

NOTES TO FINANCIAL STATEMENTS

WISCONSIN PUBLIC POWER INC.

Notes to Financial Statements

December 31, 2006 and 2005

(1) Summary of Significant Accounting Policies

(a) *Organization and Operations*

Wisconsin Public Power Inc. (WPPI) is a municipal electric company and political subdivision of the State of Wisconsin, formed in 1980. The purpose and function of WPPI is to provide an adequate, economical, and reliable wholesale supply of electricity to its members for distribution by the members' electric utilities to their retail customers. WPPI is owned by its member municipalities, which govern its policies. WPPI served 46 customer-owned electric utilities as of December 31, 2006. In 2007, Gladstone Power & Light and Alger Delta Cooperative Electric Association joined WPPI.

WPPI sells power to its members under power sales contracts that remain in effect until December 31, 2037. Under the contracts, WPPI has agreed to sell and deliver to each member, and each member has agreed to take and pay for its electric power requirements, with certain exceptions related to existing member-owned hydroelectric facilities and other specified generation. Also, a small percentage of WPPI's operating revenue comes from sales of capacity and energy to other entities including sales in the MISO market.

In addition to its power supply program, WPPI offers various services to members that are intended to enable members to operate their electric systems more efficiently. The services include rate analyses, rate comparisons, computer network support, large-customer billing, equipment testing, joint purchasing of equipment and supplies, joint arrangements for disposal of hazardous waste, and various energy- and customer-related programs.

WPPI supplies the power requirements of its members from a mix of resources, including an undivided 20% ownership in the 535 MW Boswell Unit 4 coal-fired steam unit near Grand Rapids, Minnesota; two 84 MW combustion turbine units near Fond du Lac, Wisconsin; a 54 MW twin pac combustion turbine generator unit in Kaukauna; member generation under contract to WPPI; and power purchases from other entities including the Midwest Independent System Operator (MISO) energy market. Minnesota Power owns the remaining interest in Boswell Unit 4 and is the operating agent responsible for operation and maintenance of the unit. WPPI's undivided ownership interest in Boswell Unit 4 is included in capital assets. WPPI pays 20% of the total cost to operate and maintain Boswell Unit 4. South Fond du Lac Units 1 and 4 are two of the four combustion turbine units located on a site owned by Alliant Energy. Alliant owns the other two units on the site and operates and maintains the units owned by WPPI. WPPI compensates Alliant for these services. WPPI owns the combustion turbine located in Kaukauna and Kaukauna Utilities operates it. WPPI compensates Kaukauna Utilities for operating and maintaining the combustion turbine. The member generation under contract to WPPI consists of a number of small generating units, totaling approximately 52 MW of capacity. The remainder of WPPI's power requirements are purchased from other entities.

(b) *Basis of Presentation/Chart of Accounts*

The financial statements are prepared on the economic resources measurement focus accrual basis of accounting, in conformity with U.S. generally accepted accounting principles, including the application of Statement of Financial Accounting Standards (SFAS) No. 71, *Accounting for the Effect of Certain Types of Regulation*, as the statement 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. WPPI uses the Uniform System of Accounts prescribed by the Federal Energy Regulatory Commission (FERC).

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WPPI 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*, WPPI also complies with the pronouncements of the Financial Accounting Standards Board that do not conflict with GASB pronouncements.

(c) *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.

WPPI participates in the Midwest Independent System Operator (MISO) energy market. MISO may true-up expenses and revenues for up to 546 days. WPPI accrues items that are known at the time of closing, but since there is such a large window of true-ups, actual results may differ from the estimates.

(d) *Capital Assets*

Additions to and replacements of capital assets are recorded at original cost, including allowance for borrowed funds if acquired with tax-exempt debt. Depreciation is recorded using the straight-line method using service lives of 2 to 35 years.

(e) *Deposits and Investments*

Investments of WPPI's funds are restricted by Section §66.0825 of the Wisconsin Statutes which states that notwithstanding the provisions of any other law, WPPI may invest in any funds in obligations, securities and other investments that the company deems proper.

(f) *Restricted Cash and Investments.*

WPPI's bond resolution requires the segregation of bond proceeds and prescribes the application of WPPI's revenues. Amounts classified as restricted cash and investments on the balance sheet represent cash and investments whose use is restricted by the bond resolution.

It is WPPI's practice to use restricted funds on hand, when available, before using unrestricted funds.

(g) *Unamortized Bond Issuance Costs*

Bond issuance costs are amortized over the repayment period of the related issues using a method that approximates the effective-interest method.

(h) *Future Costs to be (Returned) Recovered*

Revenues from members include amounts to pay bond principal and interest. For financial reporting purposes, WPPI recognizes depreciation and amortization pertaining to fixed assets and other assets financed by bond principal. As allowed through the application of the provisions of SFAS No. 71, future recoverable costs represent the difference between depreciation and amortization of assets financed with bond proceeds and the related principal recovered in rates in the present period. These costs will be recovered in future periods when the principal amounts exceed the related depreciation and amortization.

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In 2006 WPPI adopted the principles of regulatory asset and liability accounting in accordance with SFAS No. 71, to record the unrealized gains or losses from the annual mark to market calculations on interest rate swaps. The gain on interest rate swaps was recorded under non-operating revenues (expenses) and the deferral of the gain was recorded under future costs to be (returned) recovered. The deferrals are found on the balance sheet under deferred costs and deferred credits.

The cumulative effect of change in accounting principle represents the amounts expensed in prior years to mark to market the interest rate swaps.

(i) Other Deferred Charges

Other deferred charges primarily represent costs associated with the buyout of WPPI's obligations under capacity purchase agreements with two of its members. As allowed through the application of SFAS No. 71, such effects have been deferred and are being amortized for rate-making purposes over the original terms of the capacity purchase agreements, which expire in 2007 and 2009, respectively.

(j) Cash Equivalents

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

(k) Power Sales Accounts Receivable

Power Sales accounts receivable, representing power sales to members for the period between the last billing date and the end of the period, are accrued in the period sold.

(l) Inventories

Inventories include fuel and repair parts. They are charged to plant or operation and maintenance expense at average cost when used. Inventories are valued at the lower of average cost or fair value.

(m) Rates

Rates are reviewed and adopted by WPPI's Board of Directors annually. Under WPPI's bond resolution, WPPI's rates are expected to yield net revenues for an annual period equal to at least 1.10 times the aggregate debt service for that period. Rates are not subject to state or federal regulation.

Beginning in 2004, in December of each year the Board of Directors determines how to distribute the margin above 110%. As allowed through the application of the provisions of SFAS No. 71, the margin may be deposited in the Rate Stabilization Fund and is also reported as deferred credits on the accompanying balance sheet to be distributed in future years as revenues in the statement of revenues, expenses, and changes in net assets to cover costs that otherwise would be recovered through its rates to members. For the years ended December 31, 2006 and 2005, \$800,643 and \$628,831, respectively, was deferred and added to the Rate Stabilization Fund.

(n) Taxes

WPPI is exempt from Federal, Wisconsin, and Minnesota income taxes as a political subdivision of the State of Wisconsin. Tax expense includes Minnesota property taxes, Wisconsin payments-in-lieu-of-ad valorem taxes, payroll-related taxes, and emission fees.

The Minnesota property taxes were over-estimated in prior years. In 2006, WPPI made an estimate true-up amounting to \$831,386 which reduced tax expense and other current liabilities.

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(o) *Vacation and Sick Leave*

Under terms of employment, employees are granted one day of sick leave per month. Employees are paid annually for any sick leave accrued in excess of 960 hours. Accrued sick leave is not paid to employees when they leave employment.

Employees are allowed to accumulate up to five days of vacation pay. Employees are paid annually for any accrued vacation in excess of five days. In extraordinary circumstances, the chief executive officer may allow an employee to accumulate additional vacation in excess of five days. Accrued vacation is not considered material; therefore, no liability is recorded.

(p) *Operating Revenues and Expenses*

Operating revenues result from exchange transactions associated with the principal activity of WPPI, the sale of electricity. Reported operating revenues are affected by the contributions to or distributions from the Rate Stabilization Fund. Operating expenses are defined as expenses directly related to, or incurred in support of, the provision of electricity and other services to the members. All other expenses are classified as nonoperating expenses.

(q) *Fair Value of Financial Instruments*

The carrying amount of WPPI's cash and cash equivalents, receivables, and accounts payable approximates fair value because of the short maturities of these instruments. Investments are carried at fair value based on quoted market prices.

(r) *New Accounting Pronouncements*

In March 2003, the Government Accounting Standards Board (GASB) issued Statement No. 40, *Deposit and Investment Risk Disclosures – An Amendment of GASB Statement No. 3*. WPPI implemented Statement No. 40 during the year ended December 31, 2005. As a result of implementing this statement, WPPI revised the deposit and investment risks disclosures in note 2 to include disclosure of credit risk, concentration of credit risk, and interest rate risk.

In November 2003, the GASB issued Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*. This Statement establishes accounting and financial reporting standards for impairment of capital assets. WPPI implemented Statement No. 42 beginning with the year ending December 31, 2006.

In June of 2004, the GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Post Employment Benefits Other Than Pensions*. This Statement establishes accounting and financial reporting standards for post employment benefits other than pensions. WPPI will implement Statement No. 42 beginning with the year ending December 31, 2007. WPPI is currently evaluating the impact of adopting Statement No. 45.

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(2) Deposits and Investments

WPPI's bond resolution requires the segregation of bond proceeds and establishment of various funds, and prescribes the application of WPPI's revenues. Also, it defines what type of securities WPPI may invest in. Funds consist principally of cash, money market funds, repurchase agreements, investments in the Local Government Investment Pool, treasury notes, agencies, treasury strips, and corporate bonds. The funds' purposes and balances are summarized below:

<u>Fund</u>	<u>Held by</u>	<u>Purpose</u>
Construction	Trustee	To provide for the acquisition and construction of the power supply system.
Debt Service	Trustee	To accumulate principal and interest associated with each bond series.
Debt Service Reserve	Trustee	To establish a reserve equal to half of the largest principal and interest payment that would have to be made in any one year during the remaining life of the bonds.
Revenue	WPPI	To accumulate revenues and to provide for the payment of expenses and for disposition of revenues to various funds.
Renewals & Replacements	WPPI	To provide a reserve to be applied to the payment of the costs of renewals, replacements, and repairs to the power supply system.
Self-Insurance	WPPI	To provide a reserve to be applied to the payment of claims and losses arising from hazards and risks to the extent that the insurance required to be maintained does not cover such claims or losses.
Rate Stabilization	WPPI	To accumulate revenues which will be used to reduce rates in a future period.
Decommissioning	WPPI	To accumulate funds to pay for the eventual costs of decommissioning, retirement, or disposal of major facilities.

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	<u>2006</u>	<u>2005</u>
Restricted cash and investments:		
Noncurrent:		
Debt Service Reserve Accounts	\$ 17,557,808	\$ 16,938,383
Renewals & Replacements Fund	11,985,667	5,895,010
Self-Insurance Fund	3,256,495	3,084,255
Rate Stabilization Fund	36,024,873	35,425,534
Decommissioning	2,368,591	2,290,767
Construction Fund	87,677,635	134,992,319
Debt Service Funds	<u>15,573,950</u>	<u>25,344,883</u>
Total noncurrent	<u>174,445,019</u>	<u>223,971,151</u>
Current:		
Construction Fund	54,881,090	33,900,980
Debt Service Funds	<u>18,663,669</u>	<u>17,390,555</u>
Total current	<u>73,544,759</u>	<u>51,291,535</u>
Total restricted cash and investments	<u>247,989,778</u>	<u>275,262,686</u>
Unrestricted cash and investments:		
Noncurrent:		
Investments	675,801	657,941
Investment in ATC	<u>43,269,461</u>	<u>32,257,900</u>
	<u>43,945,262</u>	<u>32,915,841</u>
Current cash and investments:		
Petty cash	20	300
Revenue Fund	<u>22,808,797</u>	<u>18,160,397</u>
	<u>22,808,817</u>	<u>18,160,697</u>
Total cash and investments	<u>\$ 314,743,857</u>	<u>\$ 326,339,224</u>

Investments are stated at fair value, based on quoted market prices. Adjustments necessary to record investments at fair value are recorded in the statements of revenues, expenses, and changes in net assets.

WPPI has an internal investment policy that stipulates its guidelines to help ensure safety of principal, liquidity, and diversification of its investment portfolio. Generally, investments permitted by the policy within the limits of WPPI's bond resolution include U.S. government obligations, state and local government and corporate obligations rated in either of the two highest whole rating categories by a nationally recognized rating agency, guaranteed investment contracts, or a portfolio of such investments in money market funds or mutual funds, and investments in ATC.

WPPI's investments are potentially subject to various risks, including the following:

- **Custodial credit risk** – The risk that in the event of a failure of the counterparty to an investment transaction (typically a brokerage firm or financial institution), the government would not be able to recover the value of the investment or collateral securities.

Deposits and investments in each bank are insured by the Federal Deposit Insurance Corporation (FDIC) in the amount of \$100,000 for interest-bearing accounts and \$100,000 for non-interest-bearing accounts. Deposits and investments are also insured for \$400,000 by the State Deposit Guarantee Fund (SDGF). However, due to the relatively small size of SDGF in relation to the total deposits covered and other legal implications, recovery of material principal losses of the pool may not be significant to WPPI.

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At December 31, 2006 WPPI had \$1,375,882 in bank balances (\$929,594 book balances) that were uninsured and uncollateralized deposits. At December 31, 2005 WPPI had \$915,948 in bank balances (\$592,007 in book balances) that were uninsured and uncollateralized deposits. All investments held as of December 31, 2006 and December 31, 2005 were held in trust on behalf of WPPI in WPPI's name and therefore not subject to custodial credit risk.

- **Credit risk** – The risk that an issuer or other counterparty to an investment will not fulfill its obligations. WPPI makes certain investments in Guaranteed Investment Contracts. These investments are unrated. As of December 31, 2006 WPPI's other investments were rated as follows:

	Standard & Poor's	Moody's	Amount
U.S. government securities	AAA	Aaa	49,798,701
Money market mutual fund	AAAm	Aaa	52,747,874
Corporate Bonds	AAA	Aaa	1,000,000
Corporate Bonds	AA+	Aa1	1,025,318
Corporate Bonds	AA	Aa2	979,850
Corporate Bonds	AA-	Aa3	1,490,255
Corporate Bonds	A+	Aa3	483,750

As of December 31, 2005 WPPI's investments were rated as follows

	Standard & Poor's	Moody's	Amount
U.S. government securities	AAA	Aaa	43,250,249
Money market mutual fund	AAAm	Aaa	48,190,397
Corporate Bonds	AAA	Aaa	971,940
Corporate Bonds	AA-	Aa1	492,365
Corporate Bonds	AA	Aa2	484,880
Corporate Bonds	AA-	Aa3	491,440
Corporate Bonds	A-	A1	249,982

- **Concentration risk** – Investing 5% or more of WPPI's portfolio in the securities of a single issuer. This disclosure excludes U.S. Government Securities that are explicitly guaranteed by the U.S. government. WPPI has guaranteed investment contracts (repurchase agreements) with three entities for construction and capitalized interest funds. Although the contracts are with each entity, there are underlying securities supporting each contract.

The following investments exceeded the 5% threshold in 2006 and 2005:

	2006	2005
CitiGroup Guaranteed Investment Contract	\$ 99,776,385	\$ 102,916,623
JP Morgan Guaranteed Investment Contract	\$ 49,851,646	\$ 60,387,630
Morgan Stanley Guaranteed Investment Contract	\$ 15,124,034	\$ 21,583,805

- **Interest rate risk** – The risk of potential variability in the fair value of fixed rate investments resulting from changes in interest rates (the longer the period for which an interest rate is fixed, the greater the risk).

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As of December 31, 2006, WPPI's investments were classified by maturity as follows:

	Maturity in Years			Fair Value
	Less than 1	1-5	Over 5	
U.S. government securities	27,696,481	16,065,522	6,036,698	49,798,701
Money market mutual fund	52,747,874	-	-	52,747,874
Certificates of deposit	200,000	100,000	-	300,000
Guaranteed Investment Contracts	59,500,480	103,251,585	-	162,752,065
Corporate bonds	1,499,563	3,479,610	-	4,979,173
Mutual funds	20,000	350,872	-	370,872
	141,664,398	123,247,589	6,036,698	270,948,685

As of December 31, 2005, WPPI's investments were classified by maturity as follows:

	Maturity in Years			Fair Value
	Less than 1	1-5	Over 5	
U.S. government securities	13,450,547	23,245,341	6,554,361	43,250,249
Money market mutual fund	48,190,397	-	-	48,190,397
Certificates of deposit	-	-	-	-
Guaranteed Investment Contracts	38,267,939	160,337,202	-	198,605,140
Corporate bonds	249,982	2,440,625	-	2,690,607
Mutual funds	102,000	550,624	-	652,624
	100,260,865	186,573,792	6,554,361	293,389,017

(3) Investment in American Transmission Company

During 2000, WPPI purchased an equity interest in ATC Management Inc. and American Transmission Company LLC (collectively ATC). ATC is a for-profit, transmission-only company. It owns, plans, maintains, monitors, and operates electric transmission assets in portions of Wisconsin, Michigan, and Illinois. ATC began operations on January 1, 2001. At December 31, 2006 and 2005, WPPI's equity interest in ATC was approximately 5.5%. WPPI's investment in ATC qualifies for the equity method of accounting.

Under the terms of the ownership agreement with ATC, WPPI has the right, but not the obligation, to purchase additional member units in ATC as may from time to time arise in order to maintain its initial percentage interest in ATC, as well as participate in voluntary additional capital calls. At December 31 2006, WPPI had outstanding commitments to fund ATC of approximately \$1,088,843. The amount was paid in January 2007.

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Condensed financial data of ATC for 2006 and 2005 follows:

	<u>2006</u>	<u>2005</u>
	(In millions)	(In millions)
Operating statement data:		
Revenues	\$ 340.7	\$ 296.0
Operating expenses	(179.4)	(166.6)
Other income	2.0	3.5
Net interest expense	(41.4)	(36.5)
	<u>121.9</u>	<u>96.4</u>
Earnings before tax	\$ <u>121.9</u>	\$ <u>96.4</u>
Balance sheet data:		
Current assets	\$ 33.5	\$ 29.2
Noncurrent assets	1,853.7	1,516.1
	<u>1,887.2</u>	<u>1,545.3</u>
Total assets	\$ <u>1,887.2</u>	\$ <u>1,545.3</u>
Current liabilities	\$ 305.3	\$ 140.5
Long-term debt	648.9	648.7
Other noncurrent liabilities	125.7	105.3
Members' equity	807.3	650.8
	<u>1,887.2</u>	<u>1,545.3</u>
Total liabilities and members' equity	\$ <u>1,887.2</u>	\$ <u>1,545.3</u>

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(4) Capital Assets

Capital asset activity for the years ended December 31, 2006 and 2005 was as follows:

<u>2006</u>	<u>Beginning balance</u>	<u>Additions</u>	<u>Transfers</u>	<u>Retirements</u>	<u>Ending balance</u>
Nondepreciable assets:					
Land	\$ 88,883	\$ —	\$ —	\$ —	\$ 88,883
Construction work in progress	28,694,373	35,940,599	(1,571,015)	—	63,063,957
Total nondepreciable assets	<u>28,783,256</u>	<u>35,940,599</u>	<u>(1,571,015)</u>	<u>—</u>	<u>63,152,840</u>
Depreciable assets:					
Utility plant	208,923,113	203,335	1,571,015	(411,170)	210,286,293
Total depreciable assets	208,923,113	203,335	1,571,015	(411,170)	210,286,293
Accumulated depreciation and amortization	<u>(85,331,589)</u>	<u>(6,736,109)</u>	<u>—</u>	<u>679,093</u>	<u>(91,388,605)</u>
Depreciable assets, net	<u>123,591,524</u>	<u>(6,532,774)</u>	<u>1,571,015</u>	<u>267,923</u>	<u>118,897,688</u>
Capital assets, net	\$ <u>152,374,780</u>	\$ <u>29,407,825</u>	\$ <u>—</u>	\$ <u>267,923</u>	\$ <u>182,050,528</u>
<u>2005</u>	<u>Beginning balance</u>	<u>Additions</u>	<u>Transfers</u>	<u>Retirements</u>	<u>Ending balance</u>
Nondepreciable assets:					
Land	\$ 88,883	\$ —	\$ —	\$ —	\$ 88,883
Construction work in progress	57,804	29,576,534	(939,965)	—	28,694,373
Total nondepreciable assets	<u>146,687</u>	<u>29,576,534</u>	<u>(939,965)</u>	<u>—</u>	<u>28,783,256</u>
Depreciable assets:					
Utility plant	208,828,773	50,250	939,965	(895,875)	208,923,113
Total depreciable assets	208,828,773	50,250	939,965	(895,875)	208,923,113
Accumulated depreciation and amortization	<u>(79,247,568)</u>	<u>(6,641,731)</u>	<u>—</u>	<u>557,710</u>	<u>(85,331,589)</u>
Depreciable assets, net	<u>129,581,205</u>	<u>(6,591,481)</u>	<u>939,965</u>	<u>(338,165)</u>	<u>123,591,524</u>
Capital assets, net	\$ <u>129,727,892</u>	\$ <u>22,985,053</u>	\$ <u>—</u>	\$ <u>(338,165)</u>	\$ <u>152,374,780</u>

Construction work in progress at December 31, 2006 consists primarily of the 8.33% interest in two 615 MW supercritical coal-fired generating units under construction in Oak Creek, Wisconsin. Capitalized interest included in the cost of the project was \$3,960,348 and \$489,809 for the years ended December 31, 2006 and 2005, respectively. The project was financed by the proceeds of the Series 2005A and 2005B bond issues.

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(5) Asset Retirement Obligations

WPPI adopted Statement of Financial Accounting Standards No. 143 – *Accounting for Asset Retirement Obligations* (SFAS 143) in 2003. This statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS No. 143 requires an enterprise to record the fair value of an asset retirement obligation as a liability in the period in which it incurs a legal obligation associated with the retirement of a tangible long-lived asset. Adoption of this statement in 2003 resulted in an increase in net capital assets of \$576,824, an increase in accrued liabilities of \$263,987 and a change in net assets of \$312,837.

The scope of SFAS 143 includes future asset retirement obligations for the closure of ash ponds and scrubber ponds at the Boswell plant site. WPPI used information from Minnesota Power to estimate the cash flows to determine the obligation.

The following table presents the details of WPPI’s asset retirement obligations.

	2006	2005
Balance 1/1	1,896,971	1,806,068
Liabilities Incurred	-	-
Liabilities Settled	-	-
Accretion	94,219	90,903
Cash Flow Revisions	-	-
Balance 12/31	<u>1,991,190</u>	<u>1,896,971</u>

(6) Long-term Debt

The following Power Supply System Revenue Bonds were issued to finance WPPI’s acquisition and construction of utility plants:

	<u>2006</u>	<u>2005</u>
Revenue bonds:		
2003 Series A 3.00% to 5.25%		
Due July 1, 2005-2033	\$ 70,195,000	\$ 76,930,000
2003 Series B variable rate bonds		
Due July 1, 2005-2021	64,800,000	65,100,000
2003 Series C variable rate bonds		
Due July 1, 2005-2023	34,875,000	36,425,000
2005 Series A 4.625% to 5.00%		
Due July 1, 2005 -2037	143,020,000	143,020,000
2005 Series B variable rate bonds		
Due July 1, 2012-2037	<u>93,900,000</u>	<u>93,900,000</u>
Total bonds outstanding	406,790,000	415,375,000
Less: Current maturities	(6,085,000)	(8,585,000)
Unamortized discount/premium, net	<u>(11,680,077)</u>	<u>(13,223,283)</u>
	<u>\$ 389,024,923</u>	<u>\$ 393,566,717</u>

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The terms outstanding for WPPI's variable rate issues are the following:

	<u>Fixed Rate Paid</u>	<u>Variable Rate Received</u>	<u>Rate Paid to Bond Holders</u>
2003 Series B Variable Rate Bonds	3.355%	67% of 1 month LIBOR	35 day auction rate
2003 Series C Variable Rate Bonds	2.8050%	67% of 1 month LIBOR	35 day auction rate
2005 Series B Variable Rate Bonds	3.500%	68% of 1 week LIBOR	7 day auction rate

The Power Supply System Revenue Bonds are generally secured by the funds and revenues of WPPI derived from the ownership and operation of its power supply system.

The unamortized discount/premium, which includes the unamortized difference between the reacquisition price and the net carrying amount of refunded debt issues, is amortized over the terms of the related bond issues using a method that approximates the effective-interest method.

During 2005, \$143,020,000 of the Power Supply System Revenue Bonds, Series 2005A, and \$93,900,000 Power Supply System Revenue Bonds, Series 2005B were issued to purchase an 8.33% interest in two 615 MW supercritical coal-fired generating units under construction in Oak Creek, Wisconsin.

No defeased debt remained outstanding at December 31, 2006 from advance refundings entered into by WPPI.

Long-term liability activities for the years ended December 31, 2006 and 2005 were as follows:

<u>Long-term liabilities as of December 31, 2006</u>	<u>Beginning balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>Ending balance</u>
Long-term revenue bonds	\$ 415,375,000	\$ —	\$ (8,585,000)	\$ 406,790,000
Less:				
Current maturities	8,585,000	6,085,000	(8,585,000)	6,085,000
Unamortized discount/premium, net	<u>13,223,283</u>	<u>—</u>	<u>(1,543,206)</u>	<u>11,680,077</u>
Long-term revenue bonds, net	<u>\$ 393,566,717</u>	<u>\$ (6,085,000)</u>	<u>\$ 1,543,206</u>	<u>\$ 389,024,923</u>
Deferred credits and other liabilities:				
Operating reserves and accrued liabilities	\$ 9,746,133	\$ 2,477,287	\$ (2,458,180)	\$ 9,765,240
Rate stabilization	35,756,677	800,642	—	36,557,319
Asset retirement obligation	1,896,371	94,819	—	1,991,190
Fair value of interest rate swap agreements	1,226,841	—	(1,226,841)	—
Regulatory liability	<u>—</u>	<u>1,677,053</u>	<u>—</u>	<u>1,677,053</u>
Total deferred credits and other liabilities	<u>\$ 48,626,022</u>	<u>\$ 5,049,801</u>	<u>\$ (3,685,021)</u>	<u>\$ 49,990,802</u>

WISCONSIN PUBLIC POWER INC.

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<u>Long-term liabilities as of December 31, 2005</u>	<u>Beginning balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>Ending balance</u>
Long-term revenue bonds	\$ 184,055,000	\$ 236,920,000	\$ (5,600,000)	\$ 415,375,000
Less:				
Current maturities	5,600,000	8,585,000	(5,600,000)	8,585,000
Unamortized discount/premium, net	<u>20,181,268</u>	<u>(5,229,623)</u>	<u>(1,728,362)</u>	<u>13,223,283</u>
Long-term revenue bonds, net	<u>\$ 158,273,732</u>	<u>\$ 233,564,623</u>	<u>\$ 1,728,362</u>	<u>\$ 393,566,717</u>
Deferred credits and other liabilities:				
Operating reserves and accrued liabilities	\$ 9,081,927	\$ 1,564,899	\$ (900,693)	\$ 9,746,133
Rate stabilization	35,127,846	628,831	—	35,756,677
Asset retirement obligation	1,806,068	90,303	—	1,896,371
Fair value of interest rate swap agreements	<u>280,985</u>	<u>945,856</u>	<u>—</u>	<u>1,226,841</u>
Total deferred credits and other liabilities	<u>\$ 46,296,826</u>	<u>\$ 3,229,889</u>	<u>\$ (900,693)</u>	<u>\$ 48,626,022</u>

Debt service payments on the outstanding bonds and the interest rate swap agreements (see note 7) are as follows:

<u>Year</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2007	\$ 6,085,000	\$ 17,336,075	\$ 23,421,075
2008	9,325,000	17,251,289	26,576,289
2009	6,755,000	16,648,919	23,403,919
2010	9,220,000	16,450,770	25,670,770
2011	10,375,000	15,893,934	26,268,934
2012-2016	79,585,000	70,265,331	149,850,331
2017-2021	93,935,000	52,140,359	146,075,359
2022-2026	54,490,000	37,595,213	92,085,213
2027-2031	61,235,000	25,292,545	86,527,545
2032-2037	<u>75,785,000</u>	<u>10,619,053</u>	<u>86,404,053</u>
	<u>\$ 406,790,000</u>	<u>\$ 279,493,488</u>	<u>\$ 686,283,488</u>

(7) Interest Rate Swap Agreement

During 2005, WPPI entered into an interest rate swap agreement with JP Morgan and during 2003, WPPI entered into two interest rate swap agreements with Bear Stearns. Interest rate swaps involve the contractual exchange of fixed- and floating-rate interest payment obligations based on a notional principal amount. WPPI entered into the interest rate swap agreements to manage interest rate risk caused by fluctuations in interest rates. The interest rate swap agreement dated October 17, 2005 has a notional amount of \$93,900,000. The interest rate swap agreement dated February 6, 2003 has a notional amount of \$65,100,000. The interest rate swap agreement dated May 30, 2003 has a notional amount of \$36,425,000. WPPI is a receiver of floating-rate interest and a payer of a fixed-rate interest on both agreements. The fixed rates of interest were 3.5%, 3.355 % and 2.805%, respectively. As of December 31, 2006, the interest rate swaps had a positive fair value of \$1,677,053.

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(8) Available Financing

During 2006, WPPI entered into a revolving line of credit agreement with Chase Bank, which permits borrowings of up to \$25,000,000 and expires on April 30, 2009. Interest accrued on the unpaid principal amount outstanding at a rate per annum equal to the applicable British Bankers' Association LIBOR rate for deposits in U.S. dollars plus 90 basis points. At December 31, 2006, there were no outstanding amounts on the line of credit.

Line of credit activities for the year ended December 31, 2006, is as follows:

	<u>Balance</u> <u>1/1</u>	<u>Additions</u>	<u>Reductions</u>	<u>Balance</u> <u>12/31</u>
Line of credit	\$ 6,500,000	\$ —	\$ (6,500,000)	\$ —

(9) Significant Members

Two significant members of WPPI accounted for \$61,341,693 and \$63,780,091 or approximately 22.0% and 22.5% of total sales revenues for the years ended December 31, 2006 and 2005, respectively.

(10) Employee Benefits

(a) Retirement Plan

WPPI has a Simplified Employee Pension-Individual Retirement Account (SEP-IRA) covering all of its employees funded through contributions by WPPI to an investment firm. The total contributions to the plan for the years ended December 31, 2006 and 2005 were \$602,544 and \$564,623, respectively.

(b) Retention Plan

In 1999, WPPI established an initial employee retention plan. In 2006, an additional amount was added to the plan that will extend payments out until 2011. The plan will make payments to specific employees after completing the defined years of continuing employment. Plan benefit expenses of \$153,874 and \$105,227 were accrued during 2006 and 2005, respectively.

(c) Defined Benefit Plan

Effective January 1, 2007 WPPI adopted a Defined Benefit Plan for several employees. The initial deposit was made from the retention plan and an additional amount from 2006 net earnings.

(d) Post Employment Medical Insurance

WPPI provides post employment medical insurance benefits. An employee who reaches age 60 and has ten years of service with WPPI qualifies for the benefit. For each full year worked past ten, the employee receives one year of benefit credit. An employee can earn up to a maximum of five years of benefit credits. For each year of benefit credit, WPPI will reimburse the employee for a portion of the cost of medical insurance. Full-time employees qualify for 50% reimbursement and part-time employees will receive a pro rata portion. At December 31, 2006 there were no participants and no benefit payments. The plan is unfunded. Post employment expenses of \$155,989 and \$129,200 were accrued during 2006 and 2005, respectively.

WISCONSIN PUBLIC POWER INC.

Notes to Financial Statements

December 31, 2006 and 2005

	2006			2005		
	Benefit Obligation	Accrued Benefit	Unrecognized Transition Obligation	Benefit Obligation	Accrued Benefit	Unrecognized Transition Obligation
Balance 1/1	672,005	307,018	364,987	337,789	177,819	159,970
Service Cost	88,759	88,759	0	70,831	70,831	0
Interest Cost	36,916	36,916	0	31,333	31,333	0
Actuarial Gain/Loss	(31,306)	0	(31,306)	232,052	0	232,052
Amort of transition	0	30,314	(30,314)	0	27,036	(27,036)
Annual Expense	94,369	155,989	(61,620)	334,216	129,200	205,017
Benefit Payments	0	0	0	0	0	0
Balance 12/31	766,374	463,007	303,367	672,005	307,018	364,987

The estimated benefits to be paid in the next ten years are shown below.

Year 1	\$8,029
Year 2	15,777
Year 3	26,376
Year 4	43,627
Year 5	53,052
Year 6-10	284,753

The measurement dates used to determine the postretirement benefit measurements are December 31, 2006 and December 31, 2005. The assumed health care cost trend rate for 2006 and 2005 was 12% with the trend rates declining to 4% in 2015. The weighed-average discount rate used in 2006 was 5.5%. The effect of a one-percentage-point change in the trend rate is shown below.

	1% Increase	1% Decrease
Service and Interest Cost	21,527	17,869
Accumulated Postretirement Benefit Obligation	99,579	78,181

(11) Commitments

WPPI has various long-term capacity and energy purchase contracts with various power suppliers. Capacity purchases for 2006 and 2005 totaled approximately 681 and 643 MW, respectively. WPPI does not own any transmission facilities and takes service for all of its transmission requirements under contracts and tariffs approved by FERC.

During 2005, WPPI entered into a series of agreements that establish WPPI's rights to an 8.33% interest in two 615 megawatt supercritical coal-fired generating units (the Project). Except under the limited circumstances as specifically provided within the agreements, WPPI may not terminate its participation or withdraw from the Project. Absent these circumstances or events, WPPI's financial obligation for its participation is approximately \$205 million. As of December 31, 2006, WPPI has paid approximately \$56.7 million of this commitment, with the remainder expected to be requested through 2010.

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Notes to Financial Statements

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As of December 31, 2006, the water intake discharge (“WPDES”) permit issued for the Project was subject to judicial review in Dane County Circuit Court. In the event that the WPDES permit was to be invalidated, the project may incur additional costs relating to water intake and discharge systems, and WPPI would incur additional financial obligations as part of the project.

(12) Risk Management

WPPI is exposed to various risks of loss related to torts; theft of, damage to, or destruction of assets; errors and omissions; workers’ compensation; and health care of its employees. The generating plants are covered by insurance, including property and boiler and machinery policies, with deductibles. Deductibles equal \$200,000 per occurrence on Boswell Unit 4, \$1.5 million per occurrence for the South Fond du Lac units, and \$500,000 per occurrence on the Kaukauna combustion turbine. Other risks are covered through the purchase of commercial insurance, with minimal deductibles. There has been no significant reduction in insurance coverages in 2006.

WPPI maintains assets in the Self-Insurance Fund described in note 2 to be applied to the payment of claims and losses arising from hazards and risks to the extent that insurance does not cover such claims or losses.

Following is the activity for the Self-Insurance Reserve for the years ended December 31, 2006 and 2005

	<u>2006</u>	<u>2005</u>
Self-Insurance Reserve, beginning of year	\$ 2,992,263	\$ 2,875,017
Additions, representing interest	273,530	117,246
Additions		
Usage		
Self-Insurance Reserve, end of year	<u>\$ 3,265,793</u>	<u>\$ 2,992,263</u>