# MICHIGAN SOUTH CENTRAL POWER AGENCY

Litchfield, Michigan

FINANCIAL STATEMENTS

June 30, 2007 and 2006

Michigan Department of Treasury
496 (02/06)

# Auditing Procedures Report

Issued under P.A. 2 of 1968, as amended and P.A. 71 of 1919, as amended.

| Local Unit of Government Type | Local Unit Name | County |
|---|---|---|
| ☐County ☐City ☐Twp ☐Village ☒Other | Michigan South Central Power Authority | Hillsdale |

| Fiscal Year End | Opinion Date | Date Audit Report Submitted to State |
|---|---|---|
| June 30, 2007 | August 30, 2007 | September 12, 2007 |

We affirm that:

We are certified public accountants licensed to practice in Michigan.

We further affirm the following material, "no" responses have been disclosed in the financial statements, including the notes, or in the Management Letter (report of comments and recommendations).

| | YES | NO | **Check each applicable box below.** (See instructions for further detail.) |
|---|---|---|---|
| 1. | ☒ | ☐ | All required component units/funds/agencies of the local unit are included in the financial statements and/or disclosed in the reporting entity notes to the financial statements as necessary. |
| 2. | ☒ | ☐ | There are no accumulated deficits in one or more of this unit's unreserved fund balances/unrestricted net assets (P.A. 275 of 1980) or the local unit has not exceeded its budget for expenditures. |
| 3. | ☐ | ☒ | The local unit is in compliance with the Uniform Chart of Accounts issued by the Department of Treasury. |
| 4. | ☒ | ☐ | The local unit has adopted a budget for all required funds. |
| 5. | ☒ | ☐ | A public hearing on the budget was held in accordance with State statute. |
| 6. | ☒ | ☐ | The local unit has not violated the Municipal Finance Act, an order issued under the Emergency Municipal Loan Act, or other guidance as issued by the Local Audit and Finance Division. |
| 7. | ☒ | ☐ | The local unit has not been delinquent in distributing tax revenues that were collected for another taxing unit. |
| 8. | ☒ | ☐ | The local unit only holds deposits/investments that comply with statutory requirements. |
| 9. | ☒ | ☐ | The local unit has no illegal or unauthorized expenditures that came to our attention as defined in the *Bulletin for Audits of Local Units of Government in Michigan*, as revised (see Appendix H of Bulletin). |
| 10. | ☒ | ☐ | There are no indications of defalcation, fraud or embezzlement, which came to our attention during the course of our audit that have not been previously communicated to the Local Audit and Finance Division (LAFD). If there is such activity that has not been communicated, please submit a separate report under separate cover. |
| 11. | ☒ | ☐ | The local unit is free of repeated comments from previous years. |
| 12. | ☒ | ☐ | The audit opinion is UNQUALIFIED. |
| 13. | ☒ | ☐ | The local unit has complied with GASB 34 or GASB 34 as modified by MCGAA Statement #7 and other generally accepted accounting principles (GAAP). |
| 14. | ☐ | ☒ | The board or council approves all invoices prior to payment as required by charter or statute. |
| 15. | ☒ | ☐ | To our knowledge, bank reconciliations that were reviewed were performed timely. |

If a local unit of government (authorities and commissions included) is operating within the boundaries of the audited entity and is not included in this or any other audit report, nor do they obtain a stand-alone audit, please enclose the name(s), address(es), and a description(s) of the authority and/or commission.

I, the undersigned, certify that this statement is complete and accurate in all respects.

| **We have enclosed the following:** | Enclosed | Not Required (enter a brief justification) |
|---|---|---|
| Financial Statements | X | |
| The letter of Comments and Recommendations | X | |
| Other (Describe) | | not applicable |

| Certified Public Accountant (Firm Name) | Telephone Number |
|---|---|
| Virchow, Krause & Company, LLP | (608) 249-6622 |

| Street Address | City | State | Zip |
|---|---|---|---|
| 10 Terrace Court | Madison | WI | 53707 |

| Authorizing CPA Signature | Printed Name | License Number |
|---|---|---|
| Thomas Unke | Thomas Unke | 1101029416 |

# MICHIGAN SOUTH CENTRAL POWER AGENCY

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Virchow Krause & company

# INDEPENDENT AUDITORS' REPORT

To the Board of Commissioners
Michigan South Central Power Agency
Litchfield, Michigan

We have audited the accompanying financial statements as listed in the table of contents, of the Michigan South Central Power Agency (the Agency) as of June 30, 2007 and 2006, and for the years then ended. These financial statements are the responsibility of the Agency's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Michigan South Central Power Agency as of June 30, 2007 and 2006, and the changes in its financial position and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

As described in Note 16 to the financial statements, the Agency changed its method of accounting for accrued interest on member rate stabilization balances in fiscal year 2006.

The Management's Discussion and Analysis on pages 2 through 7 is not a required part of the financial statements but is supplementary information required by the accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Virchow Krause & Company LLP

Madison, Wisconsin
August 30, 2007



**Virchow, Krause & Company, LLP**
Certified Public Accountants & Consultants • An Independent Member of Baker Tilly International

# MANAGEMENT'S DISCUSSION AND ANALYSIS

# MICHIGAN SOUTH CENTRAL POWER AGENCY

MANAGEMENT'S DISCUSSION AND ANALYSIS
June 30, 2007 and 2006

The management of the Michigan South Central Power Agency (the "Agency") offers all persons interested in the Agency's financial position this narrative overview and analysis of the Agency's financial performance during the years ending June 30, 2007 and 2006. Please read this narrative in conjunction with the accompanying financial statements and the accompanying notes to financial statements.

## OVERVIEW OF THE FINANCIAL STATEMENTS

Michigan South Central Power Agency is a public body politic and corporate of the State of Michigan. The Agency was organized on March 21, 1978, under the authority of Michigan Public Act 448 of 1976, to supply electricity to member municipalities in south central Michigan. The Agency has five members: the Cities of Coldwater, Hillsdale, and Marshall; and the Villages of Clinton, and Union City.

This annual report consists of two parts: Management's Discussion and Analysis (this section) and the basic financial statements. These statements are prepared on the accrual basis of accounting in accordance with accounting principals generally accepted in the United States of America. The Agency uses the Uniform System of Accounts prescribed by the Federal Energy Regulatory Commission.

The Balance Sheet reports year end assets, liabilities and net asset balances based on the original cost adjusted for any depreciation, amortization or unrealized gains/losses as appropriate. The Statement of Revenues, Expenses and Changes in Net Assets presents information showing how the Agency's net assets changed due to the Agency's business activity. The Statement of Cash Flows reports the cash provided and used for operating activities, as well as other cash sources such as investment income and cash payments for repayment of bonds and capital additions.

## AGENCY FINANCIAL ANALYSIS

Fiscal year 2007 was a busy year, operationally and financially. This year marked the second full year of Agency operations as a "Market Participant" in the Midwest Independent System Operator (MISO) Midwest Market Initiative energy market. This market, which commenced on April 1$^{st.}$ 2005, is meant to coordinate the provision of reliable, cost-effective energy. In 2007, the Agency received a net credit from MISO market charges of approximately $51,000, while in 2006 the Agency incurred expenses of approximately $1,335,000. These amounts include a net credit of approximately $1,054,000 for 2007, as compared to 2006 expenses of $1,026,000, in "Revenue Sufficiency Guarantee" (RSG) charges. We received a refund in 2007 of the 2006 RSG Charges as a result of a Federal Energy Regulatory Commission ruling. Although there was no 2007 expense, the Agency also spent an additional $811,818 in fiscal year 2006 for "Seams Elimination Cost Adjustment" expenses, which directly relates to the MISO market.

Late in fiscal year 2004, the Agency began a relationship with American Municipal Power of Ohio (AMP-Ohio) in order to facilitate the Agency's MISO market participation. For an approximate $230,000 in fiscal year 2007 annual fees, the Agency is able to utilize the services of AMP-Ohio's energy control center. This arrangement has allowed the Agency to avoid creating and staffing its own control center. This relationship has broadened to include a bilateral sales agreement, an excess capacity sales agreement, an interagency services agreement, future power supply planning and resource management services, and the acceptance of the Agency's members as full AMP-Ohio members in July of 2006.

## AGENCY FINANCIAL ANALYSIS (cont.)

The Agency is continuing to reap the benefits of two bond transactions which were completed in fiscal year 2005. In late October 2004, a seven percent fixed rate bond was replaced by a variable rate note. This transaction has yielded interest savings of approximately $772,000 through fiscal year 2007. This savings is in addition to the $127,000 in total savings due to the October 2004 defeasance of approximately $1,060,000 in principal and interest payments on other outstanding debt. Due to current interest rate trends, the Agency has recently reconverted the variable rate note back into a fixed rate issuance.

It was reported last year that, due to retirements, the Agency's General Manager and Power Production Superintendent positions' were assumed by Mr. Glen White and Mr. James Balbo respectively. During the past year, the Agency's Director of Finance position was eliminated. These duties and responsibilities were combined with the position of Corporate Accountant, held by Mr. Robert Russell.

An analysis of the Agency's financial position begins with the review of the Balance Sheet, the Statement of Revenues, Expenses and Changes in Net Assets and the Statement of Cash Flows report information. A summary of the Agency's Balance Sheet is presented in Table 1. The Statement of Revenues, Expenses and Changes in Net Assets are summarized in Table 2 and Table 3 presents a summary of the Statement of Cash Flows.

Table 1
Condensed Balance Sheet

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| Current assets | $ 13,289,037 | $ 11,565,787 | $ 12,589,923 |
| Restricted assets | 17,556,019 | 18,814,631 | 18,237,726 |
| Other assets | 8,600,969 | 9,524,260 | 13,955,099 |
| Utility plant | 35,260,983 | 36,336,950 | 37,047,414 |
| Total Assets | 74,707,008 | 76,241,628 | 81,830,162 |
| Non-current liabilities | 38,836,277 | 46,795,374 | 53,901,310 |
| Current liabilities | 12,354,506 | 11,941,487 | 12,705,271 |
| Total Liabilities | 51,190,783 | 58,736,861 | 66,606,581 |
| Net Assets | | | |
| Invested in capital assets, net of related debt | (10,599,731) | (16,911,477) | (22,474,513 ) |
| Restricted | 17,199,220 | 18,381,657 | 17,746,642 |
| Unrestricted | 16,916,736 | 16,034,587 | 19,951,452 |
| Total Net Assets | 23,516,225 | 17,504,767 | 15,223,581 |
| Total Net Assets and Liabilities | $ 74,707,008 | $ 76,241,628 | $ 81,830,162 |

## AGENCY FINANCIAL ANALYSIS (cont.)

Table 2
Condensed Statement of Revenues, Expenses and Changes in Net Assets

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| Operating revenues | $ 42,858,324 | $ 44,961,391 | $ 38,634,773 |
| Depreciation expense | 3,281,012 | 2,999,543 | 2,987,185 |
| Other operating expenses | 32,251,849 | 34,276,073 | 27,981,056 |
| Total Operating Expenses | 35,532,861 | 37,275,616 | 30,968,241 |
| Operating income | 7,325,463 | 7,685,775 | 7,666,532 |
| Investment and miscellaneous income | 1,540,548 | 784,118 | 932,610 |
| Interest and amortization expense | (2,860,532) | (3,830,787) | (4,557,764) |
| Other income (expense) | 5,979 | 11,432 | (1,383,909) |
| Total Non-Operating Expenses | (1,314,005) | (3,035,237) | (5,009,063) |
| Income Before Cumulative Effect of Change in Accounting Principle | 6,011,458 | 4,650,538 | 2,657,469 |
| Cumulative effect of change in accounting principle | - | (2,369,352) | - |
| Change in Net Assets | 6,011,458 | 2,281,186 | 2,657,469 |
| NET ASSETS – Beginning of Year | 17,504,767 | 15,223,581 | 12,566,112 |
| **NET ASSETS – END OF YEAR** | $ 23,516,225 | $ 17,504,767 | $ 15,223,581 |

# MICHIGAN SOUTH CENTRAL POWER AGENCY

MANAGEMENT'S DISCUSSION AND ANALYSIS (cont.)
June 30, 2007 and 2006

## AGENCY FINANCIAL ANALYSIS (cont.)

Table 3
Condensed Statement of Cash Flows

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| Received from power sales | $ 43,038,111 | $ 45,158,951 | $ 36,891,974 |
| Paid to suppliers for purchased power and transmission | (29,717,526) | (31,426,615) | (22,388,808) |
| Paid to suppliers and employees for other services | (3,634,524) | (3,748,825) | (3,627,843) |
| Cash Flows from Operating Activities | 9,686,061 | 9,983,511 | 10,875,323 |
| Deferred rate stabilization withdraw | - | (3,500,000) | - |
| Debt principal and interest paid | (10,324,420) | (10,162,399) | (19,791,550) |
| Net debt issuance costs, proceeds and defeasance Costs | - | - | 8,529,181 |
| Net acquisition, disposal, and cash contribution for capital assets | (2,199,066) | (2,277,647) | (2,463,223) |
| Cash Flows from Capital and Related Financing Activities | (12,523,486) | (12,440,046) | (13,725,592) |
| Cash Flows from Investing Activities | 75,191 | 4,746,923 | 3,336,958 |
| Net Change in Cash and Cash Equivalents | (2,762,234) | (1,209,612) | 486,689 |
| CASH AND CASH EQUIVALENTS - Beginning of Year | 9,270,168 | 10,479,780 | 9,993,091 |
| **CASH AND CASH EQUIVALENTS - ENDING OF YEAR** | $ 6,507,934 | $ 9,270,168 | $ 10,479,780 |

## BALANCE SHEET

"Current assets" increased and "Restricted assets" decreased as overfunded bond reserve monies were moved to unrestricted assets. "Other assets" decreased by $.9 million during fiscal year 2007, consisting of two offsetting items. A scheduled major turbine repair was performed during the annual Agency outage approximating $1.9 million, which the board elected to defer the related costs and spread the charges starting in the current year and the remainder to future years, resulting in an increase in "Other Assets". The offsetting item was the internal funding of capital projects which decreased "Other Assets". For fiscal year 2006, detailed discussion of the Rate Stabilization Fund transaction and a related change in accounting treatment may be found in the Footnotes to the Financial Statements under "Deferred Rate Stabilization."

### BALANCE SHEET (cont.)

The Agency's commitment to maintaining and improving the Plant in order to provide reliable, value-based electricity to its members is reflected in the stability of the Utility Plant balance. As was the case in fiscal 2006, the relatively small change in fiscal 2007's Utility Plant number is the net effect of two larger transactions. In fiscal 2007, the Agency hired an outside firm to perform a major capital project in the boiler area during its annual outage of approximately $1,070,000. Additionally, the Agency elected to buyout a existing lease on equipment during the year of approximately $350,000. The $1.42 million, from these internally-funded transactions, combined with other net additions which totaled approximately $.78 million, offset a large portion of the approximately $3.3 million in normal depreciation costs. Last year, the largest addition was a $1.881 million 31.5 MW of EHV transmission lines from METC.

As was the case in fiscal year 2006, the Agency continues to reap the benefits of debt service payments that are aggressively reducing principal instead of just covering interest requirements. The reduction in Total Liabilities reflects this fact.

### STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

Operating revenues and expenses decreased by minor amounts (4.7 and 4.6 percent, respectively) versus last year. These decreases are a direct result of the RSG refunds from MISO as stated earlier, which were charged to the Agency during the first full year of operations in fiscal 2006. Additionally, excess power sales to AMP-Ohio provide for a more consistent level of operation at the Endicott Generating Station, which leads to more efficient operations. The similar outcome in Operating Income for fiscal year 2007 and 2006 is tied to the Agency's need to meet bond covenants.

"Investment and miscellaneous income" changed due to unrealized gains from investment performance increasing by approximately $260,000 during fiscal year 2007 versus decreasing approximately $487,000 during fiscal year 2006. The marked change in "Other income (expense)" over the last three years reflects the fact that previously-deferred depreciation expense had been fully recognized midway through fiscal year 2005. Further detail may be found in the Footnotes to the Financial Statements titled "Net Deferred Costs Recoverable in Future Years." The large change in Income is attributed to debt service needs – although cash is collected from members and recorded as revenue, the associated debt payment (of principal) is recorded as a balance sheet item.

The "Cumulative effect of change in accounting principle" reclassifies data previously found in a Footnote to the Financial Statements ("Deferred Rate Stabilization") to a component of Net Assets. The Agency believes that this accounting change creates a more user-friendly financial statement. Further information may be found in the previously-mentioned Footnote.

## STATEMENT OF CASH FLOWS

"Cash and cash equivalents" are defined as investments which mature in 90 days or less, plus immediately accessible bank accounts. At June 30, 2007, the Agency had increased its short term investment position to increase investment return within its debt service accounts by approx. $2.0 million over fiscal year 2006. Although these investments will mature by November 2nd, they are just out of the 90 day window to be classified as cash equivalents. The other area that affected cash was using internal funds partially offset by interest income to fund the agency's capital projects and deferred turbine repair during fiscal 2007.

## DEBT SERVICE COVERAGE

The Agency's bond documents require the Agency to maintain certain restrictive financial covenants, the most restrictive being the requirement that net revenues must equal at least 110% of the aggregate bond service for the year. The Agency fully met or exceeded all bond covenants for the years ended June 30, 2007 and 2006. Further details can be found in the Footnotes to the Financial Statements, under "Aggregate Bond Service Coverage."

## CONTACTING AGENCY MANAGEMENT

This financial report is designed to provide our members, investors, and creditors with a general overview of Michigan South Central Power Agency's finances. Questions concerning any of the information provided in this report or requests for additional information should be addressed to Michigan South Central Power Agency, 720 Herring Rd., Litchfield, MI 49252.

# MICHIGAN SOUTH CENTRAL POWER AGENCY

BALANCE SHEETS
June 30, 2007 and 2006

*ASSETS*

| | | 2007 | | 2006 |
|---|---|---|---|---|
| **CURRENT ASSETS** | | | | |
| Unrestricted cash and cash equivalents | $ | 4,221,901 | $ | 3,773,991 |
| Restricted cash and investments | | 5,664,716 | | 8,257,626 |
| Unrestricted investments | | 2,946,506 | | 1,765,338 |
| Accounts receivable | | 3,692,780 | | 3,749,884 |
| Interest receivable | | 278,353 | | 230,037 |
| Inventory | | 1,772,000 | | 1,650,131 |
| Prepayments and other current assets | | 377,497 | | 396,406 |
| Total Current Assets | | 18,953,753 | | 19,823,413 |
| **NON-CURRENT ASSETS** | | | | |
| Unrestricted investments | | 4,970,508 | | 6,686,167 |
| Restricted investments | | 11,891,303 | | 10,557,005 |
| Debt issue costs | | 1,051,663 | | 1,340,730 |
| Emissions credits | | 196,560 | | 563,320 |
| Deferred maintenance costs | | 1,766,565 | | 171,719 |
| Deferred costs recoverable in future years | | 615,673 | | 762,324 |
| Total Non-Current Assets | | 20,492,272 | | 20,081,265 |
| **CAPITAL ASSETS** | | | | |
| Utility plant (including construction work in progress) | | 97,243,534 | | 95,333,008 |
| Accumulated depreciation | | (61,982,551) | | (58,996,058) |
| Total Net Capital Assets | | 35,260,983 | | 36,336,950 |
| **TOTAL ASSETS** | $ | 74,707,008 | $ | 76,241,628 |

*LIABILITIES AND NET ASSETS*

| | 2007 | 2006 |
|---|---|---|
| **CURRENT LIABILITIES** | | |
| Accounts payable and accrued expenses | | |
| Accounts payable | $ 2,015,391 | $ 1,936,685 |
| Compensation and related amounts | 556,740 | 551,252 |
| Deferred rate stabilization | 1,349,476 | 1,226,793 |
| Total Accounts Payable and Accrued Expenses | 3,921,607 | 3,714,730 |
| Current liabilities payable from restricted assets | | |
| Current portion of long-term debt | 8,076,100 | 7,793,783 |
| Accrued interest payable | 356,799 | 432,974 |
| Total Current Liabilities Payable from Restricted Assets | 8,432,899 | 8,226,757 |
| Total Current Liabilities | 12,354,506 | 11,941,487 |
| **NON-CURRENT LIABILITIES** | | |
| Long-term debt, net of discounts, premiums and losses | 38,836,277 | 46,795,374 |
| Total Liabilities | 51,190,783 | 58,736,861 |
| **NET ASSETS** | | |
| Invested in capital assets, net of related debt | (10,599,731) | (16,911,477) |
| Restricted for debt service | 17,199,220 | 18,381,657 |
| Unrestricted | 16,916,736 | 16,034,587 |
| Total Net Assets | 23,516,225 | 17,504,767 |
| **TOTAL LIABILITIES AND NET ASSETS** | $ 74,707,008 | $ 76,241,628 |

See accompanying notes to financial statements and independent auditors' report.

## MICHIGAN SOUTH CENTRAL POWER AGENCY

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS
Years Ended June 30, 2007 and 2006

| | 2007 | 2006 |
|---|---|---|
| **OPERATING REVENUES** | | |
| Sales to Members | $ 39,765,703 | $ 42,365,877 |
| Other Sales | 3,092,621 | 2,595,514 |
| Total Operating Revenues | 42,858,324 | 44,961,391 |
| **OPERATING EXPENSES** | | |
| Operations | 27,682,099 | 29,747,444 |
| Maintenance | 2,604,848 | 2,480,632 |
| Administration and general | 1,964,902 | 2,047,997 |
| Depreciation | 3,281,012 | 2,999,543 |
| Total Operating Expenses | 35,532,861 | 37,275,616 |
| Operating Income | 7,325,463 | 7,685,775 |
| **NON-OPERATING REVENUES (EXPENSES)** | | |
| Investment and miscellaneous income | 1,280,160 | 1,271,640 |
| Net increase (decrease) in the fair value of investments | 260,388 | (487,522) |
| Interest expense on long-term debt | (2,454,462) | (2,837,349) |
| Gain on disposal of assets | 5,979 | 11,432 |
| Amortization of debt costs, discounts, premiums and losses | (406,070) | (993,438) |
| Total Non-Operating Expenses | (1,314,005) | (3,035,237) |
| Income Before Cumulative Effect of Change in Accounting Principle | 6,011,458 | 4,650,538 |
| Cumulative effect of change in accounting principle | - | (2,369,352) |
| **Change in Net Assets** | 6,011,458 | 2,281,186 |
| NET ASSETS - Beginning of Year | 17,504,767 | 15,223,581 |
| **NET ASSETS - END OF YEAR** | $ 23,516,225 | $ 17,504,767 |

See accompanying notes to financial statements and independent auditors' report.

# MICHIGAN SOUTH CENTRAL POWER AGENCY

STATEMENTS OF CASH FLOWS
Years Ended June 30, 2007 and 2006

| | 2007 | 2006 |
|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | |
| Received from sales to members and others | $ 43,038,111 | $ 45,158,951 |
| Paid to suppliers for goods and services | (29,717,526) | (31,426,615) |
| Paid to employees for services | (3,634,524) | (3,748,825) |
| Net Cash Flows from Operating Activities | 9,686,061 | 9,983,511 |
| **CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES** | | |
| Deferred rate stabilization withdrawal | - | (3,500,000) |
| **CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES** | | |
| Capital expenditures for utility plant | (2,266,065) | (2,297,097) |
| Proceeds from sale of utility plant | 66,999 | 19,450 |
| Principal payments on long-term debt | (7,793,783) | (7,266,940) |
| Interest payments on long-term debt | (2,530,637) | (2,895,459) |
| Cash Flows From Capital and Related Financing Activities | (12,523,486) | (12,440,046) |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | |
| Proceeds from sales and maturities of investments | 10,323,237 | 6,683,074 |
| Purchases of investments | (11,382,971) | (3,102,876) |
| Interest received | 1,134,925 | 1,166,725 |
| Cash Flows from Investing Activities | 75,191 | 4,746,923 |
| **Net Change in Cash and Cash Equivalents** | (2,762,234) | (1,209,612) |
| CASH AND CASH EQUIVALENTS – Beginning of Year | 9,270,168 | 10,479,780 |
| **CASH AND CASH EQUIVALENTS – END OF YEAR** | $ 6,507,934 | $ 9,270,168 |
| **NONCASH INVESTING ACTIVITY** | | |
| Unrealized gains (losses) on investments | $ 357,307 | $ (396,636) |

| | 2007 | 2006 |
|---|---|---|
| **RECONCILIATION OF OPERATING INCOME TO NET CASH FLOWS FROM OPERATING ACTIVITIES** | | |
| Operating income | $ 7,325,463 | $ 7,685,775 |
| Noncash items included in operating income | | |
| Depreciation | 3,281,012 | 2,999,543 |
| Deferred maintenance | (1,594,846) | 300,000 |
| Changes in assets and liabilities | | |
| Accounts receivable | 57,104 | 118,425 |
| Inventory | (121,869) | (756,629) |
| Prepayments and other current assets | 18,909 | 20,268 |
| Emissions credits | 366,760 | 145,180 |
| Deferred costs | 146,651 | (427,181) |
| Accounts payable | 78,706 | (208,310) |
| Compensation and related amounts | 5,488 | 27,305 |
| Deferred rate stabilization | 122,683 | 79,135 |
| **NET CASH FLOWS FROM OPERATING ACTIVITIES** | $ 9,686,061 | $ 9,983,511 |

| | | |
|---|---|---|
| **RECONCILIATION OF CASH AND CASH EQUIVALENTS TO THE BALANCE SHEET** | | |
| Unrestricted cash and cash equivalents | $ 4,221,901 | $ 3,773,991 |
| Restricted cash and investments - current | 5,664,716 | 8,257,626 |
| Unrestricted investments - current | 2,946,506 | 1,765,338 |
| Restricted investments - non-current | 11,891,303 | 10,557,005 |
| Unrestricted investments - non-current | 4,970,508 | 6,686,167 |
| Total Cash and Investments | 29,694,934 | 31,040,127 |
| Less: Long-Term Investments | (23,187,000) | (21,769,959) |
| **TOTAL CASH AND CASH EQUIVALENTS** | $ 6,507,934 | $ 9,270,168 |

See accompanying notes to financial statements and independent auditors' report.

## NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND NATURE OF OPERATIONS

The Michigan South Central Power Agency (the Agency) is a body politic and corporate, of the State of Michigan organized on March 21, 1978, under the authority of Michigan Public Act 448 of 1976 (the Act), to supply electricity to member municipalities in south central Michigan. The Act provides that the Agency will establish rates and charges so as to produce revenues sufficient to cover costs (excluding depreciation and amortization expense) including debt service, but it may not operate its projects for profit, except insofar as any such profit will insure to the benefit of the public.

The Agency's member municipalities are the Cities of Coldwater, Hillsdale and Marshall and the Village's of Clinton and Union City. Each member is a municipal corporation, organized under the laws of the State of Michigan, which owns and operates a municipal electric system. The member municipalities presently supply their customers with power and energy generated from the Agency's Project I, from the municipalities' existing generating facilities and with power purchased from other utility companies. Project I consists of a 55 MW coal fired generation facility and related transmission and substation equipment. Project II consists of a series of diesel fired peaking units capable of producing 16.5 megawatts of power. Project III consists of a series of diesel fired peaking units capable of producing 14.85 megawatts of power. The Agency is currently evaluating the feasibility of relocating units to Project I and member municipality sites. This relocation would provide for increased local generation under blackout conditions. The participants of Project I and Project III are the Cities of Coldwater, Hillsdale and Marshall, and the Villages of Clinton and Union City. All members except the Village of Union City are participants in Project II.

Each of the member municipalities entered into (a) a Power Sales Contract with the Agency for the supply of power and energy from the Agency and (b) a Substation Agreement with the Agency for services provided by the Agency to the member municipality with respect to substation facilities; both of these agreements will remain in effect as long as Power Supply System Revenue Refunding Bonds (Revenue Refunding Bonds), 2004, 2002, and 1992 Series and Power Supply System Revenue Bonds 2003 and 2000 Series are outstanding. Each member municipality also entered into an Economic Dispatch Agreement with the Agency providing for the dispatch by the Agency of power and energy from certain existing generating facilities of the member municipalities on an economic basis. The Power Sales Contract between the Agency and the member municipalities require the Agency to provide, and the member municipalities to purchase from the Agency, all of the members' bulk power supply, as defined in the contracts. Each member is obligated to pay its share of the Agency's operating and debt service costs of Project I. The Substation Agreements require the Agency to provide, and the municipalities to purchase, services of the municipalities' substation facilities for transmission, transformation and delivery of electric power and energy from the Agency to the municipalities. Under the Economic Dispatch Agreement, the member municipalities are required to sell to the Agency power generated by their facilities, defined as dedicated capacity.

During the years ended June 30, 2007 and 2006, substantially all sales of power recognized by the Agency were made to its member municipalities.

## NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND NATURE OF OPERATIONS (cont.)

### *BASIS OF PRESENTATION*

In accordance with Governmental Accounting Standards Board (GASB) No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that use Proprietary Fund accounting,* the Agency applies all applicable GASB pronouncements as well as all Financial Accounting Standards Board (FASB) Statements and Interpretations, Accounting Principals Board (APB) Opinions, and Accounting Research Bulletins (ARB), unless those pronouncements conflict with or contradict GASB pronouncements.

The Agency's accounts are maintained in accordance with the Uniform System of Accounts of the Federal Energy Regulatory Commission, as required by the Power Sales Contracts with the member municipalities, and in conformity with accounting principles generally accepted in the United States of America. A separate set of plant accounts is maintained for each of the Agency's projects.

### *USE OF ESTIMATES*

Preparation of financial statements in conformity with generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported period. Actual results could differ from those estimates.

### *CAPITAL ASSETS – UTILITY PLANT*

The Agency capitalizes assets with an original cost of $5,000 or more and a useful life of at least two years. The cost of utility plant includes direct and overhead costs. Interest incurred during construction is reflected in the capitalized value of assets, net of interest earned on the invested proceeds over the same period.

When property subject to depreciation is retired or otherwise disposed of in the normal course of business, its cost, together with the cost of removal less salvage, is charged to accumulated depreciation.

The cost of maintenance, repairs and replacements of minor items of property is charged to maintenance expense. The cost of replacements of property is charged to utility plant accounts.

Utility plant in service is depreciated using the straight-line method over the following useful lives:

| | Years |
|---|---|
| Utility Plant in Service | |
| Project I (composite) – Endicott Generation Station | 30 |
| Project II (composite) – Diesel Fired Peaking Unit | 30 |
| Project III (composite) – Diesel Fired Peaking Units | 30 |
| Substation plant (composite) | 30 |
| Transmission facilities (composite) | 55 |
| Administrative and maintenance building | 10 – 50 |
| Transportation equipment | 3 – 5 |
| Furniture and fixtures | 5 – 10 |

## NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND NATURE OF OPERATIONS (cont.)

### *CASH EQUIVALENTS*

For purposes of the statement of cash flows, cash equivalents include unrestricted checking accounts, savings accounts and institutional liquid assets, with initial maturities less than 90 days.

### *RESTRICTED AND UNRESTRICTED INVESTMENTS*

The Agency follows GASB No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools.* This standard requires investments to be reported at fair value with gains and losses included in the Statements of Revenues, Expenses and Changes in Net Assets.

### *INVENTORY*

Inventory is stated at average carrying cost and consists of coal, limestone and fuel oil.

### *DEBT RELATED ITEMS*

Bond issuance costs, premiums and discounts are deferred and amortized over the life of the bonds based on the effective interest method, with the exception of the 2002, 2003, and 2004 bond costs which are amortized on a straight line basis. Losses on refundings are amortized on the straight line method effective in fiscal 2003.

### *DEFERRED COSTS AND CREDITS*

The Agency has adopted the provisions of Statement of Financial Accounting Standards (FAS) No. 71, *Accounting for the Effects of Certain Types of Regulation* (FAS No. 71). This accounting standard provides for the deferral of costs and revenues which will be recovered through future rate adjustments.

### *OPERATING REVENUES*

The Agency distinguishes *operating* revenues and expenses from *nonoperating* items. Operating revenues and expenses generally result from providing services and producing and delivering electric service in connection with the Agency's principal ongoing operations. The principal operating revenues of the Agency are charges to members for sales and services. Operating expenses for the Agency 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.

Agency billings are rendered and recorded monthly based on month end metered usage.

## NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND NATURE OF OPERATIONS (cont.)

### *INTEREST INCOME CREDIT*

If approved by the Agency's rate-making body, the Agency may grant to its members a credit for interest income earned from the pool of temporary investments held by the Agency. There were no interest income credits granted to the Agency's members for the years ended June 30, 2007 and 2006.

### *TAXES*

The Agency is exempt from State and Federal income taxes.

### *COMPENSATED ABSENCES*

Under terms of employment, non-union employees are granted twelve sick and personal days per year on January 1st. This time cannot be carried over from year to year and is not paid out at year end. Vacation time does accrue for all employees, and up to one week (Union) on one-half of the annual accrual (non-union) may be carried over at year end. Sick leave and vacation benefits earned but not yet taken have been recorded in the financial statements. Union employees are granted three personal days per year which cannot be carried over from year to year.

### *COMPARATIVE DATA*

Certain amounts presented in the prior year data have been reclassified in order to be consistent with the current year's presentation.

## NOTE 2 – CASH AND INVESTMENTS

The Agency's Trust Indenture for the Power Supply System Revenue Refunding Bonds (Note 5) authorizes the Agency to deposit funds only in banks insured by the Federal Deposit Insurance Corporation. The Agency may also make investments in U.S. Government and Federal Agency obligations, investment grade bonds, commercial paper rated at the highest classification established by at least two standard rating services, money market mutual funds, repurchase agreements, and pooled investment funds. The Agency's internal policy is to not invest funds in repurchase agreements.

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.

Deposits in banks are insured by the FDIC in the amount of $100,000 for all interest bearing accounts and $100,000 for all noninterest bearing accounts. The difference between the bank balance and carrying amount is due to outstanding checks, deposits in transit, and/or market value adjustments.

## NOTE 2 – CASH AND INVESTMENTS (cont.)

The CLASS investment (Cooperative Liquid Assets Securities System) is an investment pool established by an intergovernmental agreement dated October 1, 1991. CLASS is available for investment by Michigan governmental entities except school districts. CLASS operates consistent with the provisions of a 2a-7 like pool, and invests only in investments legally permissible under Michigan law, with a weighted average maturity not exceeding 120 days. The value of pool shares is the same as the fair value position in the pool.

### *CUSTODIAL CREDIT RISK*

***Deposit***

Custodial credit risk is the risk that in the event of a financial institution failure, the Agency's deposits may not be returned to the Agency.

As of June 30, 2007 and 2006, $90,888 and $89,843 of the Agency's total bank balances of $331,178 and $348,332, respectively, were exposed to custodial credit risk as it was uninsured and uncollateralized.

This Agency's investment policy specifies that the Agency shall only invest in depositories deemed appropriate by the Bond Resolution securing the Agency's debt.

***Investment***

For an investment, custodial credit risk is the risk that, in the event of the failure of the counterparty, the Agency will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party.

As of June 30, 2007 and 2006, no investments were exposed to custodial credit risk.

This Agency's investment policy specifies that the Agency shall only invest in securities deemed appropriate by the Bond Resolution securing the Agency's debt.

### *CREDIT RISK*

Credit risk is the risk an issuer or other counterparty to an investment will not fulfill its obligations.

As of June 30, 2007 and 2006, the Agency's investments were rated as follows:

| Investment Type | Standard & Poor's |
|---|---|
| US Agency securities | AAA |

## NOTE 2 – CASH AND INVESTMENTS (cont.)

### *CREDIT RISK* (cont.)

The Agency also held investments in the following investments which are not rated:

External pool – Comerica
Mutual funds – U.S. Bank
Mutual funds – Fidelity
MI Class

This Agency's investment policy specifies the Agency shall only invest in securities deemed appropriate by the Bond Resolution securing the Agency's debt.

### *CONCENTRATION OF CREDIT RISK*

Concentration of credit risk is the risk of loss attributed to the magnitude of a government's investment in a single issuer. At June 30, 2007 and 2006, the investment portfolio was concentrated as follows:

| Investment Type | Issuer | Percentage of Portfolio 2007 | Percentage of Portfolio 2006 |
|---|---|---|---|
| US Government Agency Securities | Federal Farm Credit | 21% | 21% |
| | Federal Home Loan Bank | 25% | 27% |
| | Federal Home Loan Mortgage | 17% | 8% |
| | Federal National Mortgage Association | 18% | 17% |

This Agency's new investment policy, dated December 2006, specifies that no single issuer shall comprise greater than 25 percent of the overall portfolio, when measured at the last investment purchase date. Securities which are explicitly backed by the full faith and credit of the United States Government shall not be aggregated when measuring portfolio concentration.

### *INTEREST RATE RISK*

Interest rate risk is the risk changes in interest rates will adversely affect the fair value of an investment. As of June 30, 2007, the Agency's investments were as follows:

| Investment Type | Fair Value | Maturity: Less than 1 Year | Maturity: 1 – 5 Years |
|---|---|---|---|
| US Government Agency Securities | $ 23,917,651 | $ 12,246,195 | $ 11,671,456 |
| Other external pools | 1,377 | 1,377 | - |
| Mutual funds | 4,890,536 | 4,890,536 | - |
| Totals | $ 28,809,564 | $ 17,138,108 | $ 11,671,456 |

## NOTE 2 – CASH AND INVESTMENTS (cont.)

***INTEREST RATE RISK*** (cont.)

As of June 30, 2006, the Agency's investments were as follows:

| Investment Type | Fair Value | Maturity: Less than 1 Year | Maturity: 1 – 5 Years |
|---|---|---|---|
| US Government Agency Securities | $ 22,521,638 | $ 4,640,429 | $ 17,881,209 |
| US Treasuries | 984,375 | 984,375 | |
| Other external pools | 76,127 | 76,127 | - |
| Mutual funds | 6,144,370 | 6,144,370 | - |
| Totals | $ 29,726,510 | $ 11,845,301 | $ 17,881,209 |

This Agency's investment policy specifies operating funds shall be maintained in liquid investments such as money market funds, municipal investment pools, and savings accounts. Investments greater than five years are not allowed.

## NOTE 3 – RESTRICTED AND UNRESTRICTED INVESTMENTS

The Power Supply System Revenue Bond Resolution requires that the payments by the member municipalities for project power be deposited into special funds and that they be used only for operating costs, debt service and other stipulated purposes. The fund's purposes and balances are summarized below.

| Fund | Purpose |
|---|---|
| Operations and Maintenance | To accumulate sufficient funds by the end of each month to pay the subsequent month's expenses. |
| Bond Service Fund | To accumulate funds to pay the current portion of the bond principal and interest. |
| Bond Reserve Fund | To reserve funds equal to the maximum annual principal and interest requirements for the outstanding bonds. |
| Reserve and Contingency Fund | To reserve funds for major renewals and replacements, extraordinary operations and maintenance costs, and any contingencies. |

## NOTE 3 – RESTRICTED AND UNRESTRICTED INVESTMENTS (cont.)

The following is a summary of investments as of June 30, 2007 and 2006:

| | 2007 | 2006 |
|---|---|---|
| Current Investments | | |
| Restricted | | |
| Bond service fund | $ 5,664,716 | $ 5,609,634 |
| Bond reserve fund | - | 2,647,992 |
| Unrestricted | 2,946,506 | 1,765,338 |
| Total Current Investments | 8,611,222 | 10,022,964 |
| Non-Current Investments | | |
| Restricted | | |
| Bond reserve fund | 10,800,723 | 9,466,425 |
| Reserve and contingency fund | 1,090,580 | 1,090,580 |
| Unrestricted | 4,970,508 | 6,686,167 |
| Total Non-Current Investments | 16,861,811 | 17,243,172 |
| Total Investments | 25,473,033 | 27,266,136 |
| Cash and cash equivalents – unrestricted | 4,221,901 | 3,773,991 |
| Total Cash and Investments | $ 29,694,934 | $ 31,040,127 |

## NOTE 4 – CHANGES IN CAPITAL ASSETS

A summary of changes in capital assets for 2007 and 2006 follows:

***2007***

| | Balance 7/01/06 | Additions/ Reclassi-fications | Deletions/ Reclassi-fications | Balance 6/30/07 |
|---|---|---|---|---|
| Capital assets, not being depreciated | | | | |
| Land | $ 1,403,519 | $ - | $ - | $ 1,403,519 |
| Construction work in progress | 156,279 | 1,421,001 | (1,499,901) | 77,379 |
| Total Capital Assets, Not Being Depreciated | 1,559,798 | 1,421,001 | (1,499,901) | 1,480,898 |
| Capital assets being depreciated | | | | |
| Project I (composite) - Generation Station | 80,948,783 | 1,913,124 | (61,863) | 82,800,044 |
| Project II (composite) - Diesel Fired Peaking Unit | 5,920,980 | - | - | 5,920,980 |
| Project III | 2,200,000 | 102,446 | (68,625) | 2,233,821 |
| General Plant | 4,703,447 | 329,395 | (225,051) | 4,807,791 |
| Total Capital Assets Being Depreciated | 93,773,210 | 2,344,965 | (355,539) | 95,762,636 |
| Total Capital Assets | 95,333,008 | 3,765,966 | (1,855,440) | 97,243,534 |

## NOTE 4 – CHANGES IN CAPITAL ASSETS (cont.)

***2007*** (cont.)

| | Balance 7/01/06 | Additions/ Reclassi- fications | Deletions/ Reclassi- fications | Balance 6/30/07 |
|---|---|---|---|---|
| Less: Accumulated Depreciation | | | | |
| Project I (composite) - | | | | |
| Generation Station | $ 53,821,433 | $ 2,902,946 | $ (61,864) | $ 56,662,515 |
| Project II (composite) - | | | | |
| Diesel Fired Peaking Unit | 871,672 | 197,366 | - | 1,069,038 |
| Project III | 183,334 | 75,529 | (7,625) | 251,238 |
| General Plant | 4,119,619 | 105,171 | (225,030) | 3,999,760 |
| Total Accumulated Depreciation | 58,996,058 | 3,281,012 | (294,519) | 61,982,551 |
| Net Capital Assets | $ 36,336,950 | | | $ 35,260,983 |

***2006***

| | Balance 7/01/05 | Additions/ Reclassi- fications | Deletions/ Reclassi- fications | Balance 6/30/06 |
|---|---|---|---|---|
| Capital assets, not being depreciated | | | | |
| Land | $ 1,164,709 | $ 238,810 | $ - | $ 1,403,519 |
| Construction work in progress | - | 202,344 | (46,065) | 156,279 |
| Total Capital Assets, Not Being Depreciated | 1,164,709 | 441,154 | (46,065) | 1,559,798 |
| Capital assets being depreciated | | | | |
| Project I (composite) - | | | | |
| Generation Station | 79,260,077 | 1,834,667 | (145,961) | 80,948,783 |
| Project II (composite) - | | | | |
| Diesel Fired Peaking Unit | 5,920,980 | - | - | 5,920,980 |
| Project III | 2,200,000 | - | - | 2,200,000 |
| General Plant | 4,673,086 | 67,340 | (36,979) | 4,703,447 |
| Total Capital Assets Being Depreciated | 92,054,143 | 1,902,007 | (182,940) | 93,773,210 |
| Total Capital Assets | 93,218,852 | 2,343,161 | (229,005) | 95,333,008 |
| Less: Accumulated Depreciation | | | | |
| Project I (composite) - | | | | |
| Generation Station | 51,316,560 | 2,643,795 | (138,922) | 53,821,433 |
| Project II (composite) - | | | | |
| Diesel Fired Peaking Unit | 674,306 | 197,366 | - | 871,672 |
| Project III | 110,000 | 73,334 | - | 183,334 |
| General Plant | 4,070,572 | 85,049 | (36,002) | 4,119,619 |
| Total Accumulated Depreciation | 56,171,438 | 2,999,544 | (174,924) | 58,996,058 |
| Net Capital Assets | $ 37,047,414 | | | $ 36,336,950 |

## NOTE 5 – LONG-TERM DEBT

The Agency has issued the following revenue bonds:

| Date | Purpose | Final Maturity | Interest Rates | Original Issue |
|---|---|---|---|---|
| Nov. 1, 1992 | Partial refunding of 1986 revenue refunding bonds | Nov. 1, 2006 | 3.50–5.90% | $ 52,425,000 |

The 1992 revenue refunding bonds were fully paid in November 2006.

| Date | Purpose | Final Maturity | Interest Rate | Original Issue |
|---|---|---|---|---|
| Dec. 28, 2000 | Project II | May 1, 2012 | 6.00% | $ 6,475,000 |

The annual bond service requirements of the 2000 bonds to maturity are as follows:

| Fiscal Year | Principal | Interest | Total |
|---|---|---|---|
| 2008 | $ - | $ 360,000 | $ 360,000 |
| 2009 | - | 360,000 | 360,000 |
| 2010 | 990,000 | 360,000 | 1,350,000 |
| 2011 | 1,095,000 | 300,600 | 1,395,600 |
| 2012 | 3,915,000 | 234,900 | 4,149,900 |
| Totals | $ 6,000,000 | $ 1,615,500 | $ 7,615,500 |

**NOTE 5 – LONG-TERM DEBT** (cont.)

| Date | Purpose | Final Maturity | Interest Rate | Original Issue |
|---|---|---|---|---|
| Nov. 21, 2002 | Refunding of 1991 and 1986 revenue refunding bonds | Nov. 1, 2010 | 5.00% | $ 31,190,000 |

The annual bond service requirements of the 2002 bonds to maturity are as follows:

| Fiscal Year | Principal | Interest | Total |
|---|---|---|---|
| 2008 | $ 7,535,000 | $ 1,371,125 | $ 8,906,125 |
| 2009 | 7,895,000 | 985,375 | 8,880,375 |
| 2010 | 8,290,000 | 580,750 | 8,870,750 |
| 2011 | 7,470,000 | 186,750 | 7,656,750 |
| Totals | $ 31,190,000 | $ 3,124,000 | $ 34,314,000 |

| Date | Purpose | Final Maturity | Interest Rate | Original Issue |
|---|---|---|---|---|
| Sept. 3, 2003 | Project III | Nov. 1, 2010 | 4.08% | $ 2,220,000 |

The annual bond service requirements of the 2003 bonds to maturity are as follows:

| Fiscal Year | Principal | Interest | Total |
|---|---|---|---|
| 2008 | $ 321,100 | $ 43,510 | $ 364,610 |
| 2009 | 333,909 | 30,701 | 364,610 |
| 2010 | 347,229 | 17,382 | 364,611 |
| 2011 | 178,776 | 3,531 | 182,307 |
| Totals | $ 1,181,014 | $ 95,124 | $ 1,276,138 |

| Date | Purpose | Final Maturity | Interest Rate | Original Issue |
|---|---|---|---|---|
| Oct. 21, 2004 | Refunding of 1994 revenue Refunding bond | Nov. 1, 2011 | Variable | $ 9,200,000 |

### NOTE 5 – LONG-TERM DEBT (cont.)

The 2004 bonds are at a variable interest rate which adjusts monthly. As such, an exact repayment schedule is unknown. The following was prepared using the 3.375% interest rate recommended by the Agency's financial advisor. The estimated annual bond service requirements of the 2004 bonds to maturity are as follows:

| Fiscal Year | Principal | Interest | Total |
|---|---|---|---|
| 2008 | $ 220,000 | $ 306,169 | $ 526,169 |
| 2009 | 275,000 | 297,661 | 572,661 |
| 2010 | 175,000 | 290,348 | 465,348 |
| 2011 | 225,000 | 283,458 | 508,458 |
| 2012 | 8,305,000 | 116,789 | 8,421,789 |
| Totals | $ 9,200,000 | $ 1,294,425 | $ 10,494,425 |

Long-term debt activity for the year ended June 30, 2007 and 2006 is as follows:

| | 07/01/06 Balance | Additions | Reductions | 6/30/07 Balance | Due Within One Year |
|---|---|---|---|---|---|
| Revenue bonds | $ 55,364,797 | $ - | $ 7,793,783 | $ 47,571,014 | $ 8,076,100 |
| Discounts/Premiums | 1,067,448 | - | 234,154 | 833,294 | |
| Loss on refunding | (1,843,088) | - | 351,157 | (1,491,931) | |
| Net Bonds | $ 54,589,157 | | | $ 46,912,377 | |

| | 07/01/05 Balance | Additions | Reductions | 6/30/06 Balance | Due Within One Year |
|---|---|---|---|---|---|
| Revenue bonds | $ 62,631,737 | $ - | $ 7,266,940 | $ 55,364,797 | $ 7,793,783 |
| Discounts/Premiums | 1,295,725 | - | 228,273 | 1,067,448 | |
| Loss on refunding | (2,759,212) | - | 916,124 | (1,843,088) | |
| Net Bonds | $ 61,168,250 | | | $ 54,589,157 | |

***PRIOR YEAR DEFEASANCE OF DEBT***

In October of 2004, the utility defeased $475,000 of the 2000 bonds by placing the proceeds of the 2004 bonds and other sinking fund monies in an irrevocable trust to provide for all future debt service payments on the defeased bonds. Accordingly, the trust account assets and the liability for the defeased bonds are not included in the Agency's financial statements. The bonds will be paid in full on May 1, 2011. At June 30, 2007, $475,000 of bonds outstanding are considered defeased.

## NOTE 6 – NET DEFERRED COSTS RECOVERABLE IN FUTURE YEARS

Deferred costs recoverable in future years consist of costs incurred by the Agency which were not billed to the member municipalities during the period in which they were incurred.

These amounts were initially composed of depreciation and amortization expense (noncash expenditures which under the Power Sales Contracts cannot be billed to the member municipalities) in excess of the principal repayments on related debt. During fiscal 2006, these accumulated deferred costs were completely recovered.

Certain other costs incurred during fiscal 2006 and 2007 were deferred until the appropriate allocation between members can be determined.

GAAP requires that these items be removed from the statements of net revenues and expenses and accumulated equity, and recorded as an asset or liability in the year in which they were incurred. These items are then recognized in future years when the items are included as allowable costs for rate-making purposes.

The components of the deferred costs recoverable in future years as of June 30, 2007 and 2006 are as follows:

| | 2007 | 2006 |
|---|---|---|
| Deferred costs recoverable in future years | | |
| Cost to be billed once allocation is determined | $ 615,673 | $ 762,324 |

The change in the components of deferred costs recoverable in future years for the years ended June 30, 2007 and 2006, are as follows:

| | 2007 | 2006 |
|---|---|---|
| NOX Allowance – mark-to-market | $ 362,620 | $ - |
| Seams Elimination Cost Adjustment (SECA) | - | (243,178) |
| Baseload Feasibility study | 73,145 | 119,253 |
| Metering project | (82,416) | 51,106 |
| MISO RSG | (500,000) | 500,000 |
| Net Increase (Decrease) in Deferred Costs | (146,651) | 427,181 |
| Balance at Beginning of Year | 762,324 | 335,143 |
| Balance at End of Year | $ 615,673 | $ 762,324 |

Additionally, in 2001, the Agency's Board approved the deferral of approximately $3,200,000 in maintenance costs incurred for the overhaul of the turbine generator. In 2007, approximately $1,900,000 related to the turbine overhaul project was deferred. Such costs will be recognized as a component of maintenance expense. For fiscal 2006 and 2007 $300,000 per year was recognized.

## NOTE 7 – DEFERRED RATE STABILIZATION

Effective in September 1994, management of the Agency implemented a plan to provide its members with refunds utilizing assets of a rate stabilization equity fund then held by the Agency.

Effective in August 1996, management of the Agency implemented a new plan to provide rate relief in future periods to the Agency's members utilizing advance contributions of the members.

Deposits, net of withdrawals, previously included in equity were reclassified in 2003.

The equity fund, which then totaled approximately $3,000,000 consisted of member contributions aggregating approximately $1,200,000 and interest thereon totaling approximately $1,800,000, and was originally established in 1986 to provide rate relief in future periods to the Agency's members. The Agency anticipates that the remaining undistributed member contributions of $1,000,000 and undistributed interest earned on the equity fund of $1,200,000 will be distributed to its members in an indeterminable period in the future out of currently available unrestricted accumulated equity.

As of June 30, 2007 and 2006, the Agency had received cumulative contributions totaling $7,250,504 and $7,184,984, respectively, and provided cumulative distributions to its members totaling $8,871,533. Cumulative interest accrued on these funds to $2,967,944 at June 30, 2007. As of July 1, 2005, the undistributed accrued interest of $2,369,352 was removed from equity and added to the liability as the result of a change in accounting principle. See Note 16 for more details.

The Agency anticipates the member contributions will be distributed to its members in an indeterminable period in the future out of currently available unrestricted funds. Accordingly, at June 30, 2007 and 2006, the Agency has established a liability of $1,349,476 and $1,226,793, respectively, for Deferred Rate Stabilization.

## NOTE 8 – NET ASSETS

GASB No. 34 requires the classification of net assets into three components – invested in capital assets, net of related debt; restricted; and unrestricted. These classifications are defined as follows:

Invested in capital assets, net of related debt – This component of net assets consists of capital assets, including restricted capital assets, net of accumulated depreciation and reduced by the outstanding balances of any bonds, mortgages, notes, or other borrowings that are attributable to the acquisition, construction, or improvement of those assets. If there are significant unspent related debt proceeds at year-end, the portion of the debt attributable to the unspent proceeds are not included in the calculation of invested in capital assets, net of related debt. Rather, that portion of the debt is included in the same net assets component as the unspent proceeds.

## NOTE 8 – NET ASSETS (cont.)

Restricted – This component of net assets consists of constraints placed on net asset use through external constraints imposed by creditors (such as through debt covenants), grantors, contributors, or laws or regulations of other governments or constraints imposed by law through constitutional provisions or enabling legislation.

Unrestricted net assets – The component of net asset consist of net assets that do not meet the definition of "restricted" or "invested in capital assets, net of related debt."

When both restricted and unrestricted resources are available for use, it is the utilities' policy to use restricted resources first, then unrestricted resources as they are needed.

The following calculation supports the net assets invested in capital assets, net of related debt:

| | 2007 | 2006 |
|---|---|---|
| Capital Assets | | |
| Utility plant in service and work in progress | $ 97,243,534 | $ 95,333,008 |
| Allowance for depreciation | (61,982,551) | (58,996,058) |
| Related Debt | | |
| Revenue bonds payable, less current portion (includes discounts, premiums and losses) | (38,836,277) | (46,795,374) |
| Current portion of revenue bonds | (8,076,100) | (7,793,783) |
| Deferred bond issue costs – net | 1,051,663 | 1,340,730 |
| Invested in Capital Assets, Net of Related Debt | $ (10,599,731) | $ (16,911,477) |

| Restricted Net Assets | 2007 | 2006 |
|---|---|---|
| Restricted assets | | |
| Bond service fund | $ 5,664,716 | $ 5,609,634 |
| Bond reserve fund – current | - | 2,647,992 |
| Bond reserve fund – noncurrent | 10,800,723 | 9,466,425 |
| Reserve and contingency fund – noncurrent | 1,090,580 | 1,090,580 |
| Current liabilities payable from restricted assets | | |
| Accrued interest payable | (356,799) | (432,974) |
| Restricted Net Assets | $ 17,199,220 | $ 18,381,657 |

## NOTE 9 – EMPLOYEE RETIREMENT PLAN

The Agency contributes to the Municipal Employees Retirement System of Michigan (MERS), an agent defined benefit multiple-employer public employee retirement system that acts as a common investment and administrative agent for municipalities. The Agency's defined benefit pension plan provides retirement and disability benefits to covered employees and beneficiaries. The present benefit provisions of MERS are governed by Act No. 220 of the Public Acts of 1996, as amended and the MERS Plan Document as revised. The MERS issues a publicly available financial report that includes financial statements and required supplementary information. That report may be obtained by writing to Municipal Employees Retirement System of Michigan, 447 N. Canal Road, Lansing, Michigan 48917.

The Agency funds the entire cost of each employee's participation in MERS. Contribution requirements of employees and the Agency are established and may be amended by the MERS Board of Trustees.

For 2007, 2006, and 2005, the Agency's annual pension cost of $296,352, $284,664, and $279,960, respectively, for the MERS was equal to the Agency's required and actual contributions.

The 2007 required contribution was determined as part of the December 31, 2006 actuarial valuation using the entry age normal cost method. This method seeks to provide a level pattern of cost as a percentage of salary throughout an employee's working lifetime. The actuarial assumptions included: (a) 8.0% investment rate of return in 2007, 2006, and 2005; (b) projected salary increases of 4.5% in 2007, 2006, and 2005; and (c) additional projected salary increases ranging from 0% to 4.16% in 2007, 2006, and 2005 depending on age, attributable to seniority and merit.

***Schedule of Funding Progress (Unaudited – Required Information)***

| Valuation Date | Actuarial Asset Values | Actuarial Accrued Liability (AAL) | Unfunded AAL (UAAL) | Funded Ratio | Covered Payroll | UAAL as a Percentage of Covered Payroll |
|---|---|---|---|---|---|---|
| December 31, 2002 | $ 4,100,623 | $ 5,542,082 | $ 1,441,459 | 74.0% | $ 2,298,839 | 62.7% |
| December 31, 2003 | 4,606,439 | 6,276,942 | 1,670,503 | 73.4 | 2,562,793 | 65.2 |
| December 31, 2004 | 5,081,085 | 6,976,587 | 1,895,502 | 72.8 | 2,621,348 | 72.3 |
| December 31, 2005 | 5,562,479 | 7,527,441 | 1,964,962 | 73.9 | 2,634,274 | 74.6 |
| December 31, 2006 | 6,118,262 | 8,509,040 | 2,390,778 | 71.9 | 2,547,127 | 93.9 |

## NOTE 10 – LEASES

The Agency entered into an operating lease agreement for rental of certain equipment, which commenced in April 2001. The lease agreement required monthly rental payments of $29,789 through 2007.

In August 2006, the Agency entered into an agreement to purchase this equipment and terminate the remaining lease.

## NOTE 11 – LONG-TERM SUPPLY AGREEMENTS

On December 12, 2001, the Agency entered into a fixed-price contract for the continuous supply of 30 MWH of power with CMS Energy. This contract was sold to Constellation Power Services on March 27, 2003. The exact rates and terms of the agreement are subject to a confidentiality agreement.

On June 14, 2004, the Agency entered into a fixed-price Master Services Agreement with American Municipal Power–Ohio, Inc. (AMP–Ohio) for power supply and hourly load energy services. The term for this agreement was one year with a one year extension option. At this time, all Agency members have become members of AMP-Ohio and these services are provided by AMP-Ohio to the Agency on behalf of the mutual members.

## NOTE 12 – MARKET PARTICIPATION

The Agency began participating in the Midwest Independent System Operator (MISO) energy market on April 1, 2005. MISO invoices the Agency for net generation sales or power purchases. These invoices are subject to future true-ups based on improved data. True-ups typically occur 55 and 105 days after the actual date of service. At year end the Agency is unable to estimate the amount of future adjustments relating to periods prior to year end.

## NOTE 13 – RISK MANAGEMENT

The Agency is exposed to various risks of loss related to torts, theft of, damage to, or destruction of assets, errors and omissions, workers compensation, and health care of its employees. 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.

## NOTE 14 – COMMITMENTS

The Agency has entered into contracts related to work to be commenced and completed subsequent to year end. Any service provided as of June 30, 2007 has been accrued in these financial statements.

## NOTE 15 – AGGREGATE BOND SERVICE COVERAGE

**June 30, 2007**

| | | |
|---|---|---|
| **NET REVENUES** | | |
| Operating Revenues | | $ 42,858,324 |
| Less: Operating Expenses | | |
| Operations | $ 27,682,099 | |
| Maintenance | 2,604,848 | |
| Administration and General | 1,924,902 | |
| Total | | (32,211,849) |
| Plus: | | |
| Interest and Miscellaneous Income | | 1,183,241 |
| **TOTAL NET REVENUES, AS DEFINED** | | $ 11,829,716 |
| **AGGREGATE BOND SERVICE, AS DEFINED (1)** | | $ 10,430,279 |
| **COVERAGE OF AGGREGATE BOND SERVICE BY NET REVENUES** | | 1.13 |

**June 30, 2006**

| | | |
|---|---|---|
| **NET REVENUES** | | |
| Operating Revenues | | $ 44,961,391 |
| Less: Operating Expenses | | |
| Operations | $ 29,747,444 | |
| Maintenance | 2,480,632 | |
| Administration and General | 2,047,997 | |
| Total | | (34,276,073) |
| Plus: | | |
| Interest and Miscellaneous Income | | 1,180,754 |
| **TOTAL NET REVENUES, AS DEFINED** | | $ 11,866,072 |
| **AGGREGATE BOND SERVICE, AS DEFINED (1)** | | $ 10,444,962 |
| **COVERAGE OF AGGREGATE BOND SERVICE BY NET REVENUES** | | 1.14 |

## NOTE 15 – AGGREGATE BOND SERVICE COVERAGE (cont.)

### (1) AGGREGATE BOND SERVICE, AS DEFINED

| Bond Service: | Total for Fiscal Year Ended June 30, 2007 | June 30, 2006 |
|---|---|---|
| 1992 Series | $ 2,642,205 | $ 7,889,702 |
| 2000 Series | 360,000 | 355,250 |
| 2002 Series | 6,582,833 | 1,559,500 |
| 2003 Series | 364,611 | 364,611 |
| 2004 Series | 480,630 | 275,899 |
| Aggregate Bond Service | $ 10,430,279 | $ 10,444,962 |

1. Section 6.13 of the Power Supply System Revenue Bond Resolution (the Resolution) dated August 23, 1979, as amended, for each Series of Construction Bonds requires – The Agency will, at all times while any of the bonds are Outstanding, establish, fix, prescribe and collect rates and charges for the sale or use of electric power and energy or related services produced, transmitted, distributed or furnished by the System which, together with other income, are reasonably expected to yield (a) for the forthcoming twelve-month period, Net Revenues equal to at least 1.10 times the Aggregate Bond Service for that period and, (b) at all times, Revenues at least equal to the amounts of all deposits required by the terms of the Resolution to be made into the funds and accounts held under the Resolution and not otherwise provided for. Promptly upon any material change in the circumstances which were contemplated at the time the rates and charges were most recently reviewed, but not less frequently than once in each Fiscal Year, the Agency shall review the rates and charges for electric power and energy and related services and shall promptly revise the rates and charges as necessary to comply with the foregoing requirement so that the rates and charges shall produce moneys sufficient to enable the Agency to comply with all its covenants under the Resolution.

   To comply with the requirements of the above Section of the Resolution, the Michigan South Central Power Agency (the Agency) has prepared the Aggregate Bond Service Coverage Calculation for the twelve months ended June 30, 2007.

2. Definitions of the following terms included in the calculation discussed in Note 1 are as indicated in Article I Section 1.01 Definitions of the Resolution:

   Net Revenues
   Revenues
   Operations and Maintenance Costs
   Aggregate Bond Service
   Bond Service

   All references to Generally Accepted Accounting Principles in the above definitions are generally those currently in existence, except for those that are inconsistent with the Resolution, in which case the terms of the Resolution control.

## NOTE 16 – CHANGE IN ACCOUNTING PRINCIPLE

As of July 1, 2005, the Agency re-evaluated its treatment of accrued interest on member deferred rate stabilization balances. Historically, these earnings had been recognized as agency income in the period received as the intent was for members to apply them towards Agency projects, rather than transferring cash. In re-examining the policy and this treatment, it was determined that the members have the right to withdraw the accrued interest at any time, for local or Agency projects. It was, therefore, determined that treatment as a liability rather than earned income was more appropriate. The cumulative effect of this change, as of July 1, 2005 of $2,369,352, has been shown in fiscal 2006.

In addition, the $100,264 of interest accrued during the year ended June 30, 2006 has been recorded as a liability rather than interest income.

## NOTE 17 – SUBSEQUENT EVENT

On August 1, 2007, the Agency converted its 2004 Revenue Refunding Bonds from a variable interest rate to a fixed interest rate. The new bonds will have an interest rate of 4.25 – 4.50%.