

2016 ANNUAL REPORT



An RPU water team works on assembling a hydrant at the American Water Works Association (AWWA) Minnesota Section Conference in Duluth, MN.

A team of RPU line workers are timed during a competition on overhead work at the American Public Power Association (APPA) Lineworkers Rodeo held in Shakopee, MN.

RPU Core Value: Skill

Improve our own and others' abilities and knowledge



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INDEPENDENT AUDITORS' REPORT

To the Public Utilities Board
Rochester Public Utilities
Rochester, Minnesota

Report on the Financial Statements

We have audited the accompanying financial statements of Rochester Public Utilities, enterprise funds of the City of Rochester, Minnesota, as of and for the year ended December 31, 2016, and the related notes to the financial statements, as listed in the table of contents.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

Our responsibility is to express opinions on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. 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 over financial reporting relevant to Rochester Public Utilities' 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 Rochester Public Utilities' 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 opinions.

Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Rochester Public Utilities as of December 31, 2016, and the respective changes in financial position and cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

To the Public Utilities Board
Rochester Public Utilities

Emphasis of Matter

As discussed in Note 1, the financial statements present only Rochester Public Utilities enterprise funds and do not purport to, and do not, present fairly the financial position of the City of Rochester, Minnesota, as of December 31, 2016, and the respective changes in financial position, or cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America. Our opinions are not modified with respect to this matter.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the required supplementary information as listed in the table of contents be presented to supplement the financial statements. Such information, although not a part of the financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the 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 financial statements, and other knowledge we obtained during our audit of the 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.

Other Information

Our audit was conducted for the purpose of forming opinions on the financial statements as a whole. The Operating and Financial Statistics as identified in the table of contents is presented for purposes of additional analysis and is not a required part of the financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the financial statements, and accordingly, we express no opinion or provide any assurance on it.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have issued our report dated March 31, 2017 on our consideration of Rochester Public Utilities' internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering Rochester Public Utilities' internal control over financial reporting and compliance.

Baker Tilly Virchow Krause, LLP

Madison, Wisconsin
March 31, 2017

MANAGEMENT DISCUSSION & ANALYSIS

(Unaudited)

The following discussion and analysis of the financial results of Rochester Public Utilities (RPU or the Utility) provides an overview of the Utility's financial activities for the year ended December 31, 2016 compared to the year ended December 31, 2015.

This discussion is designed to be used in conjunction with the financial statements and notes, which follow this section.

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

Overview of the Financial Statements

Financial Statements

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

Notes to Financial Statements

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

See accompanying *Independent Auditors' Report*.

HIGHLIGHTS

- Rochester continued to grow with 1,520 new electric customers and 481 new water customers added in 2016. This compares with growth of 974 electric customers and 503 water customers in 2015.
- Electric retail revenues were up 6.3% over 2015, while kilowatt-hour sales were up only 0.9%. Approximately one-third of the increase in revenues was due to a 1.7% overall rate increase effective January 1, 2016. Another driver of the increase (also about one-third) was the Power Cost Adjustment (PCA), which passes through changes in wholesale power costs over or under a set base amount. Southern Minnesota Municipal Power Agency (SMMPA), RPU's primary wholesale power supplier, had a 6.0% rate increase in 2016 which resulted in revenue collections via the PCA. The annual system peak demand of 276 megawatts was set in July, and compares with a peak demand of 262 megawatts in 2015 and the all-time system peak demand of 292 megawatts in 2011.
- Water retail revenues were up 9.4% over 2015, while sales volume was up 5.3%. The increase in revenues was due to a 6.0% rate increase effective January 1, 2016 combined with the increase in sales volume. The increase in volume occurred despite a 46.3% increase in May-through-September rainfall over 2015, and was concentrated in the industrial class.
- An Electric Utility cost-of-service study was completed in 2014, and a 3-year rate track covering the years 2015 through 2017 was approved by the Utility Board and City Council. The second year's rate increase of 1.7% was effective January 1, 2016. A Water Utility cost-of-service study was completed in 2015, with the Utility Board voting for and City Council approving a 3-year rate track covering 2016 through 2018. The first year's rate increase of 6.0% was effective January 1, 2016. The rate increases were needed to build cash reserves for the future replacement of infrastructure and to support operating, maintenance, and capital activities for both Utilities.
- Purchased power costs from SMMPA and the Midcontinent Independent System Operator (MISO) market represented 70% of electric operating expenses for 2016. This is up from 68% in 2015 and is due in part to the SMMPA rate increase described above.
- Construction of Well #41 and the associated wellhouse building, located in southeast Rochester, was completed and officially placed into service on August 15, 2016. Currently the well is pumping water at a rate of approximately 1,000 gallons per minute into the main level. As the area continues to develop, the pumping rate can increase to nearly double its' current output. With the addition of Well #41, Rochester currently has 32 operable deep wells.
- Construction of the new St. Bridget water tower, also located in southeast Rochester, was completed and officially placed into service on August 1, 2016. The 500,000 gallon elevated tower serves the St. Bridget Intermediate Level. Constructed by Chicago Bridge and Iron, the St. Bridget Tower is RPU's 20th water storage facility.

See accompanying *Independent Auditors' Report*.

- August 2016 marked the kick-off of a new customer service and billing system implementation project. The new software system will improve customer self-service options and provide real-time applications and field mobility capabilities, along with realizing substantial cost savings over the current vendor. The system is scheduled to go live in November 2017.
- The final transmission line in the CapX2020 project, a 37-mile segment of 345kV line from North Rochester to the Hampton Substation, was placed into service in September 2016.
- Work began in 2016 on the Douglas Trail Substation, a high voltage substation located on West Circle Drive near the Douglas Trail to serve a new customer's load. As of December 31, 2016 significant construction work had been completed including grading and placement of structural steel and a pre-cast wall, among other items. Work planned for 2017 includes placement of the electrical switchgear, installation of the two power transformers, completion of control cabling, testing, checkout and other miscellaneous activities. RPU plans to place this substation into service by the end of May 2017.
- RPU procured the major equipment and began construction of the Westside Energy Station on a 50-acre site located on the west side of Rochester. The prime movers at the Energy Station will consist of 5 Wärtsilä reciprocating internal combustion engines driving generators with a combined output of 48 megawatts. The project is being designed and constructed by Westside Energy Partners, a general partnership between Boldt Company and Sargent & Lundy, LLC. Several high-efficiency energy design components are built into the Station including installation of a 60-kilowatt solar array to provide auxiliary energy. The project budget is set at \$75 million and is scheduled to have construction completed by December 2017 and be in commercial operation by May 1, 2018.
- Late in 2016, in preparation for an upcoming bond issue, RPU underwent reviews by both Moody's Investor Services and Fitch Ratings to determine whether the current bond rating would be affirmed or changed. Presentations were made to both agencies and additional information was provided. Both agencies affirmed RPU's current bond ratings; Moody's rating of Aa3 and Outlook Stable, Fitch rating of AA- and Outlook Stable. This will enable the Utility to obtain lower rates on future financing, potentially saving hundreds of thousands in interest costs.
- RPU once again surpassed its Aggressive Demand-Side Management (DSM) goal for 2016 of 18,546 megawatt hours in energy savings. Actual energy savings of 24,858 megawatt hours were achieved through helping commercial and residential customers install energy efficient equipment and technologies. This represents an estimated 24,858 tons of carbon reduction. The energy savings also represent 2.1% of annual retail energy sales. Savings of 2.8 million gallons of water were achieved through the use of water conservation rates, customer education, leak detection and rebates offered on clothes washers, high efficiency toilets, rain barrels and other items.

See accompanying *Independent Auditors' Report*.

FINANCIAL ANALYSIS – ELECTRIC UTILITY

Condensed Financial Information – Electric Utility

December 31, 2016 and 2015

(In millions)

Statements of Revenues, Expenses, & Changes in Net Position

	2016	2015	Change 2016 vs. 2015
Operating Revenues	\$156.4	\$145.9	\$10.5
Operating Expenses	132.2	127.6	4.6
<i>Operating Income</i>	24.2	18.3	5.9
Other Income & Expense	(0.3)	(0.5)	0.2
Interest Charges	(3.3)	(3.4)	0.1
Nonoperating Income (Expense)	(3.6)	(3.9)	0.3
<i>Income Before Transfer and Capital Contributions</i>	20.6	14.4	6.2
Transfers Out (In Lieu Of Tax Payments)	(8.5)	(8.4)	(0.1)
Capital Contributions	3.1	-	3.1
<i>Change in Net Position</i>	15.2	6.0	9.2
Net Position - Beginning of Year	119.5	124.7	(5.2)
GASB 68 Implementation	-	(11.2)	11.2
Adjusted Net Position – Beginning of Year	119.5	113.5	6.0
<i>Net Position - End of Year</i>	\$134.7	\$119.5	\$15.2

Statements of Net Position

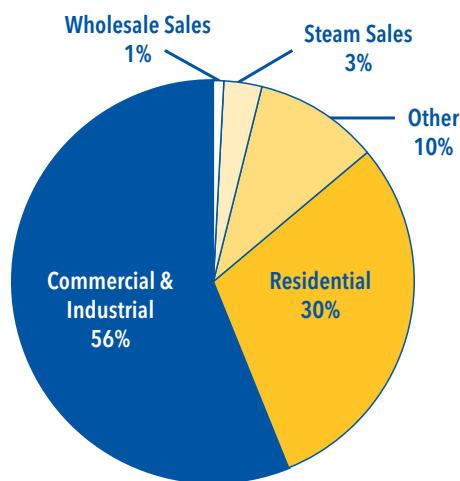
	2016	2015	Change 2016 vs. 2015
Cash and Investments – Unrestricted	\$40.8	\$41.7	\$(0.9)
Cash and Investments – Restricted	0.7	0.7	-
Other Current Assets	23.1	18.9	4.2
Capital Assets, Net	211.2	179.0	32.2
Other Noncurrent Assets	17.2	21.1	(3.9)
<i>Total Assets</i>	293.0	261.4	31.6
Deferred Outflows of Resources	9.3	3.8	5.5
<i>Total Assets Plus Deferred Outflows of Resources</i>	\$302.3	\$265.2	\$37.1
Current Liabilities	\$25.8	\$20.0	\$5.8
Long-Term Debt	119.1	110.8	8.3
Other Noncurrent Liabilities	19.1	13.0	6.1
<i>Total Liabilities</i>	164.0	143.8	20.2
Deferred Inflows of Resources	3.6	1.9	1.7
Investment in Capital Assets	94.9	74.5	20.4
Restricted – Debt Service	0.3	0.3	-
Restricted – Project Funds Held in Trust	-	0.7	(0.7)
Unrestricted	39.5	44.0	(4.5)
<i>Net Position</i>	134.7	119.5	15.2
<i>Total Liabilities, Deferred Inflows of Resources and Net Position</i>	\$302.3	\$265.2	\$37.1

See accompanying Independent Auditors' Report.

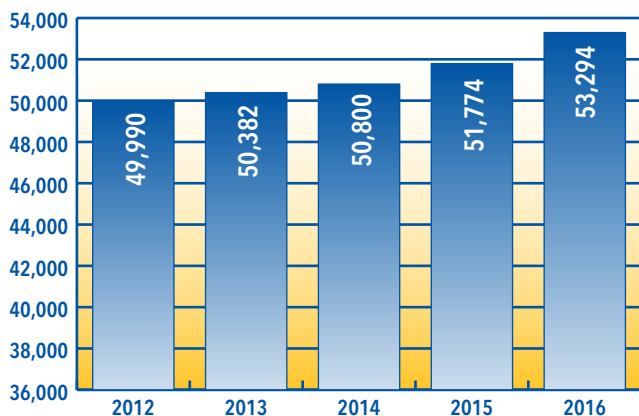
OPERATING REVENUES

Operating revenues increased \$10.5 million (7.2%) in 2016. Retail revenues were up \$8.4 million (6.3%), due in part to a 1.7% rate increase effective January 1, 2016, as well as an increase in the amount billed through the Power Cost Adjustment. Other operating revenues increased \$2.1 million (17.3%). Included in this category was an increase in transmission revenue of \$3.5 million offset by a decrease in steam and wholesale revenues of \$1.6 million (20.5%).

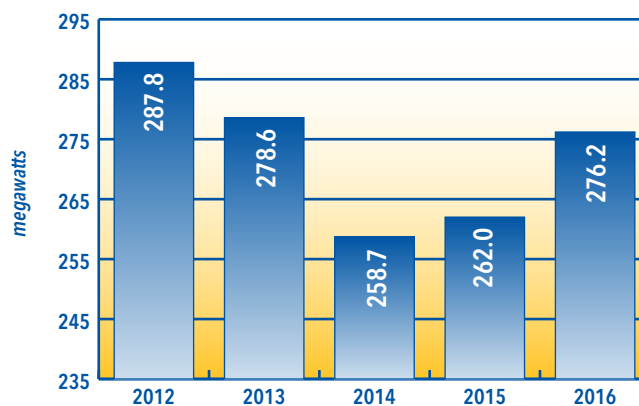
Electric Operating Revenues



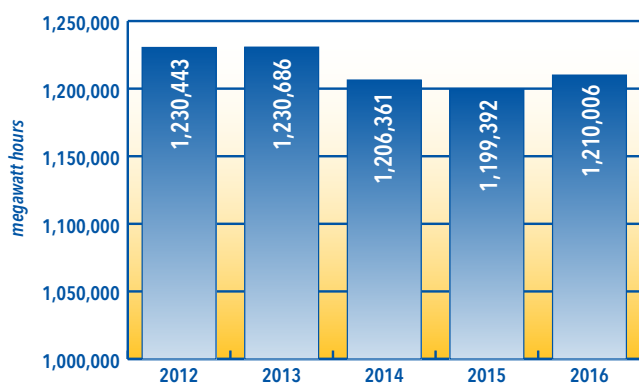
Number of Electric Customers



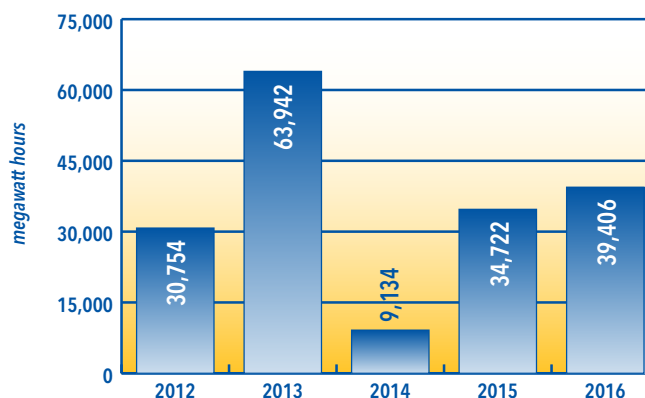
Electric System Peaks



Electric Retail Sales



Electric Wholesale Sales

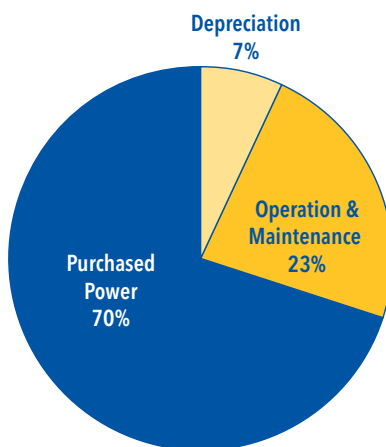


See accompanying *Independent Auditors' Report*.

OPERATING EXPENSES

Operating expenses increased \$4.6 million (3.6%) in 2016, due primarily to an increase in purchased power from slightly higher retail kilowatt-hour sales and a 6.0% rate increase from SMMPA. Salaries and benefits also accounted for part of the increase due to an increase in pension expense. These increases were partially offset by decreases in generation fuel, depreciation and materials, supplies and services. The primary driver of operating expenses for the Electric Utility continues to be purchases of power from SMMPA and the MISO market, which comprised 70% of total operating expenses.

Electric Operating Expenses



IN LIEU OF TAX PAYMENTS

The Electric Utility transfers an amount to the City of Rochester's General Fund each month based on the amount of retail kilowatt-hours sold. In 2016, \$8.5 million was transferred to the City. Because of the small increase in kilowatt-hour sales and an increase in the in lieu of tax rate, this was an increase of \$0.1 million over 2015.

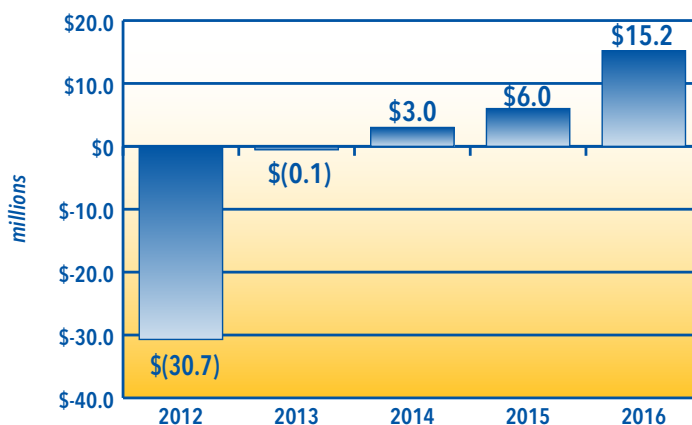
CAPITAL CONTRIBUTIONS

Capital contributions increased by \$3.1 million in 2016 due primarily to contributions in aid of construction received on a large project.

CHANGE IN NET POSITION

The increase in net position for 2016 was \$15.2 million, an improvement of \$9.2 million over 2015. Several factors contributed to this improvement. Retail revenues increased \$8.4 million over 2015 offset by a \$6.1 million increase in purchased power for a net improvement of \$2.3 million. Revenues earned on RPU's investment in transmission assets increased \$3.5 million over 2015. Lastly, expense reimbursements and contributions in aid of construction increased \$2.5 million over 2015.

Electric - Change in Net Position

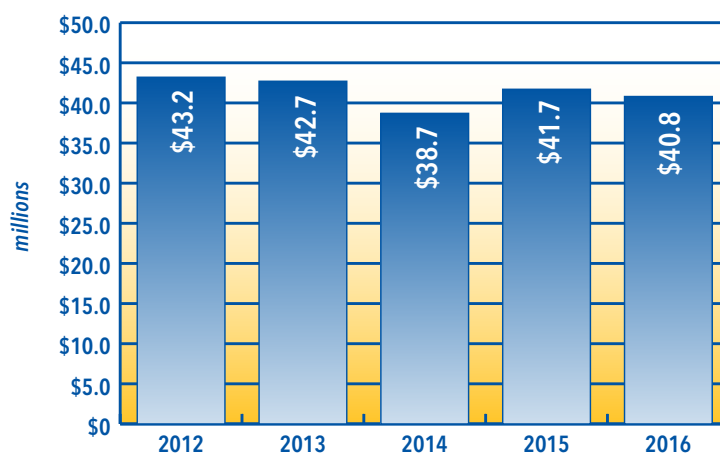


See accompanying *Independent Auditors' Report*.

CASH, INVESTMENTS AND OTHER ASSETS

The ending unrestricted cash and investments balance for 2016 was \$40.8 million, \$0.9 million lower than 2015. Although there was an increase in net cash provided by operating activities, this was offset by an increase in cash paid for capital projects. The ending restricted cash and investments balance for 2016 was \$0.7 million, with no change from 2015. This amount represents funds restricted for debt service payments. Other current assets for 2016 were \$23.1 million, \$4.2 million higher than 2015. This increase was due primarily to an increase in the Power Cost Adjustment accrual. Other noncurrent assets for 2016 were \$17.2 million, \$3.9 million lower than 2015. This was due primarily to the remaining bond proceeds being spent on the CapX2020 transmission project.

Electric - Unrestricted Cash & Investments



LIABILITIES

Current liabilities increased \$5.8 million in 2016, due primarily to a large payable booked at the end of the year for work on the Westside Energy Station.

Noncurrent liabilities increased \$6.1 million in 2016 due to an increase in pension liability for the Utility's proportionate share of the liability from the Minnesota Public Employees Retirement Association (PERA). The amount reported represents the difference between the actuarially determined benefits owed (total pension liability) and the assets accumulated by the pension plan.

NET POSITION

Net position invested in capital assets increased \$20.4 million. This increase reflects additions to capital assets funded through rate-based revenues and fees from customers. It also reflects all debt issued to fund capital projects, net of unspent debt proceeds.

Restricted net position decreased \$0.7 million. This represents funds restricted for payment of debt service as well as funds contractually committed to the CapX2020 transmission project.

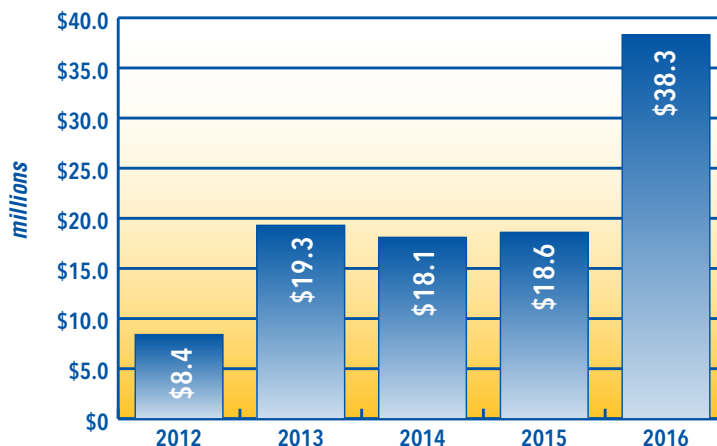
Unrestricted net position is not subject to any constraints by debt covenants or other legal requirements. In 2016, unrestricted net position decreased \$4.5 million due to the results of operations and an increase in pension liability.

See accompanying *Independent Auditors' Report*.

CAPITAL ASSETS

At December 31, 2016, the Electric Utility had \$211.2 million invested in a broad range of utility capital assets, including two gas turbines, a hydroelectric power generation plant, two diesel generators, boiler plant and related equipment to provide steam to a large customer, electric transmission and distribution facilities, and various buildings and equipment. Capital assets increased \$40.9 million in 2016, reflecting investments in general facilities and the distribution and transmission systems, a good portion of which was related to the CapX2020 transmission project. The increase in capital assets was offset by a \$8.7 million increase in accumulated depreciation. Additional details regarding the Utility's total assets (electric and water) may be found in Note 5 to the financial statements. Capital expenditures increased by \$19.7 million in 2016, due in large part to work on the Westside Energy Station.

Electric - Capital Expenditures



LONG-TERM DEBT

At the end of 2016, the Utility had \$101.4 million in revenue bonds and \$13.4 million in a credit facility outstanding. Short-term financing was obtained in April 2016 in the form of a \$25 million credit facility through U.S. Bank. This was a temporary borrowing to fund the expenditures on the Westside Energy Station until permanent financing is obtained. As of December 31, 2016, \$13.4 million had been drawn on the credit facility. In addition to the new debt issued, \$3.9 million was retired in 2016.

The Utility maintained an AA- bond rating from Fitch, and an Aa3 rating from Moody's with an outlook stable from both agencies. Additional details regarding the Utility's long-term debt may be found in Note 6 to the financial statements.

See accompanying *Independent Auditors' Report*.

FINANCIAL ANALYSIS – WATER UTILITY

Condensed Financial Information – Water Utility

December 31, 2016 and 2015

(In millions)

Statements of Revenues, Expenses, & Changes in Net Position

	2016	2015	Change 2016 vs. 2015
Operating Revenues	\$9.5	\$8.6	\$0.9
Operating Expenses	9.1	8.5	0.6
<i>Operating Income</i>	0.4	0.1	0.3
<i>Income Before Transfers and Capital Contributions</i>	0.4	0.1	0.3
Transfers Out (In Lieu Of Tax Payments)	(0.4)	(0.3)	(0.1)
Capital Contributions	2.8	2.8	-
<i>Change in Net Position</i>	2.8	2.6	0.2
Net Position - Beginning of Year	96.8	95.6	1.2
GASB 68 Implementation	-	(1.4)	1.4
Adjusted Net Position – Beginning of Year	96.8	94.2	2.6
Net Position - End of Year	\$99.6	\$96.8	\$2.8

Statements of Net Position

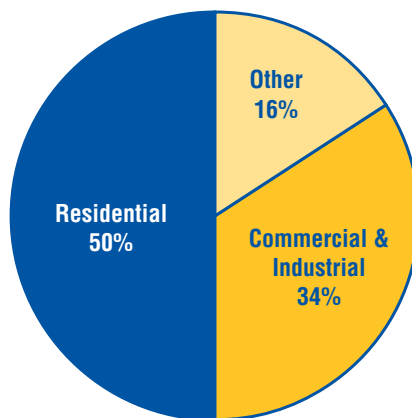
	2016	2015	Change 2016 vs. 2015
Cash and Investments	\$5.7	\$4.9	\$0.8
Other Current Assets	0.8	0.9	(0.1)
Capital Assets, Net	95.8	93.9	1.9
<i>Total Assets</i>	102.3	99.7	2.6
Deferred Outflows of Resources	0.9	0.2	0.7
Total Assets Plus Deferred Outflows of Resources	\$103.2	\$ 99.9	\$3.3
Current Liabilities	\$0.8	\$1.2	\$(0.4)
Noncurrent Liabilities	2.3	1.5	0.8
<i>Total Liabilities</i>	3.1	2.7	0.4
Deferred Inflows of Resources	0.5	0.4	0.1
Investment in Capital Assets	95.8	93.9	1.9
Unrestricted	3.8	2.9	0.9
<i>Net Position</i>	99.6	96.8	2.8
Total Liabilities, Deferred Inflows of Resources and Net Position	\$103.2	\$99.9	\$3.3

See accompanying *Independent Auditors' Report*.

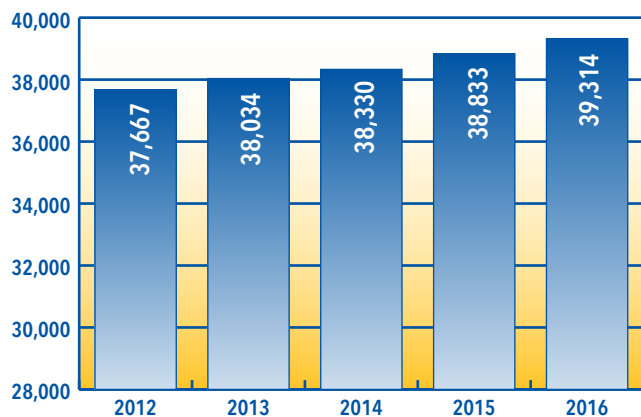
OPERATING REVENUES

Operating revenues increased by \$0.9 million (9.3%) in 2016. Retail revenues were up \$0.7 million (9.4%), due primarily to a 6.0% rate increase effective January 1, 2016, as well as increased industrial sales.

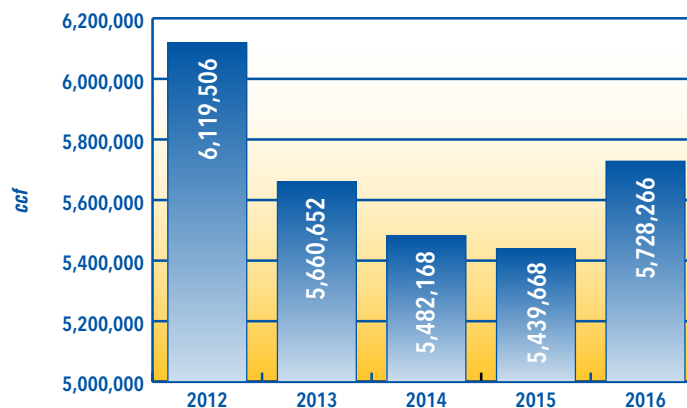
Water Operating Revenues



Number of Water Customers



Water Retail Sales

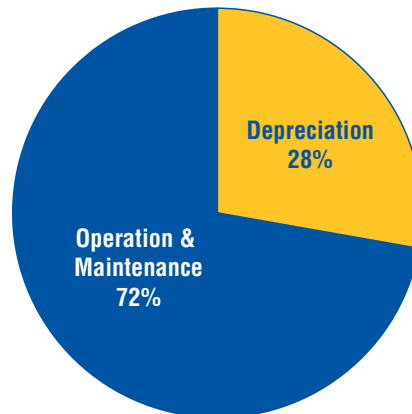


See accompanying *Independent Auditors' Report*.

OPERATING EXPENSES

Operating expenses increased by \$0.6 million (6.2%) in 2016 due to increases in billing fees, depreciation, and salaries and benefits.

Water Operating Expenses



IN LIEU OF TAX PAYMENTS

The Water Utility transfers an amount to the City of Rochester's General Fund each month based on the amount of retail ccf (hundred cubic feet) sold. In 2016, \$363,000 was transferred to the City. Because of the increase in ccf sales and an increase in the in lieu of tax rate, this was an increase of \$19,000 over 2015.

CAPITAL CONTRIBUTIONS

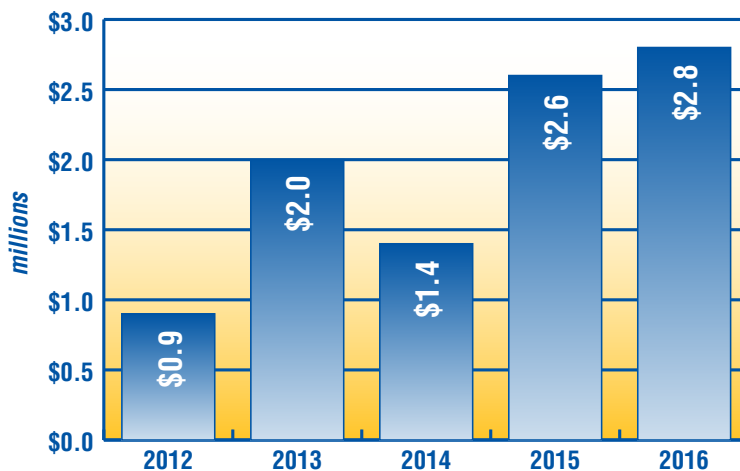
Capital contributions remained approximately the same in 2016. These are assets, primarily water mains and fire hydrants, which are contributed to the Water Utility from both the City and developers and are valued using a costing database that estimates their approximate construction costs. Beginning in 2013, the Utility took over the responsibility of paying for new water towers and reservoirs out of its own funds. The City collects a Water Availability Charge (WAC) specifically for this purpose and these funds will be used to reimburse the Water Utility for all or part of the cost of constructing new towers and reservoirs. A portion of the contribution total in 2016 consists of WAC funds received for reimbursement of the St. Bridget water tower construction costs.

See accompanying *Independent Auditors' Report*.

CHANGE IN NET POSITION

The increase in net position for 2016 was \$2.8 million, \$0.2 million higher than in 2015. This is due to a net increase in operating income in 2016.

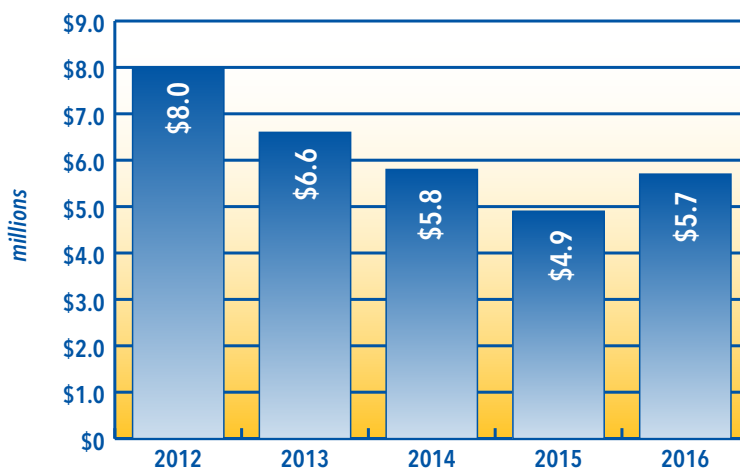
Water – Change in Net Position



CASH, INVESTMENTS AND OTHER ASSETS

The ending unrestricted cash and investments balance for 2016 was \$5.7 million, \$0.8 million higher than 2015.

Water – Unrestricted Cash & Investments



See accompanying *Independent Auditors' Report*.

LIABILITIES

Current liabilities decreased \$0.4 million in 2016 due to a decrease in accounts payable and in the amount owed to the City at the end of 2016.

Noncurrent liabilities increased \$0.8 million in 2016 due to an increase in pension liability for the Utility's proportionate share of the liability from the Minnesota Public Employees Retirement Association (PERA). The amount reported represents the difference between the actuarially determined benefits owed (total pension liability) and the assets accumulated by the pension plan.

NET POSITION

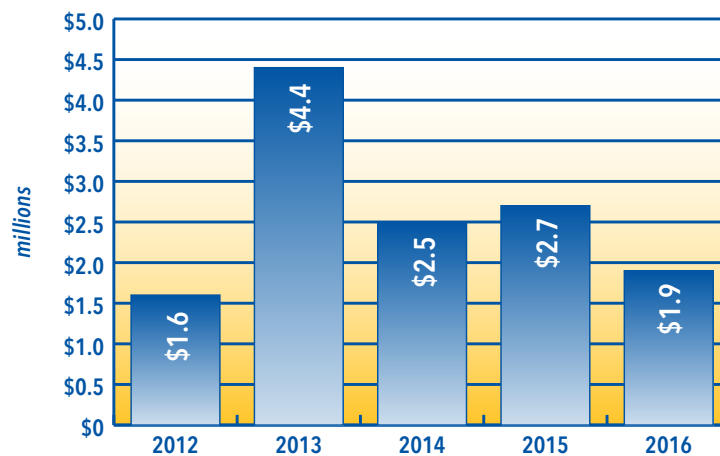
Net position invested in capital assets increased \$1.9 million. This increase reflects additions to capital assets funded through rate-based revenues and fees from customers as well as contributed assets.

Unrestricted net position is not subject to any constraints established by debt covenants or other legal requirements. In 2016, unrestricted net position increased \$0.9 million due to the results of operations and an increase in pension liability.

CAPITAL ASSETS

At December 31, 2016, the Water Utility had \$95.8 million invested in a broad range of utility capital assets, including 20 water storage facilities, 32 wells, water mains, pump station facilities, buildings, and equipment. Capital assets increased \$4.4 million in 2016, reflecting capital contributions as well as construction associated with the growth of the City and general facilities of the Water Utility. This increase in capital assets was partially offset by a \$2.5 million increase in accumulated depreciation. Additional details regarding the Utility's total assets (electric and water) may be found in Note 5 to the financial statements. Capital expenditures decreased by \$0.8 million in 2016. Some of the major expenditure components in 2016 were work on the new water tower, City projects, well house construction for Well #41 and metering.

Water - Capital Expenditures



See accompanying *Independent Auditors' Report*.

MISCELLANEOUS INFORMATION

ECONOMIC FACTORS

The City Council has approved Electric and Water rate increases as needed to support the Utility on a cost of service basis. In November 2015, the Utility Board approved a 1.7% rate increase for 2016 for the Electric Utility and a 6.0% rate increase for the Water Utility. The rate increases will build cash reserves for future replacement of infrastructure and maintain the financial health of both Utilities. The table below compares historical electric and water rate increases with the annual inflation rate, as well as an average for the last five years.

ROCHESTER PUBLIC UTILITIES ELECTRIC AND WATER RATE CHANGE VERSUS INFLATION

<u>Year</u>	<u>Inflation %</u>	<u>Electric Rates %</u>	<u>Water Rates %</u>
2017	2.0% *	3.7%	6.0%
2016	1.3% *	1.7%	6.0%
2015	0.1%	3.5%	3.5%
2014	1.6%	3.0%	1.5%
2013	1.5%	0.0%	0.0%
Annualized Average	1.3%	2.4%	3.4%

*Estimated Yearly Values

In addition to inflation, management continually plans for and identifies issues or potential contingencies that could impact future rates, such as system expansion, infrastructure needs, accelerated debt payments, future supply costs, regulatory changes, and others. Growth of the city directly affects several of these factors.

The housing market has been increasing. In 2016, there were 421 building permits totaling \$101.5 million issued for single-family homes as compared to 371 permits totaling \$87.5 million in 2015. Commercial building permits, however, decreased in 2016 to 35 with a dollar value of \$34.6 million from 45 in 2015 totaling \$44.0 million.

According to the US Department of Labor Bureau of Labor Statistics, the December 2016 unemployment rate of 3.3% for the area remains well below the state and national rates of 4.1% and 4.7%, respectively. The employment data shows that, on average, there were slightly more people working in the Rochester area than the previous year. During the past 12 months, the average unemployment rate for Rochester was 3.2%.

See accompanying *Independent Auditors' Report*.

The Destination Medical Center (DMC) initiative continues to develop and is projected to have a major impact to the future economic growth of the city. Legislation passed in 2013 required two bodies to be created: the DMC Corporation, an oversight body, and the DMC Economic Development Agency (EDA), a private nonprofit agency that contracts with the DMC Corporation Board to act as its staff, working with the City of Rochester and other stakeholders to develop and execute the DMC plans and strategy. These two groups were organized in 2013 and 2014 and now meet regularly. In March 2014, the EDA began work on the DMC Development Plan, which was adopted by the City of Rochester in March 2015 and by the DMC Corporation in April 2015. The EDA, working with stakeholder organizations and the City of Rochester, is now charged with implementing the DMC Development Plan over the next 20 years. Specifically for Rochester, this will mean the creation of thousands of new jobs and an estimated \$270 million in additional tax revenue over the next 20 years, along with the creation and retention of new businesses with a focus on biotech companies. Current priorities include Discovery Square, an integrated district for the future of biomedical, research, education, and technology innovation; Heart of the City, which would extend and enhance Peace Plaza; and transportation.

After examining all of these factors in the budgeting process, RPU has projected both electric and water rates to increase modestly over the next five years. As the result of a cost-of-service study completed in 2014, the Electric Utility is currently on a three-year rate track, with rate increases of 3.5%, 1.7% and 1.7%, respectively approved for 2015-2017. An additional rate increase of 2.0% was recently approved for 2017, adjusting the overall increase to 3.7%. The Water Utility is also currently on a three-year rate track after a 2015 cost-of-service study, with rate increases of 6.0% per year for 2016-2018.

REQUESTS FOR INFORMATION

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

See accompanying *Independent Auditors' Report*.

Electric Utility

Statement of Net Position

As of December 31, 2016

	2016
ASSETS:	
Current Assets:	
Cash and Cash Equivalents	\$6,641,528
Investments	34,111,666
Accounts Receivable and Accrued Utility Revenues	17,637,952
Inventories	4,926,547
Other Current Assets	571,797
Restricted Assets:	
Cash and Cash Equivalents	698,421
Total Current Assets	<u>64,587,911</u>
Noncurrent Assets:	
Restricted Assets:	
Investments	5,001,580
Capital Assets:	
Construction Work in Progress	33,713,148
Land and Land Rights	9,435,551
Depreciable Assets, Net	167,994,782
Net Capital Assets	<u>211,143,481</u>
Other Assets	<u>12,236,640</u>
Total Noncurrent Assets	<u>228,381,701</u>
Total Assets	<u>292,969,612</u>
DEFERRED OUTFLOWS OF RESOURCES	
Deferred Bond Refunding	1,849,484
Pension Deferred Outflows of Resources	7,493,487
Total Deferred Outflows of Resources	<u>9,342,971</u>
Total Assets Plus Deferred Outflows of Resources	<u>\$302,312,583</u>
LIABILITIES:	
Current Liabilities:	
Accounts Payable	\$16,127,106
Due to the Municipality	2,769,873
Accrued Compensated Absences	1,528,283
Accrued Compensation	381,184
Customer Deposits	592,163
Interest Payable	59,907
Current Maturities of Long-Term Debt	3,607,083
Current Liabilities Payable from Restricted Assets	
Interest Payable	370,504
Current Maturities of Long-Term Debt	327,917
Total Current Liabilities	<u>25,764,020</u>
Noncurrent Liabilities:	
Accrued Compensated Absences	1,155,623
Pre-1968 Pensions Liability	8,000
Net Pension Liability	17,900,174
Long-Term Debt	119,155,448
Total Noncurrent Liabilities	<u>138,219,245</u>
Total Liabilities	<u>163,983,265</u>
DEFERRED INFLOWS OF RESOURCES	
Deferred Revenue	1,473,314
Pension Deferred Inflows of Resources	2,146,980
Total Deferred Inflows of Resources	<u>3,620,294</u>
NET POSITION:	
Net Investment in Capital Assets	94,904,097
Restricted	
Debt Service	327,917
Unrestricted	<u>39,477,010</u>
Total Net Position	<u>134,709,024</u>
Total Liabilities, Deferred Inflows of Resources and Net Position	<u>\$302,312,583</u>

See accompanying Notes to Financial Statements.

Electric Utility

Statement of Revenues, Expenses, and Changes in Net Position

For the Year Ended December 31, 2016

	2016
Operating Revenues:	
Retail	\$142,010,940
Wholesale	2,311,084
Other	12,112,868
Total Operating Revenues	156,434,892
Operating Expenses:	
Purchased Power	92,699,804
Operations and Maintenance	29,688,703
Depreciation	9,392,360
Amortization of Regulatory Assets	412,123
Total Operating Expenses	132,192,990
Operating Income	24,241,902
Nonoperating Income (Expenses):	
Investment Income	256,460
Interest Expense	(3,290,782)
Amortization of Regulatory Assets	(215,762)
Miscellaneous, Net	(367,249)
Total Nonoperating (Expenses)	(3,617,333)
Income Before Transfers and Capital Contributions	20,624,569
Transfers Out	(8,470,041)
Capital Contributions	3,062,271
Change in Net Position	15,216,799
Net Position, Beginning of Year	119,492,225
Net Position, End of Year	\$134,709,024

See accompanying *Notes to Financial Statements*.

Electric Utility

Statement of Cash Flows

For the Year Ended December 31, 2016

	2016
Cash Flows From Operating Activities:	
Cash Received from Customers	\$143,107,240
Cash Paid to Suppliers	(98,900,186)
Cash Paid to Employees	(14,560,908)
Internal Activity - Payments From Other Funds	6,050,796
Service Territory Acquisition	(386,351)
Net Cash Provided By Operating Activities	35,310,591
Cash Flows From Noncapital Financing Activities:	
Operating Transfers to Other Funds	(8,455,756)
Cash Flows From Capital and Related Financing Activities:	
Additions to Utility Plant and Other Assets	(39,674,651)
Capital Contributions Received	3,062,271
Principal Payments on Bonds	(3,895,000)
Interest Payments on Bonds	(4,672,376)
Bond Issue Costs	(132,654)
Proceeds from Issuance of Bonds	13,350,000
Net Cash Used In Capital and Related Financing Activities	(31,962,410)
Cash Flows From Investing Activities:	
Interest Received	359,630
Investment Purchases	(3,432,185)
Investment Redemptions	5,738,692
Net Cash Provided By Investing Activities	2,666,137
Net Decrease in Cash and Cash Equivalents	(2,441,438)
Cash and Cash Equivalents, Beginning of Year	9,781,387
Cash and Cash Equivalents, End of Year	7,339,949
Classified As:	
Current Assets	6,641,528
Restricted Assets	698,421
Cash and Cash Equivalents, End of Year	\$7,339,949

	2016
Reconciliation of Operating Income to Net Cash Provided by Operating Activities:	
Operating Income	\$24,241,902
Adjustments to Reconcile Operating Income to	
Net Cash Provided by Operating Activities:	
Depreciation and Amortization	9,804,483
Bad Debts	224,085
Service Territory Payments	(386,351)
Miscellaneous Income	(367,249)
Interest Expense, Customer Deposits	(1,882)
(Increase) Decrease In:	
Accounts Receivable and Accrued Utility Revenues	(4,115,971)
Inventories	(45,407)
Other Current Assets	(331,949)
Increase (Decrease) In:	
Accrued Liabilities and Accounts Payable	11,372,403
Customer Deposits	9,804
Deferred Lease Revenues	(36,420)
Pension Deferred Outflow/Inflow	(5,056,857)
Net Cash Provided by Operating Activities	\$35,310,591

See accompanying *Notes to Financial Statements*.

Water Utility

Statement of Net Position

As of December 31, 2016

	2016
ASSETS:	
Current Assets:	
Cash and Cash Equivalents	\$929,814
Investments	4,775,634
Due From the Municipality	12,707
Accounts Receivable and Accrued Utility Revenues	615,112
Materials and Supplies Inventory	156,295
Other Current Assets	742
Total Current Assets	6,490,304
Noncurrent Assets:	
Capital Assets:	
Construction Work in Progress	3,670,970
Land and Land Rights	677,486
Depreciable Assets, Net	91,438,580
Net Capital Assets	95,787,036
Total Noncurrent Assets	95,787,036
Total Assets	102,277,340
DEFERRED OUTFLOWS OF RESOURCES	
Pension Deferred Outflows of Resources	880,549
Total Assets Plus Deferred Outflows of Resources	\$103,157,889
LIABILITIES:	
Current Liabilities:	
Accounts Payable	\$411,980
Accrued Compensated Absences	265,841
Accrued Compensation	45,637
Customer Deposits	58,038
Total Current Liabilities	781,496
Noncurrent Liabilities:	
Accrued Compensated Absences	172,833
Net Pension Liability	2,105,210
Total Noncurrent Liabilities	2,278,043
Total Liabilities	3,059,539
DEFERRED INFLOWS OF RESOURCES	
Deferred Revenue	213,234
Pension Deferred Inflows of Resources	254,212
Total Deferred Inflows of Resources	467,446
NET POSITION:	
Net Investment in Capital Assets	95,787,036
Unrestricted	3,843,868
Total Net Position	99,630,904
Total Liabilities, Deferred Inflows of Resources and Net Position	\$103,157,889

See accompanying *Notes to Financial Statements*.

Water Utility

Statement of Revenues, Expenses, and Changes in Net Position

For the Year Ended December 31, 2016

	2016
Operating Revenues:	
Retail	\$8,519,094
Other	942,180
Total Operating Revenues	9,461,274
Operating Expenses:	
Operations and Maintenance	6,528,964
Depreciation	2,524,656
Total Operating Expenses	9,053,620
Operating Income	407,654
Nonoperating Income (Expenses):	
Investment Income	62,791
Interest Expense	(20)
Miscellaneous, Net	(17,396)
Total Nonoperating Income	45,375
Income Before Transfers and Capital Contributions	453,029
Transfers Out	(362,771)
Capital Contributions	2,755,124
Change in Net Position	2,845,382
Net Position, Beginning of Year	96,785,522
Net Position, End of Year	\$99,630,904

See accompanying *Notes to Financial Statements*.

Water Utility

Statement of Cash Flows

For the Year Ended December 31, 2016

	2016
Cash Flows From Operating Activities:	
Cash Received from Customers	\$8,821,066
Cash Paid to Suppliers	(3,788,847)
Cash Paid to Employees	(1,702,069)
Internal Activity - Payments From Other Funds	188,074
Net Cash Provided By Operating Activities	3,518,224
Cash Flows From Noncapital Financing Activities:	
Operating Transfers to Other Funds	(361,290)
Cash Flows From Capital and Related Financing Activities:	
Additions to Utility Plant and Other Assets	(2,945,617)
Capital Contributions Received	513,232
Net Cash Used In Capital and Related Financing Activities	(2,432,385)
Cash Flows From Investing Activities:	
Interest Received	62,770
Investment Redemptions	(628,909)
Net Cash Used In Investing Activities	(566,139)
Net Increase in Cash and Cash Equivalents	158,410
Cash and Cash Equivalents, Beginning of Year	771,404
Cash and Cash Equivalents, End of Year	\$929,814

	2016
Reconciliation of Operating Income to Net Cash Provided by Operating Activities:	
Operating Income	\$407,654
Adjustments to Reconcile Operating Income to	
Net Cash Provided by Operating Activities:	
Depreciation	2,524,656
Bad Debts	26,051
Other	(17,396)
(Increase) Decrease In:	
Accounts Receivable and Accrued Utility Revenues	150,511
Materials and Supplies Inventory	(2,941)
Prepaid and Other Current Assets	(742)
Increase (Decrease) In:	
Accrued Liabilities and Accounts Payable	1,010,134
Customer Deposits	5,545
Deferred Revenue	6,972
Pension Deferred Outflow/Inflow	(592,220)
Net Cash Provided by Operating Activities	\$3,518,224

Noncash Capital and Related Financing Activities:	
Additions to Utility Plant and Other Assets Contributed By:	
City's Governmental Funds	\$28,845
Developers	\$2,213,047

See accompanying *Notes to Financial Statements*.

NOTES TO FINANCIAL STATEMENTS

As of and for the Year Ended December 31, 2016

NOTE 1: Summary of Significant Accounting Policies

The financial statements of Rochester Public Utilities (Utilities or RPU) have been prepared in conformity with accounting principles generally accepted in the United States of America as applied to enterprise funds of governmental units. The Governmental Accounting Standards Board (GASB) is the accepted standard-setting body for establishing governmental accounting and financial reporting principles.

The significant accounting principles and policies utilized by the Utilities are described below.

REPORTING ENTITY

The Utilities are comprised of two proprietary funds, the Electric and the Water Enterprise Funds of the City of Rochester, Minnesota (municipality). The Electric Utility is engaged in the generation, transmission, and distribution of electric power and energy, and related activities. The Water Utility is engaged in the supply, purification, and distribution of water, and related activities. The Utilities provide electric and water service to properties concentrated geographically in or near the City of Rochester.

The Utilities are a municipal utility governed by a five-member board under the authority of the Rochester City Council. The equity of the Utilities is vested in the City of Rochester, Minnesota.

MEASUREMENT FOCUS, BASIS OF ACCOUNTING AND FINANCIAL STATEMENT PRESENTATION

The Utilities are presented as enterprise funds of the municipality. Enterprise funds are used to report the same functions presented as business-type activities in the government-wide financial statements.

Activities are accounted for using the flow of economic resources measurement focus and the accrual basis of accounting. Under the accrual basis of accounting, revenues are recognized when earned and expenses are recorded when incurred, even though actual payment or receipt may not occur until after the period ends.

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

ASSETS, DEFERRED OUTFLOWS OF RESOURCES, LIABILITIES, DEFERRED INFLOWS OF RESOURCES AND NET POSITION

Deposits and Investments

For purposes of reporting cash flows the Utilities consider all highly liquid debt instruments purchased with an original maturity of 90 days or less to be cash equivalents.

Investments are stated at fair value, which is the amount at which an investment could be exchanged in a current transaction between willing parties. Fair values are based on quoted market prices. No investments are reported at amortized cost. Adjustments necessary to record investments at fair value are recorded in the operating statement as increases or decreases in investment income. Fair values may have changed significantly after year end.

Investment of utility funds is restricted by state statutes. Investments are limited to:

- (a) Direct obligations or obligations guaranteed by the United States or its agencies.
- (b) Shares of investment companies registered under the Federal Investment Company Act of 1940 and whose only investments are in securities described in (a) above.
- (c) General obligations of the State of Minnesota or its municipalities.
- (d) Bankers acceptances of United States banks eligible for purchase by the Federal Reserve System.
- (e) Commercial paper issued by United States corporations or their Canadian subsidiaries, of the highest quality, and maturing in 270 days or less.
- (f) Repurchase agreements with banks that are members of the Federal Reserve System with capitalization exceeding \$10,000,000, a reporting dealer to the Federal Reserve Bank of New York, or certain Minnesota securities broker-dealers.
- (g) Money market funds with institutions that have portfolios consisting exclusively of United States Treasury obligations and Federal Agency issues.
- (h) Guaranteed investment contract (gic's) issued or guaranteed by United States commercial banks or domestic branches of foreign banks or United States insurance company and with a credit quality in one of the top two highest categories.

As a department of the City of Rochester, MN, the utility is governed by the investment policy that has been adopted by the Rochester City Council. That policy follows the state statute for allowable investments.

Receivables/Payables and Accrued Utility Revenues

Outstanding balances between the Utilities and the primary government are reported as due from/to the municipality.

The Utilities provides an allowance for losses on receivables, as needed, for accounts considered uncollectible. Accounts receivable has been reduced by an Allowance for Doubtful Accounts of \$220,000 for the Electric Utility and \$20,000 for the Water Utility for December 31, 2016.

Revenues are recognized on the accrual basis of accounting and include estimated amounts for service rendered but not billed. Accrued revenue amounts are \$5,384,775 for the Electric Utility and \$169,772 for the Water Utility for the year ended December 31, 2016.

Inventories

Materials and supplies are generally used for construction, operation and maintenance work, not for resale. They are valued using the lower of moving average cost or market and charged to construction or expense when used. Fossil fuel inventory is valued at cost, using the last-in, first-out method.

Restricted Assets

Mandatory segregations of assets are presented as restricted assets. Such segregations are required by bond agreements and other external parties.

Other Current Assets

Prepaid expenses are recorded maintenance contracts related to computer equipment. Costs under these agreements are expensed over the time periods covered by the agreements.

Capital Assets

Capital assets are defined by the Utilities as assets with an initial, individual cost of \$5,000 or more, or group assets with a value of \$25,000 or more, and an estimated useful life in excess of one year.

Capital assets are recorded at cost or the fair value at the time of contribution to RPU. Major outlays for capital assets are capitalized as projects are constructed. Interest incurred during the construction phase is reflected in the capitalized value of the assets constructed, net of interest earned on the invested proceeds over the same period. Capital assets in service are depreciated or amortized using the straight-line method over the following useful lives:

Electric Plant	Years
Generation	10-60
Transmission	20-45
Distribution	10-50
General	5-50
 Water Plant	 Years
Source of Supply	15-70
Pumping	10-50
Water Treatment	30-80
Transmission and Distribution	50-80
General	5-80

Other Assets – Noncurrent

Other Assets – Noncurrent includes Regulatory Assets consisting of Bond Issue Costs and Service Territory Acquisition Costs.

A summary of changes in electric other assets for 2016 follows:

	<u>Balance 1/1/16</u>	<u>Increases</u>	<u>Decreases</u>	<u>Balance 12/31/16</u>
Bond issue costs	\$1,645,573	\$132,654	\$ -	\$1,778,227
Less: Amortization of bond issue costs	895,438	215,762	-	1,111,200
Nonoperating Other Assets	750,135			667,027
Regulatory asset-Service territory payments	16,025,362	377,847	-	16,403,209
Less: Amortization of Regulatory asset	4,421,473	412,123	-	4,833,596
Operating Other Assets	11,603,889			11,569,613
Net Other Assets	<u>\$12,354,024</u>			<u>\$12,236,640</u>

Deferred Outflows of Resources

The Electric Utility has issued revenue bonds to finance the advance and current refundings of the outstanding revenue bonds. The refundings resulted in a difference between the reacquisition price and net carrying amount of the old debt. This difference is being amortized and charged to operations over the bond term using the effective interest method. The unamortized balance as of December 31, 2016 is \$1,849,484.

Accrued Compensation and Compensated Absences

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

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

Customer Deposits

Customer deposits are recorded for security deposits paid by customers to receive utility services. Deposits are returned to customers with good credit history in accordance with criteria established in the Utilities' policies. Customers are paid interest on deposits at the rate established annually by the Minnesota Department of Commerce.

Long-Term Debt

Long-term debt and other obligations are reported as the Utilities' liabilities. Bond premiums and discounts are deferred and amortized over the life of the bonds using the effective interest method. Gains or losses on prior refundings are amortized over the remaining life of the old debt or the life of the new debt, whichever is shorter.

Deferred Inflows of Resources

The Electric Utility leases a portion of its transmission system, known as the North Loop, to Southern Minnesota Municipal Power Agency (SMMPA) under a noncancelable operating lease through the year 2030. The Utility is responsible for all operating and maintenance costs. The Utility received a lump sum payment of \$1,500,000 in 1989 and lease revenues are being recognized ratably over the lease term. The amount deferred as of December 31, 2016 was \$483,275.

The Electric Utility is currently constructing a substation to meet the specifications of a large customer. Under the terms of an agreement to build the substation according to those specifications, the customer is making a Contribution in Aid of Construction (CIAC) for redundant facilities for reliability purposes and also for substation capacity in excess of current needs. The customer can earn a refund of a portion of the CIAC for excess capacity based on their load requirements over the term from 2018 through 2027. As of December 31, 2016, \$990,039 of the CIAC the customer had made had been recorded as a Deferred Inflow of Resources representing the amount of the potential refund for construction costs related to excess capacity incurred as of that date. Starting in 2018, an annual determination will be made of whether or not the load requirement met the terms defined in the agreement to earn a refund. A portion of the excess capacity payment becomes ineligible for refund in each of those years if the load requirement specified in the agreement is not achieved. The amount of Deferred Inflow of Resources will be reduced each year through the ten year term, having either been refunded to the customer if load requirement has been met, or recorded as a Contribution in Aid of Construction if not met. The substation was still under construction as of December 31, 2016, and is expected to be in service in May, 2017.

The Water Utility has received advance payments for leasing antenna space on its water towers. The amount of advance payments held as of December 31, 2016 was \$213,234.

Pensions

For purposes of measuring the net pension liability, deferred outflows/inflows of resources, and pension expense, information about the fiduciary net position of the Public Employees Retirement Association of Minnesota (PERA) and additions to/deductions from PERA's fiduciary net position have been determined on the same basis as they are reported by PERA except that PERA's fiscal year end is June 30. For this purpose, plan contributions are recognized as of employer payroll paid dates and benefit payments and refunds are recognized when due and payable in accordance with the benefit terms. Investments are reported at fair value.

REVENUES AND EXPENSES

The Utilities distinguishes operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with a utility's principal ongoing operations. The principal operating revenues of the Utilities are charges to customers for sales and services. Operating expenses include the cost of sales and services, administrative expenses, and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.

Charges for Services

Billings are rendered and recorded monthly based on metered usage.

Current electric rates were approved by the Utility Board and the City Council and placed into effect on January 1, 2016.

Current water rates were approved by the Utility Board and the City Council and placed into effect on January 1, 2016.

Transfers

Transfers include the payment in lieu of taxes to the municipality.

Capital Contributions

Cash and capital assets are contributed to the Utilities from customers, the municipality or external parties. The value of property contributed to the Utilities is reported as revenues on the statement of revenues, expenses and changes in net position.

Significant Customers

Sales to the Electric Utility's largest customer were \$21,379,401 (\$17,340,565 Retail and \$4,038,836 Other) in 2016. No other customer accounted for more than 10% of the Electric Utility's operating revenues. No single customer accounted for more than 10% of the Water Utility's operating revenues.

EFFECT OF NEW ACCOUNTING STANDARDS ON CURRENT PERIOD FINANCIAL STATEMENTS

GASB has approved GASB Statement No. 74, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*, Statement No. 80, *Blending Requirements for Certain Component Units- an amendment of GASB Statement No. 14*, Statement No. 81, *Irrevocable Split-Interest Agreements*, Statement No. 82, *Pension Issues- an amendment of GASB Statements No. 67, No. 68 and No 73*, Statement No. 83, *Certain Asset Retirement Obligations* and Statement No. 84, *Fiduciary Activities*. When they become effective, application of these standards may restate portions of these financial statements.

NOTE 2: Deposits and Investments

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

The Utilities' equity in the City of Rochester cash and investment pool is based on actual cash receipts and disbursements and a monthly allocation of investment earnings on a pro-rata basis. Investments held in the investment pool, associated risks and fair value measurements are disclosed in the notes to the City of Rochester's basic financial statements included in the City's 2016 Comprehensive Annual Financial Report.

NOTE 3: Due to the Municipality

The following is a schedule of balances as of December 31, 2016:

<u>Due To</u>	<u>Due From</u>	<u>Principal Purpose</u>	<u>2015 Amount</u>
Municipality	Electric	General operating	\$59,051
Municipality	Electric	Payments in lieu of tax	692,352
Municipality	Electric	Sewer and Storm water revenue	2,674,284
Total Electric Due To Municipality			<u>3,425,687</u>
Electric	Municipality	Sewer and Storm water billing fees	121,650
Electric	Municipality	Utility bills	407,630
Electric	Municipality	Utility bill collections	130
Electric	Municipality	General operating	1,121
Electric	Municipality	Interest on investments	125,283
Total Electric Due From Municipality			<u>655,814</u>
Electric Net Due to Municipality			<u><u>\$2,769,873</u></u>
Municipality	Water	General operating	\$679
Municipality	Water	Street opening repairs	9,164
Municipality	Water	Payments in lieu of tax	26,228
Total Water Due To Municipality			<u>36,071</u>
Water	Municipality	Utility bills	9,559
Water	Municipality	WAC Funds	36,894
Water	Municipality	General operating	2,325
Total Water Due From Municipality			<u>48,778</u>
Water Net Due from Municipality			<u><u>\$12,707</u></u>

The following is a schedule of transfer balances for the year ending December 31, 2016:

<u>To</u>	<u>From</u>	<u>Principal Purpose</u>	<u>2016 Amount</u>
Municipality	Electric	Tax Equivalents	\$8,470,041
Municipality	Water	Tax Equivalents	\$362,771

NOTE 4: Restricted Assets

Certain proceeds of the Utilities' revenue bonds, as well as certain resources set aside for their repayment, are classified as restricted assets on the statement of net position because their use is limited. The following accounts are reported as restricted assets on the electric utility:

2016

Current Assets

Debt Service Account

\$698,421

Used to segregate resources accumulated for debt service payments over the next twelve months.

Noncurrent Restricted Assets

Reserve Account

\$5,001,580

Proceeds deposited to be used to pay principal and interest payments on long-term debt.

NOTE 5: Changes in Capital Assets

ELECTRIC

A summary of changes in electric capital assets for 2016 follows:

	Balance 1/1/16	Increases	Decreases	Balance 12/31/16
Capital assets, not being depreciated:				
Construction in progress	\$33,378,257	\$30,997,059	\$30,662,168	\$33,713,148
Land and land rights	4,748,483	4,687,068	-	9,435,551
Total capital assets, not being depreciated	<u>38,126,740</u>	<u>35,684,127</u>	<u>30,662,168</u>	<u>43,148,699</u>
Capital assets, being depreciated:				
Buildings, structures and improvements	35,912,550	2,428,297	-	38,340,847
Installations, equipment and fixtures	298,222,332	34,393,767	929,051	331,687,048
Total capital assets, being depreciated	<u>334,134,882</u>	<u>36,822,064</u>	<u>929,051</u>	<u>370,027,895</u>
Less: Accumulated depreciation	<u>193,261,515</u>	<u>9,392,360</u>	<u>620,762</u>	<u>202,033,113</u>
Depreciable Assets, Net	<u>140,873,367</u>			<u>167,994,782</u>
Net Capital Assets	<u>\$179,000,107</u>			<u>\$211,143,481</u>

WATER

A summary of changes in water capital assets for 2016 follows:

	Balance 1/1/16	Increases	Decreases	Balance 12/31/16
Capital assets, not being depreciated:				
Construction in progress	\$3,721,035	\$3,365,076	\$3,415,141	\$3,670,970
Land and land rights	677,486	-	-	677,486
Total capital assets, not being depreciated	4,398,521	3,365,076	3,415,141	4,348,456
Capital assets, being depreciated:				
Buildings, structures and improvements	17,354,255	1,749,614	-	19,103,869
Installations, equipment and fixtures	115,893,002	2,757,302	61,563	118,588,741
Total capital assets, being depreciated	133,247,257	4,506,916	61,563	137,692,610
Less: Accumulated depreciation	43,773,541	2,524,656	44,167	46,254,030
Depreciable Assets, Net	89,473,716			91,438,580
Net Capital Assets	\$93,872,237			\$95,787,036

In 2016, capital assets totaling \$28,845 were contributed to the Utility by other funds of the City of Rochester, and \$2,213,047 was contributed to the Utility by others.

NOTE 6: Long-Term Obligations**ELECTRIC**

The following revenue bonds have been issued:

Date	Purpose	Final Maturity	Interest Rate	Original Amount	Outstanding Amount 12/31/16
11/17/15	Revenue Bond Series 2015E-Advance refund a portion of the 2007C issue	12/1/30	3.00-5.00%	\$39,970,000	\$39,970,000
5/29/13	Revenue Bond Series 2013B-CapX 2020 Southwest Metro to Rochester to La Crosse transmission line project	12/1/43	3.00-5.00%	38,370,000	37,010,000
3/19/07	Revenue Bond Series 2007C-Emission reduction equipment at Silver Lake Plant, transmission and substation work, distribution system expansion, and advance refund of Series 2000A Bonds	12/1/30	4.00-5.00%	76,680,000	23,645,000
4/19/16	Temporary Subordinate Revenue Bond Series 2016A, Variable Rate of 0.38% plus 70% of the one-month LIBOR Rate	4/1/18	1.90%	13,350,000	13,350,000
2/26/13	Revenue Bond Series 2013A-Refund 2002 issue	12/1/17	2.00%	3,960,000	815,000

Revenue bond debt service requirements to maturity follows:

<u>Year Ending December 31</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2017	\$3,935,000	\$4,529,542	\$8,464,542
2018	17,655,000	4,292,450	21,947,450
2019	4,510,000	4,084,550	8,594,550
2020	4,730,000	3,869,363	8,599,363
2021	4,950,000	3,647,212	8,597,212
2022-2026	28,345,000	14,664,688	43,009,688
2027-2031	28,575,000	8,279,637	36,854,637
2032-2036	7,860,000	4,391,500	12,251,500
2037-2041	9,670,000	2,578,350	12,248,350
2042-2043	4,560,000	344,750	4,904,750
	<u>\$114,790,000</u>	<u>\$50,682,042</u>	<u>\$165,472,042</u>

All utility revenues net of specified operating expenses are pledged as security of the above revenue bonds until the bonds are defeased. Principal and interest paid for 2016 was \$8,567,376. Total gross revenues as defined for the same period were \$156,691,352. Annual principal and interest payments are expected to require 4% of gross revenues on average.

On April 19, 2016, a temporary subordinate revenue bond in the amount of \$25.0 million was issued in the form of a credit facility, or tax-exempt draw-down loan with U.S. Bank, at an average interest rate of 1.00%. The purpose of this borrowing was to provide temporary financing for the Westside Energy Station until permanent financing could be obtained. When that occurs, the amount drawn down at that date will be rolled into the permanent borrowing. As of December 31, 2016, \$13,350,000 has been drawn down on the loan.

LONG-TERM OBLIGATIONS SUMMARY - ELECTRIC

Long-term obligation activity for the year ended December 31, 2016 is as follows:

	<u>1/1/16 Balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>12/31/16 Balance</u>	<u>Due Within One Year</u>
Long-term debt	\$105,335,000	\$13,350,000	\$3,895,000	\$114,790,000	\$3,935,000
Bond discount/premium	9,388,414	10,152	1,098,118	8,300,448	-
Accrued Compensated Absences	2,801,573	249,461	367,128	2,683,906	1,528,283
Pre-1968 Pension Liability	10,000	-	2,000	8,000	-
Net Pension Liability	11,722,132	6,178,042	-	17,900,174	-
Totals	<u>\$129,257,119</u>	<u>\$19,787,655</u>	<u>\$5,362,246</u>	<u>\$143,682,528</u>	<u>\$5,463,283</u>

LONG-TERM OBLIGATIONS SUMMARY - WATER

Long-term obligation activity for the year ended December 31, 2016 is as follows:

	<u>1/1/16 Balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>12/31/16 Balance</u>	<u>Due Within One Year</u>
Accrued Compensated Absences	\$428,326	\$41,224	\$30,876	\$438,674	\$265,841
Net Pension Liability	1,400,562	704,648	-	2,105,210	-
Totals	<u>\$1,828,888</u>	<u>\$745,872</u>	<u>\$30,876</u>	<u>\$2,543,884</u>	<u>\$265,841</u>

INTEREST EXPENSE - ELECTRIC

	<u>2016</u>
Bond interest expense	\$4,642,109
Bond premium & discount amortization	(841,258)
Interest expense	68,569
Allowance for funds used during construction	(578,638)
Totals	<u>\$3,290,782</u>

NOTE 7: Net Position

GASB Statement No. 34 requires the classification of net position into three components – net investment in capital assets, restricted, and unrestricted. These classifications are defined as follows:

NET INVESTMENT IN CAPITAL ASSETS

This component of net position consists of capital assets, net of accumulated depreciation, reduced by the outstanding balances of bonds, mortgages, notes, or other borrowings that are attributable to the acquisition, construction, or improvement of those assets. Deferred outflows of resources and deferred inflows of resources that are attributable to the acquisition, construction, or improvement of those assets or related debt are included in this component of net position. If there are significant unspent related debt proceeds or deferred inflows of resources at the end of the reporting period, the portion of the debt or deferred inflows of resources attributable to the unspent amount are not included in the calculation of net investment in capital assets. Instead, that portion of the debt or deferred inflows of resources are included in the same net position component (restricted or unrestricted) as the unspent amount.

RESTRICTED

This component of net position consists of restricted assets reduced by liabilities and deferred inflows of resources related to those assets. Generally, a liability relates to restricted assets if the asset results from a resource flow that also results in the recognition of a liability or if the liability will be liquidated with the restricted assets reported.

UNRESTRICTED

This component of net position is the net amount of the assets, deferred outflows of resources, liabilities, and deferred inflows of resources that are not included in the determination of net investment in capital assets or the restricted component of net position.

NOTE 8: Pension Plans

A. Plan Description

The Utilities, as departments of the City of Rochester, participate in the General Employees Retirement Fund (GERF) cost-sharing multiple-employer defined benefit pension plan administered by the Public Employees Retirement Association of Minnesota (PERA). PERA's defined benefit pension plans are established and administered in accordance with Minnesota Statutes, Chapters 353 and 356. PERA's defined benefit pension plans are tax qualified plans under Section 401 (a) of the Internal Revenue Code.

All full-time and certain part-time employees of the Utilities are covered by the General Employees Retirement Fund (GERF). GERF members belong to either the Coordinated Plan or the Basic Plan. Coordinated Plan members are covered by Social Security and Basic Plan members are not. The Basic Plan was closed to new members in 1967. All new members must participate in the Coordinated Plan. All of RPU's current employees eligible to participate in the GERF are Coordinated Plan members.

Benefits Provided

PERA provides retirement, disability, and death benefits. Benefit provisions are established by state statute and can only be modified by the state legislature.

Benefit increases are provided to benefit recipients each January. Increases are related to the funding ratio of the plan. Members in a plan that are at least 90% funded for two consecutive years are given a 2.50% increase. Members in a plan that has not exceeded 90% funded, or has fallen below 80%, are given a 1.00% increase.

The benefit provisions stated in the following paragraphs of this section are current provisions and apply to active plan participants. Vested, terminated employees who are entitled to benefits but are not receiving them yet are bound by the provisions in effect at the time they last terminated their public service.

Benefits are based on a member's highest average salary for any five successive years of allowable service, age, and years of credit at termination of service. Two methods are used to compute benefits for PERA's Coordinated Plan members. The retiring member receives the higher of a step-rate benefit accrual formula (Method 1) or a level accrual formula (Method 2). Under Method 1, the annuity accrual rate for a Coordinated Plan member is 1.2 percent of average salary for each of the first ten years and 1.7 percent for each remaining year. Under Method 2, the annuity accrual rate is 1.7 percent for Coordinated Plan members for each year of service. For members hired prior to July 1, 1989 a full annuity is available when age plus years of service equal 90 and normal retirement age is 65. For members hired on or after July 1, 1989 normal retirement age is the age for unreduced Social Security benefits capped at 66.

Contributions

Minnesota Statutes Chapter 353 sets the rates for employer and employee contributions. Contribution rates can only be modified by the state legislature.

Coordinated Plan members were required to contribute 6.50% of their annual covered salary in calendar year 2016. The Utilities were required to contribute 7.50% for Coordinated Plan members in calendar year 2016. The Utilities' contributions to the GERF for the year ended December 31, 2016, were \$1,047,623 and \$125,295 for the Electric Utility and Water Utility respectively. The Utilities' contributions were equal to the required contributions as set by state statute.

B. Pension Costs

At December 31, 2016, the Electric Utility reported a liability of \$17,900,174, and the Water Utility reported a liability of \$2,105,210 as each utility's allocated share of the City of Rochester's proportionate share of \$59,036,914 of the GERS's net pension liability. The City of Rochester's net pension liability reflected a reduction due to the State of Minnesota's contribution of \$6 million to the fund in 2016. The State of Minnesota is considered a nonemployer contributing entity and the state's contribution meets the definition of a special funding situation. The State of Minnesota's proportionate share of the net pension liability associated with the City of Rochester totaled \$771,048. The net pension liabilities were measured as of June 30, 2016 and the total pension liabilities used to calculate the net pension liabilities were determined by an actuarial valuation as of that date. The City of Rochester's net pension liability was based on the City's contributions received by PERA during the measurement period for employer payroll paid dates from July 1, 2015, through June 30, 2016, relative to the total employer contributions received from all of PERA's participating employers. At June 30, 2016, the City's proportion share was 0.7271% which was a decrease of 0.0139% from its proportion measured as of June 30, 2015.

For the year ended December 31, 2016, the Electric Utility and Water Utility recognized pension expense of \$2,121,645 and \$232,171 respectively as allocated shares of the City of Rochester's GERS pension expense.

At December 31, 2016, the Electric Utility reported its allocated share of the City of Rochester's GERS deferred outflows of resources and deferred inflows of resources related to pensions from the following sources:

	<u>Deferred Outflows of Resources</u>	<u>Deferred Inflows of Resources</u>
Differences between expected and actual economic experience	\$ -	\$1,462,720
Changes in actuarial assumptions	3,504,870	-
Difference between projected and actual investment earnings	3,418,603	-
Changes in proportion	-	684,260
Contributions paid to PERA subsequent to the measurement date	570,014	-
Total	<u>\$7,493,487</u>	<u>\$2,146,980</u>

\$570,014 reported as deferred outflows of resources related to pensions resulting from Electric Utility contributions subsequent to the measurement date will be recognized as a reduction of the net pension liability in the year ended December 31, 2017. Other amounts reported as deferred outflows and inflows of resources related to pensions will be recognized in pension expense as follows:

Year ended December 31:	Pension Expense Amount
2017	\$1,224,459
2018	1,224,459
2019	1,680,990
2020	646,585
Total	<u>\$4,776,493</u>

At December 31, 2016, the Water Utility reported its allocated share of the City of Rochester's GERS deferred outflows of resources and deferred inflows of resources related to pensions from the following sources:

	<u>Deferred Outflows of Resources</u>	<u>Deferred Inflows of Resources</u>
Differences between expected and actual economic experience	\$ -	\$172,763
Changes in actuarial assumptions	412,202	-
Difference between projected and actual investment earnings	403,615	-
Changes in proportion	-	81,449
Contributions paid to PERA subsequent to the measurement date	64,732	-
Total	<u>\$880,549</u>	<u>\$254,212</u>

\$64,732 reported as deferred outflows of resources related to pensions resulting from Water Utility contributions subsequent to the measurement date will be recognized as a reduction of the net pension liability in the year ended December 31, 2017. Other amounts reported as deferred outflows and inflows of resources related to pensions will be recognized in pension expense as follows:

Year ended December 31:	Pension Expense Amount
2017	\$143,672
2018	143,671
2019	198,218
2020	76,044
Total	<u>\$561,605</u>

C. Actuarial Assumptions

The total pension liability in the June 30, 2016, actuarial valuation was determined using the following actuarial assumptions:

Inflation	2.50% per year
Active Member Payroll Growth	3.25% per year
Investment Rate of Return	7.50%

Salary increases were based on a service-related table. Mortality rates for active members, retirees, survivors and disabilitants were based on RP-2014 tables for males or females, as appropriate, with slight adjustments. Cost of living benefit increases for retirees are assumed to be: 1% for all future years.

Actuarial assumptions used in the June 30, 2016, valuation were based on the results of actuarial experience studies. The most recent four-year experience study in the General Employees Plan was completed in 2015.

The following changes in actuarial assumptions occurred in 2016:

- The assumed post-retirement benefit increase rate was changed from 1.0% per year through 2035 and 2.5% per year thereafter to 1.0% per year for all future years.
- The assumed investment return was changed from 7.9% to 7.5%. The single discount rate was changed from 7.9% to 7.5%.
- Other assumptions were changed pursuant to the experience study dated June 30, 2015. The assumed future salary increases, payroll growth, and inflation were decreased by 0.25% to 3.25% for payroll growth and 2.50% for inflation.

The long-term expected rate of return on pension plan investments is 7.50%. The State Board of Investment, which manages the investments of PERA, prepares an analysis of the reasonableness on a regular basis of the long-term expected rate of return using a building-block method in which best estimate ranges of expected future rates of return are developed for each major asset class. These ranges are combined to produce an expected long-term rate of return by weighting the expected future rates of return by the target asset allocation percentages. The target allocation and best estimates of geometric real rates of return for each major asset class are summarized in the following table:

Asset Class	Target Allocation	Long-Term Expected Real Rate of Return
Domestic Stocks	45%	5.50%
International Stocks	15%	6.00%
Bonds	18%	1.45%
Alternative Assets	20%	6.40%
Cash	2%	0.50%

D. Discount Rate

The discount rate used to measure the total pension liability in 2016 was 7.50%, a reduction from the 7.9% used in 2015. The projection of cash flows used to determine the discount rate assumed that contributions from plan members and employers will be made at rates set in Minnesota Statutes. Based on these assumptions, the fiduciary net position of the General Employees Fund was projected to be available to make all projected future benefit payments of current plan members. Therefore, the long-term expected rate of return on pension plan investments was applied to all periods of projected benefit payments to determine the total pension liability.

E. Pension Liability Sensitivity

The following presents the Electric Utility's and Water Utility's allocated shares of the City of Rochester's net pension liability for the GERP plan participated in, calculated using the discount rate disclosed in the preceding paragraph, as well as what the each utility's allocated share of the net pension liability would be if it were calculated using a discount rate 1 percentage point lower or 1 percentage point higher than the current discount rate:

	1% Decrease in Discount Rate (6.5%)	Discount Rate (7.5%)	1% Increase in Discount Rate (8.5%)
Electric Utility's allocated share of the GERP net pension liability:	\$25,423,552	\$17,900,174	\$11,702,958
Water Utility's allocated share of the GERP net pension liability:	\$2,990,023	\$2,105,210	\$1,376,366

F. Pension Plan Fiduciary Net Position

Detailed information about each pension plan's fiduciary net position is available in a separately issued PERA financial report that includes financial statements and required supplementary information. That report may be obtained on the Internet at www.mnpera.org.

G. Other Pension Plans

The Utilities had maintained an unqualified supplemental pension plan. The plan was unfunded and was discontinued in 1968. Funds have been deposited with a plan administrator to fund the estimated benefits due under the plan. The pension reserve deposit as of December 31, 2016 was \$33,841.

NOTE 9: Risk Management

The Utilities are exposed to various risks of loss related to torts, theft of, damage to, or destruction of assets, errors and omissions. These risks are covered through the purchase of commercial insurance, with minimal deductibles. Settled claims have not exceeded the commercial liability in any of the past three years. There were no significant reductions in coverage compared to the prior year.

The City of Rochester has established a self-insurance program for group health coverage and workers' compensation. Rochester Public Utilities participates in this self-insurance program. The group health program is limited to losses of \$275,000 per claim with a variable annual aggregate, and the 2016 workers' compensation coverage is limited to \$1,000,000 per occurrence, both through the use of stop-loss policies. The City recognizes a liability on individual claims when a loss is probable and the amount can be reasonably estimated. In addition, the City recognizes an estimated liability on unreported claims that are incurred but not yet reported. Additional details regarding the self-insurance program are disclosed in the notes to the City of Rochester's basic financial statements included in the City's 2016 Comprehensive Annual Financial Report.

NOTE 10: Accounting for the Effects of Rate Regulation

The Utilities are subject to the provisions of GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 10, 1989 FASB and AICPA Pronouncements*. This statement recognizes the economic ability of regulators, through the ratemaking process, to create future economic benefits and obligations affecting rate-regulated entities. Accordingly, the Utilities record these future economic benefits and obligations as regulatory assets and regulatory liabilities, respectively.

Regulatory assets represent probable future revenues associated with previously incurred costs that are expected to be recovered from customers. Regulatory liabilities represent probable future reductions in revenues associated with amounts that are expected to be refunded to customers through the ratemaking process.

In order for a rate-regulated entity to continue to apply the provisions of GASB Statement No. 62, it must continue to meet the following three criteria:

1. The entities' rates for regulated services provided to its customers must be established by an independent third-party regulator or its own governing board empowered by a statute to establish rates that bind customers;
2. The regulated rates must be designed to recover the specific entities' costs of providing the regulated services;
3. In view of the demand for the regulated services and the level of competition, it is reasonable to assume that rates set at levels that will recover the entities' costs can be charged to and collected from customers.

Based upon the Utilities' management evaluation of the three criteria discussed above in relation to its operations, and the effect of competition on its ability to recover its costs, the Utilities believe that GASB Statement No. 62 continues to apply.

NOTE 11: Commitments and Contingencies

POWER SALES AGREEMENT

The Electric Utility has a Resource Management Agreement with The Energy Authority, Inc. as its market participant in the Midcontinent Independent System Operator energy and operating reserves market for the Cascade Creek combustion turbines.

SERVICE TERRITORY SETTLEMENTS

Under settlement agreements with People's Energy Cooperative (PEC), the Electric Utility is required to make payments to PEC related to the acquisitions of certain electric service rights from PEC. The payment is based on kilowatt hours (kWh) sold in acquired areas and varies by each settlement agreement. The kWh compensation rate ranges from 13.49 mills (tenths of a cent) per kWh to 16.46 mills per kWh. These commitments expire over various periods with a maximum term of ten years for each acquisition. Costs are recognized under these agreements as service is provided and are recorded as a regulatory asset for utility rate-making purposes under the provisions of GASB Statement No. 62 and amortized over 40 years.

SOUTHERN MINNESOTA MUNICIPAL POWER AGENCY

The Electric Utility is a voting member of the Southern Minnesota Municipal Power Agency (SMMPA). The Utility has entered into a power purchase contract with SMMPA, whereby SMMPA will provide all Utility power requirements up to 216 megawatts, the contract rate of delivery. This contract expires in the year 2030. In 1999, the Utility and SMMPA agreed to a contract rate of delivery (CROD) that began in 2000. The CROD caps the amount of power SMMPA must supply to the Utility under the power purchase contract. The Utility is responsible for acquiring its power needs above the CROD. The Utility purchased 1,230,780,640 kilowatt hours totaling \$91,687,490 from SMMPA during the year ended December 31, 2016.

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

WESTSIDE ENERGY STATION

Construction of the Westside Energy Station began in October, 2016. It is comprised of five 9,600KW Wärtsilä reciprocating gas engines with a total capacity of 48MW at an approximate cost of \$75 million. The quick responding, highly efficient natural gas powered generating station will provide for future capacity needs and support system reliability. As more intermittent renewable generation is added to the regional grid, quick responding generating units such as this are critical to ensure grid stability. Work prior to construction included acquiring the necessary permits, purchasing the engines, executing an engineer, procure, and construct (EPC) contract with Westside Energy Partners (a collaboration between Sargent & Lundy and Boldt Construction), and performing detailed design. The anticipated in-service date for the plant is spring of 2018.

The contract purchase price for the Wärtsilä engines was \$22,516,646 USD, of which \$18,731,184 USD was denominated in Euro's. After making an initial deposit of \$1,404,839 USD on the Euro-denominated portion of the purchase price, RPU was exposed to foreign exchange risk on the remaining \$17,326,345 USD from December 28, 2015, the date the contract was executed, until August 31, 2016, the date RPU gave Wärtsilä notice to proceed with construction after RPU had obtained the necessary permits.

In order to limit and manage the foreign exchange risk and overall purchase cost of the Wärtsilä engine purchase, RPU entered into two forward contracts to mitigate the Euro US Dollar exchange rate risk as follows:

		<u>USD</u>	<u>Exchange Rate</u>	<u>Euro's</u>
2/18/2016	Forward Contract dated 3/1/2017 to Purchase Euro's	(\$17,000,000)	@1.1274	15,078,943
8/31/2016	Forward Contract dated 3/1/2017 to Sell Euro's	16,926,114	@1.1225	(15,078,943)
12/28/2015	Euro Denominated portion of Wärtsilä contract	17,326,345	@1.1266	15,379,323
8/31/2016	Euro Denominated portion of Wärtsilä contract	(17,175,628)	@1.1168	(15,379,323)
	Gain	76,831		
	Transaction Costs	(20,356)		
	Net Gain	\$56,475		

The two forward contracts were abated on September 14, 2016. The gain is included as part of the engine purchase.

OPEN CONSTRUCTION CONTRACTS AND OTHER SIGNIFICANT COMMITMENTS

The Utilities have several active projects and agreements as of December 31, 2016. At year end, the Utilities' significant commitments are as follows:

<u>Electric Projects</u>	<u>Spent-to-Date</u>	<u>Remaining Commitment</u>
CapX 2020	\$40,634,088	\$1,247,615
West Side Energy Station	20,229,998	42,614,478
Stock Materials	5,399,766	667,667
Douglas Trail Substation	3,016,752	2,920,663
FERC filing	746,303	98,697
Cayenta Implementation	566,822	1,498,306
Customer Billing and Payments	87,121	1,976,879
Engineering Services	48,845	150,270
NERC Compliance	33,443	105,495
Building Expansion	17,149	735,676
Communication Systems	419	147,599
Tree trimming	-	772,222
Cascade Creek Transformer Replacement	-	765,615
Insurance	-	535,590
Equipment	-	213,008
Generator Maintenance	-	109,015

<u>Water Projects</u>	<u>Spent-to-Date</u>	<u>Remaining Commitment</u>
Uniforms	15,869	10,303
Engineering & Consulting	11,785	44,711
Watermain Relocation	-	71,405
Stock Materials	-	29,768
12" Insert Valve	-	19,000
Well Motor Repair	-	11,002

LEGAL MATTERS

The Electric Utility is engaged in an administrative hearing before the Federal Energy Regulatory Commission involving the recovery of RPU's Annual Transmission Revenue Requirement from transmission customers in the Midcontinent Independent System Operator, Inc. region. It does not involve a claim or assessment against RPU. It is not presently expected that the outcome of this matter, when resolved, will have a material adverse impact on the financial position of the Electric Utility.

CLAIMS AND JUDGMENTS

From time to time, the Utilities are party to various pending claims and legal proceedings. Although the outcome of such matters cannot be forecasted with certainty, it is the opinion of management and the Utilities' attorney that the likelihood is remote that any such claims or proceedings will have a material adverse effect on the Utilities' financial position or results of operations.

NOTE 12: Subsequent Events

In November 2016, the Utility Board and the City Council approved a 3.7% overall rate increase for the Electric Utility effective January 1, 2017.

In November 2015, the Utility Board and the City Council approved rate schedules to be effective January 1, 2016, 2017 and 2018 for the Water Utility. The general increase is 6.0% each year.

On February 15, 2017, the Electric Utility issued Revenue and Refunding Bonds (Series 2017A) in the amount of \$108,255,000. The proceeds of the Bonds, along with other available funds, will be used to finance additional Electric Utility capital improvements including without limitation the Westside Energy Station, a portion of RPU's percentage interest in the CapX2020 Hampton to Rochester to La Crosse transmission line project, improvements to the Lake Zumbro Hydroelectric facility, expansion of the 4000 East River Road NE service center, refund the City's Temporary Subordinate Electric Utility Revenue Bond, Series 2016A which was previously issued to finance the initial stages of construction of the Westside Energy Station, currently refund the outstanding portion of the Series 2007C Bonds, fund certain debt reserves, and fund the costs of issuance. The total amount of debt refunded was \$44,495,000, of which \$20,850,000 was the balance on the Series 2016A Bond and \$23,645,000 was the outstanding portion of the Series 2007C Bonds.

On February 28, 2017, the RPU Board of Directors approved executing a contract between the RPU Water Utility and Osseo Construction Co. LLC for \$295,000 for repairing and repainting a 500,000 gallon water tower located in northwest Rochester. The work is to be completed in 2017.

On February 28, 2017, the RPU Board of Directors approved executing a five-year contract between the RPU Electric Utility and Ancor Information Management, DBA Utilitec, for \$1,380,400. Under the terms of the contract Utilitec is to print and mail utility bills to RPU customers as well as some additional customer notices. The start of the five year period will be effective with the implementation of a new utility billing customer account system anticipated in late 2017.

On March 28, 2017, the RPU Board of Directors approved executing a five-year contract between the RPU Electric Utility and A&A Electric & Underground Construction, Inc. for \$3,128,650. Under the terms of the agreement, the contractor is to provide directional boring and related services which results in the installation of electrical and communication conduit and cable, primarily in existing residential neighborhoods.

In preparing these financial statements, Rochester Public Utilities has evaluated events and transactions for potential recognition or disclosure through March 31, 2017, the date the financial statements were available to be issued.

REQUIRED SUPPLEMENTARY INFORMATION (unaudited)

As of and for the Year Ended December 31, 2016

The Schedule of Employer Contributions shows the employer's required annual contributions from the annual actuarial valuation, compared with the actual contributions remitted over the past ten years.

Schedule of Rochester Public Utilities – Electric Utility Contributions Public Employees General Employees Retirement Fund Required Supplementary Information (Last Ten Years*)

Fiscal Year Ending (for the Financial Reporting Period)	Statutorily Required Contribution (a)	Contributions in Relation to the Statutorily Required Contribution (b)	Contribution Deficiency (Excess) (a-b)	Covered-Employee Payroll (d)	Contributions as a Percentage of Covered-Employee Payroll (b/d)
December 31, 2015	\$1,053,611	\$1,053,611	\$ -	\$14,048,147	7.5%
December 31, 2016	\$1,047,623	\$1,047,623	\$ -	\$13,968,307	7.5%

*This schedule is presented prospectively beginning with the fiscal year ended December 31, 2015.

Schedule of Rochester Public Utilities – Water Utility Contributions Public Employees General Employees Retirement Fund Required Supplementary Information (Last Ten Years*)

Fiscal Year Ending (for the Financial Reporting Period)	Statutorily Required Contribution (a)	Contributions in Relation to the Statutorily Required Contribution (b)	Contribution Deficiency (Excess) (a-b)	Covered-Employee Payroll (d)	Contributions as a Percentage of Covered-Employee Payroll (b/d)
December 31, 2015	\$125,932	\$125,932	\$ -	\$1,679,093	7.5%
December 31, 2016	\$125,295	\$125,295	\$ -	\$1,670,600	7.5%

*This schedule is presented prospectively beginning with the fiscal year ended December 31, 2015.

See accompanying *Independent Auditors' Report* and accompanying *Note to the Required Supplementary Information*.

**Schedule of Rochester Public Utilities – Electric Utility Proportionate Share of Net Pension Liability
Public Employees General Employees Retirement Fund
Required Supplementary Information (Last Ten Years*)**

Fiscal Year Ending (for the Measurement Period)	City of Rochester's Proportion (Percentage) of Net Pension Liability (Asset)	RPU Electric Utility's Allocated Share (Amount) of the Net Pension Liability (Asset) (a)	RPU Electric Utility's Covered-Employee Payroll (b)	RPU Electric Utility's Allocated Share of the Net Pension Liability (Asset) as a Percentage of its Covered-Employee Payroll (a/b)	Plan Fiduciary Net Position as a Percentage of the Total Pension Liability
June 30, 2015	0.7410%	\$11,722,132	\$13,004,761	90.14%	78.19%
June 30, 2016	0.0727%	\$17,900,174	\$13,124,826	136.38%	68.91%

**Schedule of Rochester Public Utilities – Water Utility Proportionate Share of Net Pension Liability
Public Employees General Employees Retirement Fund
Required Supplementary Information (Last Ten Years*)**

Fiscal Year Ending (for the Measurement Period)	City of Rochester's Proportion (Percentage) of Net Pension Liability (Asset)	RPU Water Utility's Allocated Share (Amount) of the Net Pension Liability (Asset) (a)	RPU Water Utility's Covered-Employee Payroll (b)	RPU Water Utility's Allocated Share of the Net Pension Liability (Asset) as a Percentage of its Covered-Employee Payroll (a/b)	Plan Fiduciary Net Position as a Percentage of the Total Pension Liability
June 30, 2015	0.7410%	\$1,400,562	\$1,512,163	92.62%	78.19%
June 30, 2016	0.0727%	\$2,105,210	\$1,582,656	133.02%	68.91%

See accompanying *Independent Auditors' Report* and accompanying *Note to the Required Supplementary Information*.

NOTE TO THE REQUIRED SUPPLEMENTARY INFORMATION

As of and for the Year Ended December 31, 2016

NOTE 1: General Employees Retirement Fund (GERF) administered by the Public Employees Retirement Association of Minnesota (PERA)

The amounts determined for each fiscal year were determined as of the calendar year-end that occurred within the fiscal year. The City of Rochester is required to present the last ten fiscal years of data; however accounting standards allow the presentation of as many year as are available until ten fiscal years are presented.

There were no changes of benefit terms for any participating employer in the GERF.

The following changes in actuarial assumptions occurred in 2016:

- The assumed post-retirement benefit increase rate was changed from 1.0% per year through 2035 and 2.5% per year thereafter to 1.0% per year for all future years.
- The assumed investment return was changed from 7.9% to 7.5%. The single discount rate was changed from 7.9% to 7.5%.
- Other assumptions were changed pursuant to the experience study dated June 30, 2015. The assumed future salary increases, payroll growth, and inflation were decreased by 0.25% to 3.25% for payroll growth and 2.50% for inflation.

OPERATING AND FINANCIAL STATISTICS (unaudited)

ELECTRIC

	<u>2016</u>	<u>2015</u>	<u>2014</u>	<u>2013</u>	<u>2012</u>	<u>2007</u> <i>(ten years ago)</i>
RETAIL CUSTOMERS:						
Residential	48,426	46,961	46,035	45,651	45,244	42,429
General Service	4,862	4,807	4,759	4,725	4,740	4,519
Industrial / Commercial	2	2	2	2	2	2
Other	4	4	4	4	4	4
Total Retail Customers	53,294	51,774	50,800	50,382	49,990	46,954
RETAIL SALES: (mWh)						
Residential	346,974	335,708	341,452	348,952	342,986	342,601
General Service	653,742	644,067	637,360	641,210	634,692	640,913
Industrial / Commercial	194,520	205,164	212,297	225,082	236,566	307,952
Other	14,770	14,453	15,252	15,442	16,199	16,431
Total Retail Sales (mWh)	1,210,006	1,199,392	1,206,361	1,230,686	1,230,443	1,307,897
RETAIL REVENUE:						
Residential	\$46,886,573	\$44,025,807	\$42,818,865	\$42,344,833	\$41,924,195	\$37,758,843
General Service	69,181,817	66,051,022	63,734,518	62,342,255	62,452,007	55,981,623
Industrial / Commercial	18,212,053	18,227,249	18,277,321	18,562,734	19,405,820	20,276,556
Other	7,730,497	5,256,388	5,617,573	5,614,439	5,698,237	4,520,207
Total Retail Revenue	\$142,010,940	\$133,560,465	\$130,448,277	\$128,864,261	\$129,480,259	\$118,537,229
Steam Sales (MLBs)	453,699	441,791	424,402	451,945	447,579	391,828
Steam Revenues	\$4,038,836	\$5,412,228	\$6,743,606	\$4,849,550	\$5,427,419	\$4,449,701
Annual Peak (Megawatts)	276.2	262.0	258.7	278.6	287.8	276.2
Total mWh Generated	55,396	47,384	20,770	75,775	38,210	395,558
Total mWh Purchased	1,239,832	1,226,956	1,237,135	1,255,701	1,273,851	1,338,176
Year End Restricted/ Unrestricted Cash & Investment Balance	\$46,453,195	\$51,201,139	\$60,598,748	\$76,101,705	\$45,760,328	\$61,308,702

WATER

	<u>2016</u>	<u>2015</u>	<u>2014</u>	<u>2013</u>	<u>2012</u>	<u>2007</u> <i>(ten years ago)</i>
RETAIL CUSTOMERS:						
Residential	35,736	35,332	34,871	34,571	34,213	32,671
Industrial / Commercial	3,578	3,501	3,459	3,463	3,454	3,399
Total Retail Customers	39,314	38,833	38,330	38,034	37,667	36,070
RETAIL SALES: (ccf)						
Residential	2,654,992	2,675,696	2,792,307	2,863,062	3,170,446	3,180,064
Industrial / Commercial	3,073,274	2,763,972	2,689,861	2,797,590	2,949,060	3,189,389
Total Retail Sales (ccf)	5,728,266	5,439,668	5,482,168	5,660,652	6,119,506	6,369,453
RETAIL REVENUE:						
Residential	\$4,768,468	\$4,385,870	\$4,283,619	\$4,286,290	\$4,526,267	\$4,257,801
Industrial / Commercial	3,236,888	2,806,087	2,647,654	2,684,057	2,808,702	2,865,348
Public Fire Protection	513,738	596,323	571,535	558,113	555,154	528,748
Total Retail Revenue	\$8,519,094	\$7,788,280	\$7,502,808	\$7,528,460	\$7,890,123	\$7,651,897
Total Pumped (billion gallons)	4.5	4.3	4.4	4.5	4.8	5.1
Year End Restricted/ Unrestricted Cash & Investment Balance	\$5,705,448	\$4,918,129	\$5,747,264	\$6,569,559	\$7,959,122	\$3,843,521

LEADERSHIP



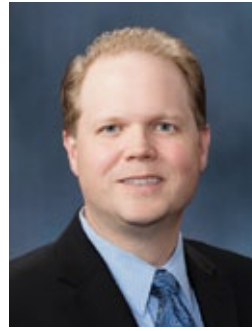
Mark Kotschevar
General Manager



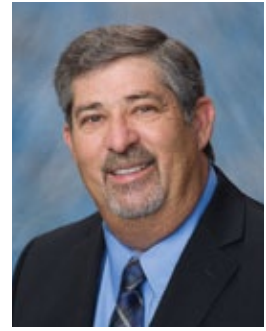
Sidney Jackson
*Director of
Core Services*



Peter Hogan
*Director of
Corporate Services*



Steve Nyhus
*Director of
Compliance and
Public Affairs*



Walter Schlink
*Director of
Power Resources/
Customer Relations*

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*Board Member &
City Council Liaison
Owner – Elite
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City of Rochester*

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