

PRESQUE ISLE ELECTRIC & GAS CO-OP
REPORT ON FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2006 AND 2005

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**PRESQUE ISLE ELECTRIC & GAS CO-OP
BOARD OF DIRECTORS
DECEMBER 31, 2006**

Allan H. Bruder	Chairperson
Allen L. Barr	Vice-Chairperson
Sally L. Knopf	Secretary
Robert W. Wegmeyer	Treasurer
Glen G. Alsobrooks	Director
John F. Brown	Director
Bernice C. Krajniak	Director
David W. Smith	Director
Raymond Wozniak	Director

President & Chief Executive Officer

Brian J. Burns



HARRIS GROUP

Certified Public Accountants


Independent Auditor's Report

The Board of Directors
Presque Isle Electric & Gas Co-op
Onaway, Michigan

We have audited the accompanying balance sheets of Presque Isle Electric & Gas Co-op as of December 31, 2006 and 2005, and the related statements of revenue and patronage capital, and cash flows for the years then ended. These financial statements are the responsibility of Presque Isle Electric & Gas Co-op'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 Presque Isle Electric & Gas Co-op as of December 31, 2006 and 2005, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.



Certified Public Accountants
January 31, 2007

PRESQUE ISLE ELECTRIC & GAS CO-OP
BALANCE SHEETS
DECEMBER 31, 2006 AND 2005

	2006	2005
ASSETS		
UTILITY PLANT:		
In-Service – at cost	\$ 94,510,769	\$ 91,184,593
Construction work in progress	8,850,304	7,748,244
SUBTOTAL	103,361,073	98,932,837
Less accumulated depreciation and amortization	33,312,044	31,509,040
NET UTILITY PLANT	70,049,029	67,423,797
OTHER ASSETS AND INVESTMENTS		
Investments on associated organizations	15,235,058	13,492,900
CURRENT ASSETS:		
Cash and temporary cash investments	1,058,270	905,687
Accounts Receivable, less allowance for possible losses of \$118,000 and \$94,000 in 2006 and 2005, respectively	5,574,686	6,715,917
Materials and supplies (at average cost)	1,128,951	981,297
Other current assets	129,297	105,611
TOTAL CURRENT ASSETS	7,891,204	8,708,512
DEFERRED DEBITS	225,822	241,524
TOTAL ASSETS	\$ 93,401,113	\$ 89,866,733

The accompanying notes are an integral part of these statements.

EQUITIES AND LIABILITIES	<u>2006</u>	<u>2005</u>
EQUITIES:		
Memberships	\$ 207,240	\$ 200,180
Patronage capital	32,289,209	29,857,657
Other equities	<u>687,457</u>	<u>687,457</u>
 TOTAL EQUITIES	 <u>33,183,906</u>	 <u>30,745,294</u>
LONG-TERM DEBT, NET OF CURRENT MATURITIES:		
Mortgage notes to National Rural Utilities Cooperative Finance Corporation (CFC)	47,020,519	48,376,767
Accrued post – retirement benefits	<u>284,930</u>	<u>399,529</u>
 TOTAL LONG-TERM DEBT	 <u>47,305,449</u>	 <u>48,776,296</u>
CURRENT LIABILITIES:		
Current maturities of long-term debt	1,340,000	1,270,000
CFC line of credit	6,379,542	3,764,883
Accounts payable, purchased energy	2,337,305	2,029,235
Accounts payable, other	326,127	416,664
Patronage capital payable	98,013	98,013
Customer deposits	167,607	133,508
Accrued property taxes	607,553	646,671
Accrued interest	249,220	258,035
Accrued sick and vacation pay	570,708	575,326
Accrued other	<u>234,297</u>	<u>327,591</u>
 TOTAL CURRENT LIABILITIES	 <u>12,310,372</u>	 <u>9,519,926</u>
 DEFERRED CREDITS	 <u>601,386</u>	 <u>825,217</u>
 TOTAL EQUITIES AND LIABILITIES	 <u>\$ 93,401,113</u>	 <u>\$ 89,866,733</u>

PRESQUE ISLE ELECTRIC & GAS CO-OP
STATEMENTS OF REVENUE AND PATRONAGE CAPITAL
FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005

	2006	2005
OPERATING REVENUES	\$ 34,355,773	\$ 33,155,949
OPERATING EXPENSES:		
Cost of energy	21,268,779	20,005,354
Distribution – operation	1,522,958	1,477,699
Distribution – maintenance	2,034,804	2,004,090
Consumers accounts	1,382,541	1,283,460
Customer service and information expense	125,760	129,565
Administrative and general	1,448,159	1,321,719
Depreciation and amortization	2,514,658	2,472,289
Taxes – property	902,455	869,181
Taxes – other	177,862	179,663
TOTAL OPERATING EXPENSES	31,377,976	29,743,020
OPERATING MARGIN BEFORE FIXED CHARGES	2,977,797	3,412,929
FIXED CHARGES:		
Interest	3,038,161	2,867,322
Other deductions	1,498	1,217
TOTAL FIXED CHARGES	3,039,659	2,868,539
OPERATING MARGINS AFTER FIXED CHARGES	(61,862)	544,390
CAPITAL CREDITS:		
Generation and transmission capital credits	2,029,954	1,985,080
Other capital credits	365,666	269,937
TOTAL CAPITAL CREDITS	2,395,620	2,255,017
NET OPERATING MARGINS	2,333,758	2,799,407

The accompanying notes are an integral part of these statements.

PRESQUE ISLE ELECTRIC & GAS CO-OP
STATEMENTS OF REVENUE AND PATRONAGE CAPITAL
FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005
(Continued)

	<u>2006</u>	<u>2005</u>
NET OPERATING MARGINS (from previous page)	\$ 2,333,758	\$ 2,799,407
NON-OPERATING MARGINS:		
Interest and dividend income	103,615	89,042
Other	<u>(68,401)</u>	<u>(231,230)</u>
TOTAL NON-OPERATING MARGINS	<u>35,214</u>	<u>(142,188)</u>
NET MARGINS	2,368,972	2,657,219
PATRONAGE CAPITAL, beginning of year	29,857,657	27,192,004
Other equity transactions – assignment of sales tax refund	<u>62,580</u>	<u>8,434</u>
PATRONAGE CAPITAL, end of year	<u>\$ 32,289,209</u>	<u>\$ 29,857,657</u>

The accompanying notes are an integral part of these statements.

PRESQUE ISLE ELECTRIC & GAS CO-OP
STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005

	2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Cash received from consumers	\$ 35,595,397	\$ 31,252,457
Cash paid to suppliers and employees	(27,285,674)	(25,861,013)
Interest received	103,615	89,042
Interest paid	(3,181,971)	(2,986,133)
Taxes paid	(1,584,859)	(1,429,196)
	<u>3,646,508</u>	<u>1,065,157</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Construction and acquisition of plant	(5,227,978)	(4,330,132)
Plant removal costs	(119,787)	(292,601)
(Increase) decrease in:		
Material inventory	(147,654)	(1,537)
Investments – associated organizations	653,462	323,305
	<u>(4,841,957)</u>	<u>(4,300,965)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:		
Advances from CFC	16,384,659	20,993,697
Payment of debt	(15,056,248)	(17,392,313)
Memberships issued	7,060	6,405
Increased (decrease) in:		
Consumer deposits	30,115	44,712
Deferred credits	(80,133)	(138,463)
Other equities	(1)	1,530
Patronage capital retired		
Sales tax refund to be assigned	62,580	8,434
	<u>1,348,032</u>	<u>3,524,002</u>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	152,583	288,194
CASH AND CASH EQUIVALENTS, beginning of year	905,687	617,493
CASH AND CASH EQUIVALENTS, end of year	\$ 1,058,270	\$ 905,687

The accompanying notes are an integral part of these statements.

PRESQUE ISLE ELECTRIC & GAS CO-OP
STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005
(Continued)

	2006	2005
RECONCILIATION OF NET MARGINS TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Net Margins	\$ 2,368,972	\$ 2,657,219
Adjustments to reconcile net margins to net cash provided by		
Operating activities:		
Depreciation and amortization	2,606,431	2,560,868
(Gain) loss on disposition of assets	111,352	257,005
G&T and other capital credits	(2,395,620)	(2,255,017)
(Increase) decrease in:		
Customer and other accounts receivable	1,141,261	(1,960,454)
Other currents assets	(23,686)	(84,237)
Deferred debits	15,702	16,258
Amortization of debt discount	(134,995)	(134,995)
Increase (decrease) in:		
Accounts payable	217,534	296,459
Accrued property taxes	(39,118)	(93,100)
Accrued interest payable	(8,815)	16,184
Current and accrued liabilities – other	(212,510)	(211,033)
Total Adjustments	1,277,536	(1,592,062)
NET CASH PROVIDED BY OPERATING ACTIVITIES	\$ 3,646,508	\$ 1,065,157
NON-CASH ITEMS – INVESTING & FINANCING		
Capital credits from associated organizations	2,395,620	2,255,017

The accompanying notes are an integral part of these statements.

PRESQUE ISLE ELECTRIC & GAS CO-OP
NOTES TO FINANCIAL STATEMENTS

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The following is a summary of the accounting policies adopted by Presque Isle Electric & Gas Co-op which have a significant effect on the financial statements.

Organization

Presque Isle Electric & Gas Co-op (Presque Isle) is a non-profit organization generally exempt from income tax under Section 501(c)(12) of the United States Internal Revenue Code. Presque Isle is subject to the Single Business Tax Act of the State of Michigan.

The process of preparing financial statements in conformity with generally accepted accounting principles requires the use of estimates and assumptions regarding certain types of assets, liabilities, revenues and expenses. Such estimates primarily relate to unsettled transactions and events as of the date of the financial statements. Accordingly, upon settlement, actual results may differ from estimated amounts.

Utility Plant

Additions, with a life expectancy of more than one year, are recorded at cost, less contributions in aid of construction received from customers. As items are retired or otherwise disposed of, the asset account is credited for the cost and the accumulated depreciation account is charged. The cost of removal, less salvage, is charged to the loss on disposition of utility plant account, and shown on the Statement of Revenue.

Investments

The carrying values of investments in associated organizations are stated at cost, adjusted for capital credits earned or retired. Short-term investments are stated at cost, which approximates market value.

Cash

For purposes of the statement of cash flows, Presque Isle considers all short-term debt securities purchased with a maturity of three months or less to be cash equivalents.

Consumer Energy Prepayments and Unbilled Revenues

Seasonal account billings are accounted for as deferred credits and recognized as income on a straight-line basis over a period of one year. There were no estimated net unbilled revenues for the year.

Accounts receivable

Accounts receivable consist primarily of amounts due from members for electric and gas service. An allowance for doubtful accounts has been estimated based on collection history. When a member's account becomes past due and uncollectible, the member's service is terminated. The Board of Directors approve all accounts charged off.

PRESQUE ISLE ELECTRIC & GAS CO-OP
NOTES TO FINANCIAL STATEMENTS

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

Materials and Supplies

Electrical materials and supplies are valued at average cost. Merchandise held for resale is valued on the first-in, first-out basis.

Retirement Plan

Presque Isle has a retirement savings plan for substantially all employees. Under the terms of the plan, Presque Isle is required to contribute 10 to 16 percent of the employee's total base earnings to the retirement plan.

Flex Benefit Plan

Presque Isle has a Flexible Benefits Plan. The purpose of the plan is to provide eligible employees a choice between cash and the specified welfare benefits described in the plan. Pre-Tax Premium elections under the plan are intended to qualify for the exclusion from income provided in Section 125 of the Internal Revenue Code of 1986.

Contributions in Aid of Construction

Contributions in aid of construction are received from customers on electrical and gas installations and re-applied against the construction costs.

NOTE 2: ASSETS PLEDGED

Substantially all assets are pledged as collateral on long-term debt payable to the National Rural Utilities Cooperative Finance Corporation (CFC).

NOTE 3: ELECTRIC AND GAS PLANT AND DEPRECIATION RATES AND PROCEDURES

Major classes of electric and gas plant as of December 31, 2006 and 2005 consisted of:

	<u>2006</u>	<u>2005</u>
Intangible plant	\$ 984,008	\$ 979,674
Distribution plant	88,821,955	85,625,649
General plant	<u>4,704,806</u>	<u>4,579,270</u>
	94,510,769	91,184,593
Construction work in progress	<u>8,850,304</u>	<u>7,748,244</u>
TOTAL	<u>\$ 103,361,073</u>	<u>\$ 98,932,837</u>

PRESQUE ISLE ELECTRIC & GAS CO-OP
NOTES TO FINANCIAL STATEMENTS

NOTE 4: ELECTRIC AND GAS PLANT AND DEPRECIATION RATES AND PROCEDURES - continued

Provision has been made for depreciation of the distribution plant at a straight-line rate of 10 to 50 years for all distribution plant additions.

General plant depreciation rates have been applied on a straight-line basis as follows for the year ended December 31, 2006:

	<u>Years</u>
Structures and improvements	10-50
Office furniture equipment	3-7
Transportation equipment	4-7
Power operated equipment	3-16
Other	4-5

Depreciation and amortization of electric and gas plant in service was charged as follows for the years ended December 31, 2006 and 2005:

	<u>2006</u>	<u>2005</u>
Charged to:		
Classified as depreciation and amortization	\$ 2,514,658	\$ 2,472,289
Classified in other operating expenses	91,773	88,579
	<u>2,606,431</u>	<u>2,560,868</u>
Charged to construction	206,391	205,558
	<u>206,391</u>	<u>205,558</u>
TOTAL DEPRECIATION AND AMORTIZATION	<u><u>\$ 2,812,822</u></u>	<u><u>\$ 2,766,426</u></u>

NOTE 5: INVESTMENTS IN ASSOCIATED ORGANIZATIONS

Investments in associated organizations consisted of the following at December 31, 2006 and 2005:

	<u>2006</u>	<u>2005</u>
Wolverine Power Supply Coop. Inc. - capital credits	\$ 8,558,801	\$ 8,333,888
Wolverine Power Supply Coop. Inc. - PSDF	3,992,527	2,593,694
National Rural Utilities Cooperative Finance Corp.:		
Capital term certificates maturing December 1, 2020 through October 1, 2080 at interest rates between 3% and 5%	1,719,442	1,732,413
Patronage capital certificates	755,940	663,747
Other	208,348	169,158
	<u>208,348</u>	<u>169,158</u>
TOTAL	<u><u>\$ 14,478,817</u></u>	<u><u>\$ 13,492,900</u></u>

**PRESQUE ISLE ELECTRIC & GAS CO-OP
NOTES TO FINANCIAL STATEMENTS**

NOTE 6: SHORT-TERM INVESTMENTS - RESTRICTED

On March 20, 1984, the Michigan Public Service Commission issued its opinion and order in Case No. U-7901, directing Michigan's Rural Electric Cooperatives to maintain power supply cost recovery over-collections and refundable contributions in restricted accounts to be used only for the purpose for which they are intended.

In order to accomplish the objectives of the Commission, a non-complex mechanism acceptable to CFC and a workable approach acceptable to Presque Isle Electric & Gas Co-op, Inc., on December 17, 1985, entered into an agreement with CFC to escrow power supply cost recovery over-collections and refundable contributions. A monthly certification is to be included with the monthly form advising CFC as to amounts included in the special funds representing power supply cost recovery over-collections and refundable contributions.

Presque Isle is to provide CFC a copy of the monthly certification described above which will serve as notice to CFC as to the amount below which the fund should not fall. Under the provisions of the agreement with CFC when the amount of deposits held by CFC falls below the level set forth in the latest available certification furnished CFC, CFC will advise the Commission if Presque Isle has not remedied the deficiency within three business days of notification by CFC to Presque Isle.

There were no amounts required to be restricted as of December 31, 2006 and 2005.

NOTE 7: CASH AND INVESTMENTS

Statements of Financial Accounting Standards (SFAS) No. 105 require disclosure of significant concentrations of credit risk arising from cash deposits in excess of federally insured limits.

	<u>Per Institution</u>	<u>Per Book</u>
Insured	\$ 340,200	\$ 341,212
Uninsured	<u>676,226</u>	<u>716,058</u>
Cash in banks, credit union & CFC	<u>\$ 1,016,426</u>	1,057,270
Working funds		<u>1,000</u>
Total per books		<u>\$ 1,058,270</u>

PRESQUE ISLE ELECTRIC & GAS CO-OP
NOTES TO FINANCIAL STATEMENTS

NOTE 8: DEFERRED DEBITS

The Cooperative has recorded deferred debits in the following amounts:

	<u>2006</u>	<u>2005</u>
Prepaid tap fees	\$ 77,343	\$ 79,339
Prepaid years of service	<u>148,479</u>	<u>162,185</u>
TOTAL	<u>\$ 225,822</u>	<u>\$ 241,524</u>

NOTE 9: MEMBERSHIPS

The following is a summary of changes in memberships for the years ended December 31, 2006 and 2005:

	<u>2006</u>	<u>2005</u>
Balance, beginning	\$ 200,180	\$ 193,775
Membership and subscriptions issued	7,190	7,935
Adjustment	<u>(130)</u>	<u>(1,530)</u>
Balance, ending	<u>\$ 207,240</u>	<u>\$ 200,180</u>

Memberships have been adjusted to reflect the number of members currently receiving service. In accordance with the Co-op by-laws, memberships are not refunded when a member leaves the service area. The membership fee is transferred to donated capital when the member terminates service.

NOTE 10: PATRONAGE CAPITAL

Patronage capital balances as of December 31, 2006 and 2005 consisted of:

	<u>2006</u>	<u>2005</u>
Assignable	\$ 2,368,972	\$ 2,657,219
Sales tax refund assignable	62,580	8,434
Assigned to date	<u>34,004,540</u>	<u>31,338,887</u>
	36,436,092	34,004,540
Less retirements to date	<u>4,146,883</u>	<u>4,146,883</u>
Balance	<u>\$ 32,289,209</u>	<u>\$ 29,857,657</u>

PRESQUE ISLE ELECTRIC & GAS CO-OP
NOTES TO FINANCIAL STATEMENTS

NOTE 10: PATRONAGE CAPITAL - continued

Under the provisions of the Mortgage Agreement, until the equities and margins equal or exceed thirty percent of the total assets of the Cooperative, the return to patrons of capital contributed by them is limited generally to twenty-five percent of the patronage capital or margins received by the Cooperative in the next preceding year. The equities and margins of Presque Isle represent 35.00% and 34.21% of the total assets for the years 2006 and 2005, respectively. There were capital credits retired of \$0 during 2006 or 2005, respectively.

NOTE 11: MORTGAGE NOTES

Long-term debt is composed of 4.30 percent to 6.65 percent mortgage notes payable to the National Rural Utilities Cooperative Finance Corporation (CFC). All mortgage notes to CFC will be repriced and the interest rate adjusted accordingly during the next 10 years in accordance with the policy and procedure governing such repricing. The notes are for 35 year periods each, with principal and interest installments due either quarterly or monthly. The notes are scheduled to be fully repaid at various times from September 2010 through February 2038.

There were unadvanced loan funds available at December 31, 2006 in the amount of \$14,000,000.

Detail of the long-term debt is as follows:

	<u>2006</u>	<u>2005</u>
National Rural Utilities Cooperative Finance Corporation mortgage notes bearing interest at 4.30% to 6.65% per annum for 2006 and 2005	\$ 48,333,019	\$ 49,569,267
Zero term certificate loan (ZTC) non-interest Bearing	<u>27,500</u>	<u>77,500</u>
	48,360,519	49,646,767
Less current maturities	<u>1,340,000</u>	<u>1,270,000</u>
TOTAL LONG-TERM DEBT	<u><u>\$ 47,020,519</u></u>	<u><u>\$ 48,376,767</u></u>

Maturities of long-term debt for each of the next five years are as follows:

2007	\$ 1,340,000
2008	\$ 1,415,000
2009	\$ 1,490,000
2010	\$ 1,570,000
2011	\$ 1,650,000

NOTE 12: LINE OF CREDIT

Presque Isle has available a short-term line of credit from CFC of \$6,400,000 for 2006 and \$5,890,000 for 2005 with a revolving credit and term of sixty months. The agreement requires that within 360 days of the first advance, the cooperative will reduce to zero for a period of at least five consecutive business days amounts outstanding. The Cooperative was in compliance with this provision during 2006 and 2005. Balance available at December 31, 2006 and 2005 was \$20,458 and \$2,125,117. The outstanding balance at December 31, 2006 and 2005 was \$6,379,542 and \$3,764,883, respectively.

**PRESQUE ISLE ELECTRIC & GAS CO-OP
NOTES TO FINANCIAL STATEMENTS**

NOTE 13: DEFERRED CREDITS

Following is a summary of the amounts recorded as deferred credits as of December 31, 2006 and 2005:

	2006	2005
Deferred gain from extinguishments of debt	\$ 1,214,960	\$ 1,349,955
Customer energy prepayments	(613,574)	(524,738)
TOTAL	\$ 601,386	\$ 825,217

NOTE 14: RETIREMENT PLAN

Retirement plan benefits for substantially all employees are provided through participation in a defined contribution SelectRE pension plan with 401k option with cash and deferred arrangement of the National Rural Electric Cooperative Association (NRECA) and its member systems. The income earned by funds while held under the plan is tax-exempt under Code Sections 401 and 501 of the Internal Revenue Code. Contributions to the savings program, which are based on a percentage of the employees' compensation were \$378,484 in 2006 and \$369,566 in 2005.

NOTE 15: POWER SUPPLY COST RECOVERY CLAUSE

On October 12, 1982, the Governor of the State of Michigan signed PA 304 of 1982 into law creating the Power Supply Cost Recovery Clause (PSCR), a power cost recovery mechanism.

Wolverine Power Supply Cooperative, Inc. (Wolverine) and the member-distribution Cooperatives including Presque Isle, obtained authority to implement and apply PSCR clauses and monthly factors. Presque Isle's monthly factor may not exceed 16.61 mills per KWH for the current period.

Due to fluctuations in market conditions, over-collections or under-collections could result between the generation cooperative and distribution cooperative as well as between the distribution cooperatives and their member-consumers.

The PSCR clause includes provisions whereby power cost recovery over-collections must be remedied by refunds and power cost recovery under-collections must be remedied by additional collections.

Presque Isle's balance sheets reflect an amount due from/(to) member-consumers for under/(over) collections in the amounts of \$352,305 and \$1,602,931 at December 31, 2006 and 2005, respectively. These amounts are included in the accounts receivable balance.

On September 1, 2006, Presque Isle Electric & Gas Co-op implemented a new rate setting mechanism for its natural gas operations in 34 of its 36 franchised jurisdictions. This included a Gas Cost Recovery (GCR) mechanism. Due to fluctuations in market conditions, over-collections and under-collections of natural gas supply costs could result between the distribution cooperative and its member-consumers.

The GCR mechanism includes provisions whereby gas cost recovery over-collections must be remedied by refunds and gas cost recovery under-collections must be remedied by additional collections.

Presque Isle's balance sheet reflects an amount due from member-consumers for under collections in the amounts of \$194,212. This amount is included in the accounts receivable balance

PRESQUE ISLE ELECTRIC & GAS CO-OP
NOTES TO FINANCIAL STATEMENTS

NOTE 16: POST-RETIREMENT BENEFITS OTHER THAN PENSIONS

The cooperative has chosen to recognize the accounting method required by the Statement of Financial Accounting Standards No. 106 for Employer's Accounting for Post-retirement Benefits Other Than Pensions. The statement requires a transition from accounting, for these benefits, on a pay-as-you go (cash basis) to recognizing the benefit cost as they are earned (accrual basis). The change in accounting method requires the accounting for costs incurred to date but unpaid, which is called the Transition amount. This amount may be either expensed in the year of transition or it may be amortized over either the benefit period or twenty-years.

The plan sponsored by the company is a defined benefit post-retirement plan that covers all employees who retire from the cooperative before April 1, 1997 after (i) attainment of age 55 and completion of 30 years of service, or (ii) attainment of age 62. Spouses of pensioners are also insured until the pensioner's death.

At the end of 2006 there were no active participants and the accounting rules of the Financial Accounting Standards Board Statement No. 88 regarding curtailment must be recognized. The reconciliation of the funded status at December 31, 2006 is as follows:

	<u>2006</u>	<u>2005</u>
(Accrued) post-retirement benefit costs, beginning	\$ (399,529)	\$ (520,300)
Net periodic post-retirement benefit (costs)	(45,833)	(45,833)
Contributions made	<u>160,432</u>	<u>166,604</u>
(Accrued) post-retirement benefit cost, end of year	<u>\$ (284,930)</u>	<u>\$ (399,529)</u>

Net periodic post-retirement benefit cost includes the following components:

	<u>2006</u>	<u>2005</u>
Interest cost	\$ 25,667	\$ 25,667
Net amortization and deferral	<u>20,166</u>	<u>20,166</u>
Net periodic post-retirement benefit cost	<u>\$ 45,833</u>	<u>\$ 45,833</u>

For measurement purposes a 13.0% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2006; the rate was assumed to decrease gradually to an ultimate rate of 3.5% per annum. The health care cost trend rate assumption has a significant effect on the amounts reported. To illustrate, increasing the assumed health care cost trend rates by 1 percentage point in each year would increase the accumulated post-retirement benefit obligation \$122,940 and the aggregate of the service and interest cost components of the net periodic benefit cost by \$8,299. Decreasing the assumed health care cost trend rates by 1 percentage point in each year would decrease the accumulated post-retirement benefit obligation \$111,396 and the aggregate of the service and interest cost components of the net periodic benefit cost by \$7,519.

The weighted-average discount rate used in determining the accumulated post-retirement benefit obligation was 7.5 percent.

PRESQUE ISLE ELECTRIC & GAS CO-OP
NOTES TO FINANCIAL STATEMENTS

NOTE 17: FLEX BENEFIT PLAN - under Section 125 of the Internal Revenue Code

The Flexible Benefit Plan is for the benefit of substantially all employees who have been employed for at least 30 days. The Cooperative has elected to offer to eligible employees the following Benefit Plans and Policies subject to the terms and conditions of the plan: (1) Disability Income - Short-Term (A&S); (2) Cancer Insurance; (3) Intensive Care Insurance; (4) Accident Insurance; and (5) Medical Care Expense Reimbursement, not to exceed \$1,200 per plan year. The maximum Pre-Tax Premiums a participant can contribute via the Salary Redirection Agreement is the aggregate cost of the applicable Benefit Plans or Policies selected minus any Nonelective Contributions made by the employer. It is intended that such Pre-Tax Premium accounts shall, for tax purposes, constitute an employer contribution.

NOTE 18: LETTERS OF CREDIT

The Co-op has a letter of credit outstanding to the State of Michigan for \$100,000 at December 31, 2006. In order to maintain status as a licensed Alternative Gas Supplier in the State of Michigan the Michigan Public Service Commission requires this letter of credit.

The Co-op has a letter of credit outstanding to the WPS Energy for \$2,000,000 at December 31, 2006. This letter of credit is required in order to mitigate counter party risk in natural gas purchase transactions. This also is a risk management tool for the Co-op with respect to market to market issues.

NOTE 19: RECLASSIFICATION OF AMOUNTS

Certain amounts previously reported have been reclassified to conform to the 2006 presentation.

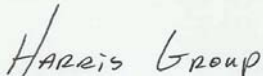


HARRIS GROUP

Certified Public Accountants

AUDITORS' CERTIFICATION REGARDING LOAN FUND EXPENDITURES

During the period of this audit, Presque Isle Electric & Gas Co-op received \$0 in long-term loan fund advances from CFC on loans controlled by the 100% CFC Mortgage and Loan Agreement. Based on our review of construction work orders and other plant accounting records created during the audit period, it is our opinion that these CFC loan funds were expended for purposes contemplated in the Loan Agreements on such loans.

A handwritten signature in dark blue ink that reads "HARRIS GROUP". The signature is written in a cursive, slightly slanted style.

Certified Public Accountants
January 31, 2007