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ALLETE INC
Form 10-K
February 16, 2007

FORM 10-K

United States
Securities and Exchange Commission
Washington, D.C. 20549

(Mark One)

Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the fiscal year ended DECEMBER 31, 2006

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from _____ to _____

Commission File No. 1-3548

ALLETE, INC.
(Exact name of registrant as specified in its charter)

MINNESOTA 41-0418150
(State or other jurisdiction of (I.R.S. Employer Identification No.)
incorporation or organization)

30 WEST SUPERIOR STREET, DULUTH, MINNESOTA 55802-2093
(Address of principal executive offices, including zip code)

(218) 279-5000
(Registrant's telephone number, including area code)

SECURITIES REGISTERED PURSUANT TO SECTION 12(B) OF THE ACT:

| Title of Each Class ----- | Name of Each Stock Exchange on Which Registered ----- |
|---------------------------------|---|
| Common Stock, without par value | New York Stock Exchange |

SECURITIES REGISTERED PURSUANT TO SECTION 12(G) OF THE ACT:

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405

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of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. /X/

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer (as defined in Rule 12b-2 of the Act).

Large Accelerated Filer /X/ Accelerated Filer / / Non-Accelerated Filer / /

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

Yes / / No /X/

The aggregate market value of voting stock held by nonaffiliates on June 30, 2006, was \$1,427,346,731.

As of February 1, 2007, there were 30,446,854 shares of ALLETE Common Stock, without par value, outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2007 Annual Meeting of Shareholders are incorporated by reference in Part III.

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DEFINITIONS

The following abbreviations or acronyms are used in the text. References in this report to "we," "us" and "our" are to ALLETE, Inc. and its subsidiaries, collectively.

| ABBREVIATION OR ACRONYM | TERM |
|----------------------------------|--|
| ADESA | ADESA, Inc. |
| AICPA | American Institute of Certified Public Accountants |
| ALLETE | ALLETE, Inc. |
| ALLETE Properties | ALLETE Properties, LLC |
| AREA | Arrowhead Regional Emission Abatement |
| ATC | American Transmission Company LLC |
| BNI Coal | BNI Coal, Ltd. |
| Boswell | Boswell Energy Center |
| Company | ALLETE, Inc. and its subsidiaries |
| Constellation Energy Commodities | Constellation Energy Commodities Group, |

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| | |
|------------------|--|
| DOC | Inc. |
| DRI | Minnesota Department of Commerce |
| EITF | Development of Regional Impact |
| Enventis Telecom | Emerging Issues Task Force |
| EPA | Enventis Telecom, Inc. |
| ESOP | Environmental Protection Agency |
| FASB | Employee Stock Ownership Plan |
| FERC | Financial Accounting Standards Board |
| Florida Landmark | Federal Energy Regulatory Commission |
| Florida Water | Florida Landmark Communities, Inc. |
| Form 8-K | Florida Water Services Corporation |
| Form 10-K | ALLETE Current Report on Form 8-K |
| Form 10-Q | ALLETE Annual Report on Form 10-K |
| FPL Energy | ALLETE Quarterly Report on Form 10-Q |
| FPSC | FPL Energy, LLC |
| FSP | Florida Public Service Commission |
| | Financial Accounting Standards Board Staff |
| | Position |
| GAAP | Accounting Principles Generally Accepted |
| | in the United States |
| Invest Direct | ALLETE's Direct Stock Purchase and |
| | Dividend Reinvestment Plan |
| IPO | Initial Public Offering |
| kV | Kilovolt(s) |
| Laskin | Laskin Energy Center |
| MBtu | Million British thermal units |
| Minnesota Power | An operating division of ALLETE, Inc. |
| Minnkota Power | Minnkota Power Cooperative, Inc. |
| MISO | Midwest Independent Transmission System |
| | Operator, Inc. |
| Moody's | Moody's Investors Service, Inc. |
| MPCA | Minnesota Pollution Control Agency |
| MPUC | Minnesota Public Utilities Commission |
| MW / MWh | Megawatt(s) / Megawatthour(s) |

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DEFINITIONS (CONTINUED)

| ABBREVIATION OR ACRONYM | TERM |
|--------------------------|--|
| NOx | Nitrogen Oxide |
| Northwest Airlines | Northwest Airlines, Inc. |
| Note ____ | Note ____ to the consolidated financial statements in this Form 10-K |
| NPDES | National Pollutant Discharge Elimination System |
| NYSE | New York Stock Exchange |
| OAG | Office of the Attorney General |
| Oliver Wind I | Oliver Wind I Energy Center |
| Oliver Wind II | Oliver Wind II Energy Center |
| Palm Coast Park | Palm Coast Park development project in Florida |
| Palm Coast Park District | Palm Coast Park Community Development District |
| PolyMet Mining | PolyMet Mining, Inc. |
| PSCW | Public Service Commission of Wisconsin |
| PUHCA 1935 | Public Utility Holding Company Act of 1935 |
| PUHCA 2005 | Public Utility Holding Company Act of 2005 |
| Rainy River Energy | Rainy River Energy Corporation |

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| | |
|----------------------|---|
| SEC | Securities and Exchange Commission |
| SFAS | Statement of Financial Accounting Standards No. |
| SO2 | Sulfur Dioxide |
| Split Rock Energy | Split Rock Energy LLC |
| Square Butte | Square Butte Electric Cooperative |
| Standard & Poor's | Standard & Poor's Ratings Services, a division of The McGraw-Hill Companies, Inc. |
| SWL&P | Superior Water, Light and Power Company |
| Taconite Harbor | Taconite Harbor Energy Center |
| Town Center | Town Center at Palm Coast development project in Florida |
| Town Center District | Town Center at Palm Coast Community Development District |
| WDNR | Wisconsin Department of Natural Resources |

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SAFE HARBOR STATEMENT UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

In connection with the safe harbor provisions of the Private Securities Litigation Reform Act of 1995, we are hereby filing cautionary statements identifying important factors that could cause our actual results to differ materially from those projected in forward-looking statements (as such term is defined in the Private Securities Litigation Reform Act of 1995) made by or on behalf of ALLETE in the Annual Report on Form 10-K, in presentations, in response to questions or otherwise. Any statements that express, or involve discussions as to expectations, beliefs, plans, objectives, assumptions, or future events or performance (often, but not always, through the use of words or phrases such as "anticipates," "believes," "estimates," "expects," "intends," "plans," "projects," "will likely result," "will continue," "could," "may," "potential," "target," "outlook" or similar expressions) are not statements of historical facts and may be forward-looking.

Forward-looking statements involve estimates, assumptions, risks and uncertainties, which are beyond our control and may cause actual results or outcomes to differ materially from those that may be projected. These statements are qualified in their entirety by reference to, and are accompanied by, the following important factors, in addition to any assumptions and other factors referred to specifically:

- our ability to successfully implement our strategic objectives;
- our ability to manage expansion and integrate acquisitions;
- prevailing governmental policies and regulatory actions, including those of the United States Congress, state legislatures, the FERC, the MPUC, the PSCW, and various local and county regulators, and city administrators, about allowed rates of return, financings, industry and rate structure, acquisition and disposal of assets and facilities, real estate development, operation and construction of plant facilities, recovery of purchased power and capital investments, present or prospective wholesale and retail competition (including but not limited to transmission costs), and zoning and permitting of land held for resale;
- effects of restructuring initiatives in the electric industry;
- economic and geographic factors, including political and economic risks;
- changes in and compliance with laws and policies;
- weather conditions;
- natural disasters and pandemic diseases;

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- war and acts of terrorism;
- wholesale power market conditions;
- population growth rates and demographic patterns;
- effects of competition, including competition for retail and wholesale customers;
- changes in the real estate market;
- pricing and transportation of commodities;
- changes in tax rates or policies or in rates of inflation;
- unanticipated project delays or changes in project costs;
- availability of construction materials and skilled construction labor for capital projects;
- unanticipated changes in operating expenses and capital expenditures;
- global and domestic economic conditions;
- our ability to access capital markets and bank financing;
- changes in interest rates and the performance of the financial markets;
- our ability to replace a mature workforce, and retain qualified, skilled and experienced personnel; and
- the outcome of legal and administrative proceedings (whether civil or criminal) and settlements that affect the business and profitability of ALLETE.

Additional disclosures regarding factors that could cause our results and performance to differ from results or performance anticipated by this report are discussed in Item 1A under the heading "Risk Factors" beginning on page 24 of this Form 10-K. Any forward-looking statement speaks only as of the date on which such statement is made, and we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which that statement is made or to reflect the occurrence of unanticipated events. New factors emerge from time to time, and it is not possible for management to predict all of these factors, nor can it assess the impact of each of these factors on the businesses of ALLETE or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statement. Readers are urged to carefully review and consider the various disclosures made by us in this Form 10-K and in our other reports filed with the SEC that attempt to advise interested parties of the factors that may affect our business.

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PART I

ITEM 1. BUSINESS

ALLETE has been incorporated under the laws of Minnesota since 1906. ALLETE's corporate headquarters are in Duluth, Minnesota. As of December 31, 2006, we had approximately 1,500 employees, 100 of which were part-time. Statistical information is presented as of December 31, 2006, unless otherwise indicated. All subsidiaries are wholly owned unless otherwise specifically indicated. References in this report to "we," "us" and "our" are to ALLETE and its subsidiaries, collectively.

ALLETE makes its SEC filings, including its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and any amendments to those reports, available free of charge on ALLETE's Website www.allete.com, as soon as reasonably practicable after they are electronically filed with or furnished to the SEC.

ALLETE is a diversified company providing fundamental products and services. This includes our two core businesses--ENERGY and REAL ESTATE, as well as former operations in the water, paper, telecommunication and automotive industries.

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ENERGY is comprised of Regulated Utility, Nonregulated Energy Operations and Investment in ATC.

- REGULATED UTILITY includes retail and wholesale rate regulated electric, natural gas and water services in northeastern Minnesota and northwestern Wisconsin under the jurisdiction of state and federal regulatory authorities.
- NONREGULATED ENERGY OPERATIONS includes our coal mining activities in North Dakota, approximately 50 MW of nonregulated generation and Minnesota land sales.

In 2004 and 2005, Nonregulated Energy Operations also included nonregulated generation from our Taconite Harbor facility in northern Minnesota, and generation secured through the Kendall County power purchase agreement. Effective January 1, 2006, Taconite Harbor was integrated into our Regulated Utility business to help meet forecasted base load energy requirements. In April 2005, the Kendall County power purchase agreement was assigned to Constellation Energy Commodities.

- INVESTMENT IN ATC includes our equity ownership interest in ATC.

REAL ESTATE includes our Florida real estate operations.

OTHER includes our investments in emerging technologies, and earnings on cash and short-term investments.

| YEAR ENDED DECEMBER 31 | 2006 | 2005 |
|--|---------|---------|
| <hr/> | | |
| Consolidated Operating Revenue - Millions | \$767.1 | \$737.4 |
| <hr/> | | |
| Percentage of Consolidated Operating Revenue | | |
| Regulated Utility | | |
| Industrial | | |
| Taconite Producers | 24% | 23% |
| Paper and Wood Products | 9 | 9 |
| Pipelines and Other Industries | 6 | 6 |
| <hr/> | | |
| Total Industrial | 39 | 38 |
| Residential | 10 | 10 |
| Commercial | 11 | 11 |
| Municipals | 5 | 5 |
| Other Power Suppliers | 12 | 7 |
| Other Revenue | 6 | 7 |
| <hr/> | | |
| Total Regulated Utility | 83 | 78 |
| Nonregulated Energy Operations | 9 | 16 |
| Real Estate | 8 | 6 |
| <hr/> | | |
| | 100% | 100% |
| <hr/> | | |

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For a detailed discussion of results of operations and trends, see Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations. For business segment information, see Notes 1 and 2.

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DISCONTINUED OPERATIONS. In the past five years, we also had business operations in the automotive, water and telecommunications industries.

SPIN-OFF OF AUTOMOTIVE SERVICES. Through a June 2004 IPO, our Automotive Services business, doing business as ADESA, Inc. (NYSE: KAR), issued 6.3 million shares of common stock, representing 6.6% of ADESA's common stock outstanding. In September 2004, we spun off the business by distributing to ALLETE shareholders all of ALLETE's remaining 93.4% of ADESA common stock.

SALE OF WATER SERVICES BUSINESSES. In early 2005, we completed the exit from our Water Services businesses with the sale of our wastewater assets in Georgia. In mid-2004, we sold our North Carolina water and wastewater assets, and our remaining 72 water and wastewater systems in Florida. Substantially all of our water assets in Florida were sold in 2003, under condemnation or imminent threat of condemnation. The net cash proceeds from the sale of all water and wastewater assets, after transaction costs, retirement of most Florida Water debt and payment of income taxes, were approximately \$300 million.

SALE OF ENVENTIS TELECOM. On December 30, 2005, we sold all the stock of our telecommunications subsidiary, Enventis Telecom for \$35.5 million. The transaction resulted in an after-tax loss of \$3.6 million, which was included in our 2005 loss from discontinued operations. Net cash proceeds realized from the sale were approximately \$29 million after transaction costs, repayment of debt and payment of income taxes.

ENERGY - REGULATED UTILITY

MINNESOTA POWER, an operating division of ALLETE, provides regulated utility electric service in a 26,000 square-mile service territory in northeastern Minnesota to 140,000 retail customers and wholesale electric service to 16 municipalities. SWL&P provides regulated utility electric, natural gas and water service in northwestern Wisconsin to 14,000 electric customers, 12,000 natural gas customers and 10,000 water customers.

Minnesota Power had an annual net peak load of 1,586 MW on July 28, 2006. Our regulated power supply sources are listed below.

| REGULATED UTILITY POWER SUPPLY | UNIT NO. | YEAR INSTALLED | NET WINTER CAPABILITY | E |
|-----------------------------------|-------------|-------------------|--------------------------|----|
| | | | | MW |
| Steam | | | | |
| Coal-Fired | | | | |
| Boswell Energy Center | 1 | 1958 | 69 | |
| in Cohasset, MN | 2 | 1960 | 69 | |
| | 3 | 1973 | 351 | |
| | 4 | 1980 | 428 | |

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| | | | | |
|---|----------|--------------------|----------|-----|
| | | | 917 | 6, |
| ----- | | | | |
| Laskin Energy Center in Hoyt Lakes, MN | 1 2 | 1953 1953 | 55 55 | |
| ----- | | | | |
| | | | 110 | |
| ----- | | | | |
| Taconite Harbor Energy Center in Taconite Harbor, MN | 1, 2 & 3 | 1957, 1957 1967 | 220 | 1, |
| ----- | | | | |
| Purchased Steam Hibbard Energy Center in Duluth, MN | 3 & 4 | 1949, 1951 | 50 | |
| ----- | | | | |
| Total Steam | | | 1,297 | 8, |
| ----- | | | | |
| Hydro Group consisting of ten stations in MN | Various | | 115 | |
| ----- | | | | |
| Total Company Generation | | | 1,412 | 8, |
| ----- | | | | |
| Purchased Power | | | | |
| Square Butte burns lignite coal near Center, ND | | | 299 | 2, |
| Oliver Wind I Energy Center near Center, ND | | | 50 | |
| All Other - Net | | | - | 2, |
| ----- | | | | |
| Total Purchased Power | | | 349 | 4, |
| ----- | | | | |
| Total | | | 1,761 | 13, |
| ----- | | | | |
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ENERGY - REGULATED UTILITY (CONTINUED)

We have electric transmission and distribution lines of 500 kV (8 miles), 230 kV (605 miles), 161 kV (43 miles), 138 kV (126 miles), 115 kV (1,209 miles) and less than 115 kV (6,875 miles). We own and operate 169 substations with a total capacity of 9,525 megavoltamperes. Some of our transmission and distribution lines interconnect with other utilities.

We own offices and service buildings, an energy control center and repair shops, and lease offices and storerooms in various localities. Substantially all of our electric plant is subject to mortgages, which collateralize the outstanding first mortgage bonds of Minnesota Power and of SWL&P. Generally, we hold fee interest in our real properties subject only to the lien of the mortgages. Most of our electric lines are located on land not owned in fee, but are covered by appropriate easement rights or by necessary permits from governmental authorities. Wisconsin Public Power, Inc. (WPPI) owns 20% of Boswell Unit 4.

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WPPI has the right to use our transmission line facilities to transport its share of Boswell generation. (See Note 4.)

SPLIT ROCK ENERGY was a joint venture between Minnesota Power and Great River Energy. In March 2004, we terminated our ownership interest upon receipt of FERC approval.

ELECTRIC SALES

Our regulated utility operations include retail and wholesale activities under the jurisdiction of state and federal regulatory authorities. (See Regulatory Issues.)

REGULATED UTILITY ELECTRIC SALES YEAR ENDED DECEMBER 31

2006

2005

MILLIONS OF KILOWATTHOURS

Retail and Municipals

| | | |
|----------------------|-------|-------|
| Residential | 1,100 | 1,102 |
| Commercial | 1,335 | 1,327 |
| Industrial | 7,206 | 7,130 |
| Municipals and Other | 990 | 956 |

Other Power Suppliers

10,631

10,515