and cash equivalents are used for construction needs of the Agency.
- Capital assets, net decreased by approximately $9.6 million during 2012 primarily due to the decrease in electric plant in service associated with a grant received by Oak Glen Wind Farm, LLC that reduced the cost basis of the Oak Glen Wind Farm project and by depreciation on capital assets in place. This was partially offset by the Agency applying capital lease accounting to a portion of its contract with the City of Chaska related to the Minnesota River Station, resulting in a capital lease asset.
- Current liabilities increased by approximately $2.6 million from 2011 to 2012 primarily due to the increase of accounts payable, accrued interest payable, and bonds due within one year. This was partially offset by a decrease in retainage payable.
- Long-term liabilities decreased by approximately $11.5 million from 2011 to 2012, primarily the result of the redemption of the Agency's Series 2010B bonds. This was partially offset by the Agency applying capital lease accounting to a portion of its contract with the City of Chaska related to the Minnesota River Station, resulting in a capital lease liability. Long-term liabilities consist of the bonds issued for construction of the Agency's generating facilities and the Agency's capital lease liability.

- Deferred inflows increased by $10.0 million, the result of the Agency making contributions to its rate stabilization account in 2012. Deferred inflows represent the Agency's rate stabilization account.

Comparison of 2011 with 2010

The following table summarizes the financial position of the Agency as of December 31:

Condensed Statements of Net Position

	2011	2010	Dollar change	Percentage change
Capital assets, net	$ 267,396,382	231,544,627	35,851,755	15.5%
Current assets	37,445,049	29,257,882	8,187,167	28.0
Other noncurrent assets	54,631,008	90,008,928	(35,377,920)	(39.3)
Total assets	359,472,439	350,811,437	8,661,002	2.5
Deferred outflows of resources	475,300	271,520	203,780	75.1
Total assets and deferred outflows	$ 359,947,739	351,082,957	8,864,782	2.5
Current liabilities	$ 26,755,526	21,747,356	5,008,170	23.0
Long-term liabilities	291,743,748	298,382,513	(6,638,765)	(2.2)
Total liabilities	318,499,274	320,129,869	(1,630,595)	(0.5)
Deferred inflows of resources	11,500,000	5,000,000	6,500,000	130.0
Total liabilities and deferred inflows	329,999,274	325,129,869	4,869,405	1.5
Net position:				
Net investment in capital assets	6,618,366	6,031,347	587,019	9.7
Restricted	6,695,254	3,922,647	2,772,607	70.7
Unrestricted	16,634,845	15,999,094	635,751	4.0
Total net position	29,948,465	25,953,088	3,995,377	15.4
Total liabilities, deferred inflows, and net position	$ 359,947,739	351,082,957	8,864,782	2.5

Condensed statements of net position highlights are as follows:

- The assets of the Agency exceeded its liabilities at the close of 2011 by approximately $29.9 million (net position) as compared with $26.0 million at the end of 2010. Net position provides necessary liquidity to the Agency and supports its investment-grade credit rating.
- Current assets increased by $8.2 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 future recoverable costs, decreased by approximately $35.4 million from 2010 to 2011, primarily the result of construction funds from the Series 2010 bond issue being spent and a $3.1 million increase in future recoverable costs related to the levelization of depreciation and bond interest. Restricted cash and cash equivalents are used for 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 $5.0 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 decreased by $6.6 million from 2010 to 2011, primarily due to principal payments on Agency debt. Long-term liabilities consist of the bonds issued for construction of the Agency's generating facilities.
- Deferred inflows increased by $6.5 million, the result of the Agency making contributions to its rate stabilization account in 2011. Deferred inflows represent the Agency's rate stabilization account.

The following table summarizes the changes in financial position of the Agency for the years ended December 31, 2012 and 2011:

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

	2012	2011	Dollar change	Percentage change
Operating revenues, power sales	$ 101,116,338	97,094,061	4,022,277	4.1%
Other nonoperating revenues	1,192,174	1,469,876	(277,702)	(18.9)
Total revenues	102,308,512	98,563,937	3,744,575	3.8
Operating expenses	86,794,323	87,121,916	(327,593)	(0.4)
Other nonoperating expenses	14,802,125	10,503,886	4,298,239	40.9
Total expenses	101,596,448	97,625,802	3,970,646	4.1
Future recoverable costs	4,487,791	3,057,242	1,430,549	46.8
Change in net position	5,199,855	3,995,377	1,204,478	30.1
Beginning net position	29,948,465	25,953,088	3,995,377	15.4
Ending net position	$ 35,148,320	29,948,465	5,199,855	17.4

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

- Operating revenues – power sales increased by approximately $4.0 million between 2012 and 2011 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 decreased by approximately $0.3 million between 2012 and 2011, primarily as a result of lower net purchased power costs because of the Agency's Oak Glen Wind Farm being in service for a full year.
- Other nonoperating revenues decreased by approximately $0.3 million between 2012 and 2011 as the result of lower grant revenue related to the Hometown GeoPower component unit.
- Other nonoperating expenses increased by approximately $4.3 million in 2012 primarily due to increased interest expense.
- Future recoverable costs increased by approximately $1.4 million in 2012 primarily due to the application of the Agency's policy regarding the levelization of costs for generating assets financed by debt to the Oak Glen Wind Farm project.

The following table summarizes the changes in financial position of the Agency for the years ended December 31, 2011 and 2010:

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

	2011	2010	Dollar change	Percentage change
Operating revenues, power sales	$ 97,094,061	87,632,693	9,461,368	10.8%
Other nonoperating revenues	1,469,876	882,721	587,155	66.5
Total revenues	98,563,937	88,515,414	10,048,523	11.4
Operating expenses	87,121,916	78,041,262	9,080,654	11.6
Other nonoperating expenses	10,503,886	9,321,865	1,182,021	12.7
Total expenses	97,625,802	87,363,127	10,262,675	11.7
Future recoverable costs	3,057,242	3,030,386	26,856	0.9
Change in net position	3,995,377	4,182,673	(187,296)	(4.5)
Beginning net position	25,953,088	21,770,415	4,182,673	19.2
Ending net position	$ 29,948,465	25,953,088	3,995,377	15.4

Condensed statements of revenues, expenses, and changes in net position 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 $9.1 million between 2011 and 2010, primarily as a result of higher purchased power costs.

- Other nonoperating revenues increased by approximately $0.6 million between 2011 and 2010 as the result of higher investment income and grant revenue related to the Hometown GeoPower component unit.
- Other nonoperating expenses increased by approximately $1.2 million in 2011 primarily due to increased interest expense.

Debt Administration

As of December 31, 2012, the Agency had long-term debt outstanding of approximately $262.1 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 redeemed the Series 2010B bonds in full on June 28, 2012.

The Agency continued to hold an A3 rating from Moody's in 2012.

MINNESOTA MUNICIPAL POWER AGENCY

Statements of Net Position

December 31, 2012 and 2011

Assets		**2012**	**2011**
Current assets:			
Cash and cash equivalents	$	33,442,632	21,949,935
Restricted cash and cash equivalents		5,039,754	5,345,034
Grant receivable		24,299	65,887
Accrued interest receivable		210,934	211,991
Power sales receivables		8,282,040	7,912,709
Other receivable		899,494	—
Fuel inventory		494,027	378,978
Plant inventory – spares		1,406,814	952,225
Prepaid expenses		550,418	628,290
Total current assets		50,350,412	37,445,049
Noncurrent assets:			
Capital assets:			
Equipment		661,394	649,670
Capital lease asset		29,080,531	—
Land		1,140,665	822,655
Electric plant		262,036,603	285,307,557
Rotable combustion turbine parts		6,063,531	6,063,531
Less accumulated depreciation		(53,885,376)	(33,146,590)
Property and equipment, net		245,097,348	259,696,823
Construction in progress		12,745,248	7,699,559
Total capital assets, net		257,842,596	267,396,382
Restricted cash and cash equivalents		11,761,080	17,253,810
Restricted investments		19,945,133	20,518,277
Prepaid expenses		622,653	653,359
Future recoverable costs		25,649,748	16,205,562
Total noncurrent assets		315,821,210	322,027,390
Total assets		366,171,622	359,472,439
Deferred outflows of resources		98,140	475,300
Total assets and deferred outflows of resources	$	366,269,762	359,947,739
Liabilities and Net Position			
Liabilities:			
Current liabilities:			
Accounts payable and accrued liabilities	$	19,005,496	14,825,920
Retainage payable		—	1,775,477
Accrued interest payable		3,233,586	3,560,496
Long-term debt due within one year		6,333,333	6,118,333
Capital lease liability due within one year		727,359	—
Derivative instruments – futures		98,140	475,300
Total current liabilities		29,397,914	26,755,526
Long-term debt, net		257,859,891	291,743,748
Capital lease liability		22,363,637	—
Total noncurrent liabilities		280,223,528	291,743,748
Total liabilities		309,621,442	318,499,274
Deferred inflows of resources – rate stabilization		21,500,000	11,500,000
Total liabilities and deferred inflows of resources		331,121,442	329,999,274
Net position:			
Net investment in capital assets		8,010,528	6,618,366
Restricted for debt service		5,143,346	6,695,254
Unrestricted		21,994,446	16,634,845
Total net position		35,148,320	29,948,465
Total liabilities and deferred inflows of resources and net position	$	366,269,762	359,947,739

See accompanying notes to financial statements.

MINNESOTA MUNICIPAL POWER AGENCY

Statements of Revenues, Expenses, and Changes in Net Position

Years ended December 31, 2012 and 2011

	2012	2011
Operating revenues:		
Power sales to members	$ 96,857,967	93,047,049
Power sales to nonmembers	4,258,371	4,047,012
Total operating revenues	101,116,338	97,094,061
Operating expenses:		
Power acquisition expense	49,324,302	56,706,246
Transmission	9,329,735	8,563,612
Other operating expenses	17,741,244	14,444,617
Depreciation	10,399,042	7,407,441
Total operating expenses	86,794,323	87,121,916
Operating income	14,322,015	9,972,145
Nonoperating revenues (expenses):		
Amortization of premium on long-term debt, net	197,631	305,322
Interest expense	(14,999,756)	(10,660,618)
Investment income	923,752	889,738
Loss on disposition of property	—	(148,590)
Gain on sale of investments	317	—
Gain on bond retirement	242,696	—
Grant revenue	25,409	580,138
Total nonoperating revenues (expenses), net	(13,609,951)	(9,034,010)
Change in net position before future recoverable costs	712,064	938,135
Future recoverable costs	4,487,791	3,057,242
Change in net position	5,199,855	3,995,377
Total net position, beginning of year	29,948,465	25,953,088
Total net position, end of year	$ 35,148,320	29,948,465

See accompanying notes to financial statements.

MINNESOTA MUNICIPAL POWER AGENCY

Statements of Cash Flows

Years ended December 31, 2012 and 2011

		2012	2011
Cash flows from operating activities:			
Receipts from power sales	$	109,847,513	103,245,965
Payments for power acquisition/production and operating expenses		(72,676,765)	(79,434,846)
Net cash provided by operating activities		37,170,748	23,811,119
Cash flows from noncapital financing activity:			
Grant revenue received		66,997	578,420
Net cash provided by noncapital financing activity		66,997	578,420
Cash flows from capital and related financing activities:			
Construction of capital assets		(9,351,466)	(37,914,876)
Payments received from grant for capital asset construction		25,471,916	—
Principal payments on electric revenue bonds		(33,148,333)	(4,213,333)
Principal payments on capital lease		(686,382)	—
Payment of interest		(15,326,666)	(13,520,210)
Payment of debt issuance costs		—	(17,824)
Net cash used in capital and related financing activities		(33,040,931)	(55,666,243)
Cash flows from investing activities:			
Proceeds from sales of investments		15,619,310	15,031,305
Purchase of investments		(15,046,166)	(22,281,237)
Interest received		924,729	878,910
Net cash provided by (used in) investing activities		1,497,873	(6,371,022)
Net change in cash and cash equivalents		5,694,687	(37,647,726)
Cash and cash equivalents, beginning of year		44,548,779	82,196,505
Cash and cash equivalents, end of year	$	50,243,466	44,548,779
Cash components:			
Cash and cash equivalents	$	33,442,632	21,949,935
Restricted cash and cash equivalents		16,800,834	22,598,844
Cash and cash equivalents, end of year	$	50,243,466	44,548,779
Cash flows from operating activities:			
Operating income	$	14,322,015	9,972,145
Adjustments to reconcile operating income to net cash provided by operating activities:			
Depreciation		10,399,042	7,407,441
Changes in current assets and liabilities:			
Power sales receivables		(369,331)	(348,096)
Other receivables		(899,494)	—
Fuel inventory		(115,049)	11,417
Plant inventory – spares		(454,589)	(176,367)
Prepaids		108,578	393,617
Accounts payable and accrued liabilities		4,179,576	50,962
Deferred revenue – rate stabilization		10,000,000	6,500,000
Total adjustments		22,848,733	13,838,974
Net cash provided by operating activities	$	37,170,748	23,811,119
Supplemental cash flow information and noncash capital and related financing activities:			
Amortization of premium on electric revenue bonds	$	197,631	305,322
Capital assets in retainage payable		—	1,775,477
Capitalized interest		—	3,717,433

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, 2012, the Agency comprises 11 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.

Blended Component Units: Minnesota Renewable Energy, LLC (formerly known as Oak Glen Holding, LLC) owns 100% of Oak Glen Wind Farm, LLC and 100% of Hometown BioEnergy, 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. Hometown BioEnergy, LLC is responsible for the construction of the Hometown BioEnergy project, an 8 MW renewable energy project to be located in Le Sueur, Minnesota. The Agency owns 100% of Minnesota Renewable Energy, LLC. Hometown GeoPower, LLC 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 2012. The power capacity charge for 2012 is approximately $2.7 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. During 2012, management determined that part of the Chaska agreement should have been historically treated as a capital lease. Accordingly, as of January 1, 2012, the net book value of assets was increased by $18,740,786, capital lease liability was increased by $23,777,378, and future regulatory costs were increased by $5,036,592. See note 4 for more information. 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:	
2013	96
2014	86
2015	76
2016	76
2017	41

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, 2012, plus ancillary charges.

The Agency had a long-term contract with the Manitoba Hydro-Electric Board (Manitoba Hydro) that provided 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 purchase, generation, and sale of electric power to or from its member cities, the Midwest Independent Transmission System Operator (MISO) and other wholesale market participants. 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. Substantially all of the Agency's power purchases and sales are with MISO. 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 Governmental Accounting Standards Board (GASB) Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, as the guidance relates to Regulated Operations. The guidance allows for 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.

(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 $0 and $3,717,433 for the years ended December 31, 2012 and 2011, 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 the remaining life of the FEP asset. The amount on the statements of net position 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 statements of net position 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 amortized 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 GASB 62, 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.

(Continued)

(g) Unamortized Debt Premium/Discount

Debt premium/discount is 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 MISO 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.

(p) Recently Adopted Accounting Principles

In November 2010, GASB Statement No. 61, *The Financial Reporting Entity: Omnibus – an amendment of GASB Statements No. 14 and No. 34*. (GASB 61), was issued which related to the financial reporting entity and component units. The Agency retrospectively adopted GASB 61 effective January 1, 2012, resulting in the Agency blending the Hometown GeoPower component unit that had previously been reported as a discrete component. There was no material effect on the financial statements as a result of adoption.

In December 2010, GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements* (GASB 62), was issued which codified all generally accepted accounting principles into one source. The Agency retrospectively adopted GASB 62 during 2012. There was no material effect on the financial statements as a result of adoption.

In June 2011, GASB Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position* (GASB 63), was issued and provides financial reporting guidance for deferred outflows of resources and deferred inflows of resources. In addition, GASB 63 identifies net position as the residual of all other elements presented in the statements of net position. The Agency retrospectively adopted GASB 63 effective January 1, 2012. There was no material effect on the financial statements as a result of adoption.

In March 2012, GASB Statement No. 65, *Items Previously Reported as Assets and Liabilities* (GASB 65), was issued and establishes accounting and financial reporting standards that reclassify, as deferred outflows of resources or deferred inflows of resources, certain items that were previously reported as assets and liabilities and recognizes, as outflows of resources or inflows of resources, certain items that were previously reported as assets and liabilities. The Agency retrospectively adopted GASB 65 effective January 1, 2012. There was no material effect on the financial statements as a result of adoption.

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(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	
	2012	**2011**
Current assets:		
Cash and cash equivalents	$ 33,442,632	21,949,935
Restricted cash and cash equivalents	5,039,754	5,345,034
Total current assets	38,482,386	27,294,969
Noncurrent assets:		
Restricted cash and cash equivalents	11,761,080	17,253,810
Restricted investments	19,945,133	20,518,277
Total noncurrent assets	31,706,213	37,772,087
Total	$ 70,188,599	65,067,056

At December 31, 2012, 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, 2012 and 2011:

	December 31, 2012			December 31, 2011		
	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	$ 7,523,134	6,214,781	—	7,523,033	6,242,431	—
U.S. Treasuries	—	668,234	—	—	1,207,217	—
Certificates of deposit	679,000	291,000	—	—	970,000	—
State and local bonds	—	4,568,984	—	—	4,575,596	—
Money market accounts	—	—	16,697,241	—	—	22,598,844
Cash and cash equivalents	—	—	33,546,225	—	—	21,949,935
Total	$ 8,202,134	11,742,999	50,243,466	7,523,033	12,995,244	44,548,779

(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, 2012 and 2011:

	December 31, 2012			
		Quality ratings		
	Fair value	AA	AAA	Unrated
Investment type:				
U.S. government agencies	$ 13,737,915	13,737,915	—	—
U.S. Treasuries	668,234	668,234	—	—
Certificates of deposit	970,000	—	—	970,000
State and local bonds	4,568,984	4,568,984	—	—
Money market accounts	16,697,241	—	16,697,241	—
Cash and cash equivalents	33,546,225	—	—	33,546,225
Total	$ 70,188,599	18,975,133	16,697,241	34,516,225

	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	21,949,935	—	—	21,949,935
Total	$ 65,067,056	19,548,277	22,598,844	22,919,935

(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's adopted and revised investment policy addresses, among other things, custodial credit risk. At December 31, 2012 and 2011, 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:

		2012		
	Beginning balance	**Additions**	**Retirements/ Transfers**	**Ending balance**
Nondepreciable capital assets:				
Construction work in progress	$ 7,699,559	5,612,093	(566,404)	12,745,248
Land	822,655	318,010	—	1,140,665
Depreciable capital assets:				
Telemetering and telecommunication	649,670	11,724	—	661,394
Capital lease asset	—	29,080,531	—	29,080,531
Electric plant	285,307,557	2,271,422	(25,542,376)	262,036,603
Rotable combustion turbine parts	6,063,531	—	—	6,063,531
Less accumulated depreciation for assets in service	(33,146,590)	(10,399,042)	(10,339,744)	(53,885,376)
Capital assets, net	$ 267,396,382	26,894,738	(36,448,524)	257,842,596

		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

(Continued)

(4) Long-Term Debt

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

	2012	2011
Series 2004A, 3.40% – 5.25%, due October 1, 2010 to 2034	$ 47,395,000	48,295,000
Series 2005, 3.50% – 5.00%, due October 1, 2007 to 2035	102,185,000	104,580,000
Series 2007, 4.00% – 5.00%, due October 1, 2007 to 2037	24,435,000	24,945,000
Series 2009A, 1.40%, due October 1, 2009 to 2023	3,666,666	4,000,000
Series 2010A, 3.00% – 5.25%, due October 1, 2011 to 2035	84,380,000	86,360,000
Series 2010B, 4.00%, due October 1, 2013	—	27,030,000
Total bonds outstanding	262,061,666	295,210,000
Less current maturities	(6,333,333)	(6,118,333)
Add unamortized premium	2,131,558	2,652,081
	$ 257,859,891	291,743,748

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.

The Agency redeemed the Series 2010B bonds in full on June 28, 2012.

Debt service requirements on the outstanding bonds are as follows:

Year	Principal	Interest	Total
2013	$ 6,333,333	12,934,341	19,267,674
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	7,553,333	11,708,667	19,262,000
2018 – 2022	43,716,667	52,518,133	96,234,800
2023 – 2027	53,868,333	40,947,654	94,815,987
2028 – 2032	73,635,000	26,123,644	99,758,644
2033 – 2037	56,185,000	5,907,875	62,092,875
	$ 262,061,666	187,171,952	449,233,618

The Agency has an agreement with the City of Chaska to purchase capacity, described more fully in note 1. A portion of the payments under this agreement are accounted for as a capital lease as shown in the table above. Future minimum payments under the agreement are as follows:

Year		Principal	Interest	Executory costs	Payment
2013	$	727,359	1,323,016	590,692	2,641,067
2014		770,782	1,279,593	590,692	2,641,067
2015		816,798	1,233,577	590,692	2,641,067
2016		865,561	1,184,815	590,692	2,641,068
2017		917,235	1,133,141	590,692	2,641,068
2018 – 2022		5,475,939	4,775,938	2,953,462	13,205,339
2023 – 2027		7,317,678	2,934,200	2,953,462	13,205,340
2028 – 2031		6,199,644	634,942	1,968,975	8,803,561
	$	23,090,996	14,499,222	10,829,359	48,419,577

Long-term liability activity for the years ended December 31, 2012 and 2011 was as follows:

Long-term liabilities as of December 31, 2012		Beginning balance	Additions	Reductions	Ending balance
Long-term bonds	$	295,210,000	—	(33,148,334)	262,061,666
Less current maturities		(6,118,333)	(6,333,333)	6,118,333	(6,333,333)
Add unamortized premium, net		2,652,081	—	(520,523)	2,131,558
Long-term bonds, net	$	291,743,748	(6,333,333)	(27,550,524)	257,859,891
Capital lease liability	$	—	23,777,378	(686,382)	23,090,996

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

(5) Power Acquisition Expense

Power acquisition expense consists primarily of power purchases, production fuel, and related expenses. The Agency sells substantially all of the power and energy produced by its generating facilities into the MISO market and purchases substantially all of its power and energy needs for sales to members and others from the MISO market. The Agency reports its purchases from and sales to MISO on a net basis.

The components of power acquisition expense are as follows:

		2012	2011
Power purchases	$	32,864,538	46,525,166
Production fuel		16,459,764	10,181,080
Total power acquisition expense	$	49,324,302	56,706,246

(6) Letters of Credit and Credit Facilities

At December 31, 2012, the Agency had an unused standby letter of credit of $850,000 to support energy and capacity purchases from Manitoba Hydro. The agreement provided for interest at the bank's reference rate plus 1%. This standby letter of credit expired in 2012 along with the energy and capacity purchase agreement with Manitoba Hydro.

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, 2012 or 2011.

(7) 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.

(8) 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.