

ALLETE INC
Form 10-Q
October 31, 2012
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

☒ Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended September 30, 2012

or

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

Commission File Number 1-3548

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

Minnesota 41-0418150
(State or other jurisdiction of incorporation or organization) (IRS Employer Identification No.)

30 West Superior Street
Duluth, Minnesota 55802-2093
(Address of principal executive offices)
(Zip Code)

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

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 whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). ☒ Yes ☐ No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer ☒ Accelerated Filer ☐
Non-Accelerated Filer ☐ Smaller Reporting Company ☐

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Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). ☐ Yes ☒ No

Common Stock, no par value,
38,845,290 shares outstanding
as of September 30, 2012

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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
AC	Alternating Current
AFUDC	Allowance for Funds Used During Construction – consisting of the cost of both the debt and equity funds used to finance utility plant additions during construction periods
ALLETE	ALLETE, Inc.
ALLETE Clean Energy	ALLETE Clean Energy, Inc.
ALLETE Properties	ALLETE Properties, LLC, and its subsidiaries
ARS	Auction Rate Securities
ATC	American Transmission Company, LLC
Bison 1	Bison 1 Wind Facility
Bison 2	Bison 2 Wind Project
Bison 3	Bison 3 Wind Project
BNI Coal	BNI Coal, Ltd.
Boswell	Boswell Energy Center
CAIR	Clean Air Interstate Rule
CO ₂	Carbon Dioxide
Company	ALLETE, Inc., and its subsidiaries
CSAPR	Cross-State Air Pollution Rule
DC	Direct Current
EPA	Environmental Protection Agency
ESOP	Employee Stock Ownership Plan
FASB	Financial Accounting Standards Board
FERC	Federal Energy Regulatory Commission
Form 10-K	ALLETE Annual Report on Form 10-K
Form 10-Q	ALLETE Quarterly Report on Form 10-Q
GAAP	United States Generally Accepted Accounting Principles
GHG	Greenhouse Gases
Hibbard	Hibbard Renewable Energy Center
Invest Direct	ALLETE’s Direct Stock Purchase and Dividend Reinvestment Plan
Item ____	Item ____ of this Form 10-Q
kV	Kilovolt(s)
Laskin	Laskin Energy Center
LIBOR	London Interbank Offered Rate
MACT	Maximum Achievable Control Technology
Manitoba Hydro	Manitoba Hydro-Electric Board
MATS	Mercury and Air Toxics Standards
Medicare Part D	Medicare Part D provision of The Patient Protection and Affordable Care Act of 2010
Mesabi Nugget	Mesabi Nugget Delaware, LLC
Minnesota Power	An operating division of ALLETE, Inc.
Minnkota Power	Minnkota Power Cooperative, Inc.
MISO	Midwest Independent Transmission System Operator, Inc.
MPCA	Minnesota Pollution Control Agency

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Definitions (Continued)

Abbreviation or Acronym	Term
MPUC	Minnesota Public Utilities Commission
MW / MWh	Megawatt(s) / Megawatt-hour(s)
NAAQS	National Ambient Air Quality Standards
NDPSC	North Dakota Public Service Commission
Non-residential	Retail commercial, non-retail commercial, office, industrial, warehouse, storage and institutional
NO ₂	Nitrogen Dioxide
NO _x	Nitrogen Oxide
Note ____	Note ____ to the consolidated financial statements in this Form 10-Q
NPDES	National Pollutant Discharge Elimination System
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
PPA	Power Purchase Agreement
PPACA	Patient Protection and Affordable Care Act of 2010
PSCW	Public Service Commission of Wisconsin
Rainy River Energy	Rainy River Energy Corporation - Wisconsin
SEC	Securities and Exchange Commission
SIP	State Implementation Plan
SO ₂	Sulfur Dioxide
Square Butte	Square Butte Electric Cooperative
SWL&P	Superior Water, Light and Power Company
Taconite Harbor	Taconite Harbor Energy Center
Taconite Ridge	Taconite Ridge Energy Center
Town Center	Town Center at Palm Coast development project in Florida
Town Center District	Town Center at Palm Coast Community Development District
U.S.	United States of America
USS Corporation	United States Steel Corporation
WDNR	Wisconsin Department of Natural Resources

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Forward-Looking Statements

Statements in this report that are not statements of historical facts are considered “forward-looking” and, accordingly, involve risks and uncertainties that could cause actual results to differ materially from those discussed. Although such forward-looking statements have been made in good faith and are based on reasonable assumptions, there is no assurance that the expected results will be achieved. Any statements that express, or involve discussions as to, future expectations, risks, beliefs, plans, objectives, assumptions, events, uncertainties, financial performance, or growth strategies (often, but not always, through the use of words or phrases such as “anticipates,” “believes,” “estimates,” “expects,” “intends,” “plans,” “projects,” “likely,” “will continue,” “could,” “may,” “potential,” “target,” “outlook” or words of similar meaning) are not statements of historical facts and may be forward-looking.

In connection with the safe harbor provisions of the Private Securities Litigation Reform Act of 1995, we are providing this cautionary statement to identify important factors that could cause our actual results to differ materially from those indicated in forward-looking statements made by or on behalf of ALLETE in this Form 10-Q, in presentations, on our website, in response to questions or otherwise. 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 in connection with such forward-looking statements that could cause our actual results to differ materially from those indicated in the forward-looking statements:

- our ability to successfully implement our strategic objectives;
- regulatory or legislative actions, including changes in governmental policies of the United States Congress, state legislatures, the FERC, the MPUC, the PSCW, the NDPSC, the EPA and various state, local and county regulators, and city administrators, about allowed rates of return, capital structure, 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, capital investments and other expenses, present or prospective wholesale and retail competition (including but not limited to transmission costs), zoning and permitting of land held for resale and environmental matters;
- our ability to manage expansion and integrate acquisitions;
- our industrial customers’ ability to execute potential expansion plans;
- the potential impacts of climate change and future regulation to restrict the emissions of GHG on our Regulated Operations;
- effects of restructuring initiatives in the electric industry;
- economic and geographic factors, including political and economic risks;
- changes in and compliance with laws and regulations;
- weather conditions, natural disasters and pandemic diseases;
- war, acts of terrorism and cyber attacks;
- 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;
- project delays or changes in project costs;
- availability and management of construction materials and skilled construction labor for capital projects;
- changes in operating expenses and capital expenditures;
- global and domestic economic conditions affecting us or our customers;
- 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.

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 26 of our 2011 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-Q 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. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

ALLETE

CONSOLIDATED BALANCE SHEET

Millions – Unaudited

	September 30, 2012	December 31, 2011
Assets		
Current Assets		
Cash and Cash Equivalents	\$104.3	\$101.1
Accounts Receivable (Less Allowance of \$1.1 and \$0.9)	73.2	79.7
Inventories	76.7	69.1
Prepayments and Other	23.8	27.1
Total Current Assets	278.0	277.0
Property, Plant and Equipment - Net	2,239.9	1,982.7
Regulatory Assets	334.6	345.9
Investment in ATC	105.5	98.9
Other Investments	139.7	132.3
Other Non-Current Assets	40.4	39.2
Total Assets	\$3,138.1	\$2,876.0
Liabilities and Equity		
Liabilities		
Current Liabilities		
Accounts Payable	\$57.4	\$71.8
Accrued Taxes	22.5	26.4
Accrued Interest	14.2	12.8
Long-Term Debt Due Within One Year	67.3	5.4
Notes Payable	0.3	1.1
Other	53.1	45.6
Total Current Liabilities	214.8	163.1
Long-Term Debt	947.6	857.9
Deferred Income Taxes	400.0	373.6
Regulatory Liabilities	54.8	43.5
Defined Benefit Pension and Other Postretirement Benefit Plans	254.0	253.5
Other Non-Current Liabilities	109.4	105.1
Total Liabilities	1,980.6	1,796.7
Commitments, Guarantees and Contingencies (Note 13)		
Equity		
Common Stock Without Par Value, 80.0 Shares Authorized, 38.8 and 37.5 Shares Outstanding	759.4	705.6
Unearned ESOP Shares	(22.8)	(29.0)
Accumulated Other Comprehensive Loss	(26.7)	(28.9)
Retained Earnings	447.6	431.6
Total Equity	1,157.5	1,079.3
Total Liabilities and Equity	\$3,138.1	\$2,876.0

The accompanying notes are an integral part of these statements.

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ALLETE
CONSOLIDATED STATEMENT OF INCOME
Millions Except Per Share Amounts – Unaudited

	Quarter Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Operating Revenue	\$248.8	\$226.9	\$705.2	\$689.0
Operating Expenses				
Fuel and Purchased Power	79.5	74.8	228.7	229.8
Operating and Maintenance	98.7	90.5	294.8	276.3
Depreciation	25.0	22.7	74.4	67.1
Total Operating Expenses	203.2	188.0	597.9	573.2
Operating Income	45.6	38.9	107.3	115.8
Other Income (Expense)				
Interest Expense	(12.3)	(10.9)	(33.4)	(32.6)
Equity Earnings in ATC	4.9	4.7	14.3	13.7
Other	1.5	0.5	3.4	2.3
Total Other Expense	(5.9)	(5.7)	(15.7)	(16.6)
Income Before Non-Controlling Interest and Income Taxes	39.7	33.2	91.6	99.2
Income Tax Expense	10.3	12.7	23.4	24.7
Net Income	29.4	20.5	68.2	74.5
Less: Non-Controlling Interest in Subsidiaries	—	—	—	(0.2)
Net Income Attributable to ALLETE	\$29.4	\$20.5	\$68.2	\$74.7
Average Shares of Common Stock				
Basic	37.7	35.6	37.3	35.1
Diluted	37.8	35.7	37.3	35.2
Basic Earnings Per Share of Common Stock	\$0.78	\$0.57	\$1.83	\$2.13
Diluted Earnings Per Share of Common Stock	\$0.78	\$0.57	\$1.83	\$2.12
Dividends Per Share of Common Stock	\$0.46	\$0.445	\$1.38	\$1.335

The accompanying notes are an integral part of these statements.

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ALLETE

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

Millions – Unaudited

	Quarter Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Comprehensive Income (Loss)				
Millions				
Net Income	\$29.4	\$20.5	\$68.2	\$74.5
Other Comprehensive Income (Loss)				
Unrealized Gain (Loss) on Securities				
Net of Income Taxes of \$0.5, \$(1.1), \$0.7 and \$(0.3)	0.5	(1.4)	1.0	(0.3)
Unrealized Loss on Derivatives				
Net of Income Taxes of \$(0.1), \$(0.2), \$(0.2) and \$(0.2)	—	(0.3)	(0.2)	(0.3)
Defined Benefit Pension and Other Postretirement Benefit Plans				
Net of Income Taxes of \$0.2, \$0.3, \$0.9 and \$0.8	0.4	0.3	1.4	1.1
Total Other Comprehensive Income (Loss)	0.9	(1.4)	2.2	0.5
Total Comprehensive Income	\$30.3	\$19.1	\$70.4	\$75.0
Less: Non-Controlling Interest in Subsidiaries	—	—	—	(0.2)
Comprehensive Income Attributable to ALLETE	\$30.3	\$19.1	\$70.4	\$75.2

The accompanying notes are an integral part of these statements.

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ALLETE
CONSOLIDATED STATEMENT OF CASH FLOWS
Millions – Unaudited

	Nine Months Ended September 30,	
	2012	2011
Operating Activities		
Net Income	\$68.2	\$74.5
Allowance for Funds Used During Construction	(3.4)	(1.7)
Income from Equity Investments, Net of Dividends	(2.7)	(1.9)
Gain on Sale of Assets	—	(0.9)
Depreciation Expense	74.4	67.1
Amortization of Debt Issuance Costs	0.7	0.7
Deferred Income Tax Expense	23.4	24.6
Share-Based Compensation Expense	1.7	1.7
ESOP Compensation Expense	5.5	5.3
Defined Benefit Pension and Postretirement Benefit Expense	20.6	18.5
Bad Debt Expense	0.9	1.0
Changes in Operating Assets and Liabilities		
Accounts Receivable	5.6	22.8
Inventories	(7.6)	(9.1)
Prepayments and Other	3.3	5.8
Accounts Payable	(1.3)	(16.5)
Other Current Liabilities	7.4	(4.4)
Cash Contributions to Defined Benefit Pension and Other Postretirement Benefit Plans	—	(17.5)
Changes in Regulatory and Other Non-Current Assets	(5.0)	0.6
Changes in Regulatory and Other Non-Current Liabilities	3.8	14.5
Cash from Operating Activities	195.5	185.1
Investing Activities		
Proceeds from Sale of Available-for-sale Securities	1.2	7.4
Payments for Purchase of Available-for-sale Securities	(1.5)	(1.6)
Investment in ATC	(3.9)	(2.0)
Changes to Other Investments	(5.5)	(4.1)
Additions to Property, Plant and Equipment	(331.9)	(156.8)
Proceeds from Sale of Assets	—	2.2
Cash for Investing Activities	(341.6)	(154.9)
Financing Activities		
Proceeds from Issuance of Common Stock	52.1	30.1
Proceeds from Issuance of Long-Term Debt	175.6	75.0
Proceeds (Payments) from (for) Notes Payable	(0.8)	4.6
Payments for Long-Term Debt	(24.1)	(2.8)
Debt Issuance Costs	(1.3)	—
Dividends on Common Stock	(52.2)	(46.9)
Cash from Financing Activities	149.3	60.0
Change in Cash and Cash Equivalents	3.2	90.2

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Cash and Cash Equivalents at Beginning of Period	101.1	44.9
Cash and Cash Equivalents at End of Period	\$104.3	\$135.1

The accompanying notes are an integral part of these statements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The accompanying unaudited consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X and do not include all of the information and notes required by GAAP for complete financial statements. Similarly, the December 31, 2011, Consolidated Balance Sheet was derived from audited financial statements but does not include all disclosures required by GAAP. All adjustments are of a normal, recurring nature, except as otherwise disclosed. Operating results for the period ended September 30, 2012, are not necessarily indicative of results that may be expected for any other interim period or for the year ending December 31, 2012. For further information, refer to the consolidated financial statements and notes included in our 2011 Form 10-K.

NOTE 1. OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES

Inventories. Inventories are stated at the lower of cost or market. Amounts removed from inventory are recorded on an average cost basis.

	September 30, 2012	December 31, 2011
Inventories		
Millions		
Fuel	\$31.3	\$28.6
Materials and Supplies	45.4	40.5
Total Inventories	\$76.7	\$69.1

	September 30, 2012	December 31, 2011
Prepayments and Other Current Assets		
Millions		
Deferred Fuel Adjustment Clause	\$18.2	\$17.5
Other	5.6	9.6
Total Prepayments and Other Current Assets	\$23.8	\$27.1

	September 30, 2012	December 31, 2011
Other Current Liabilities		
Millions		
Customer Deposits	\$28.8	\$16.3
Other	24.3	29.3
Total Other Current Liabilities	\$53.1	\$45.6

	September 30, 2012	December 31, 2011
Other Non-Current Liabilities		
Millions		
Asset Retirement Obligation	\$61.7	\$57.0
Other	47.7	48.1
Total Other Non-Current Liabilities	\$109.4	\$105.1

Supplemental Statement of Cash Flows Information.

	2012	2011
For the Nine Months Ended September 30,		
Millions		
Cash Paid During the Period for Interest – Net of Amounts Capitalized	\$32.3	\$32.4

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Cash Paid (Received) During the Period for Income Taxes	\$0.2	\$(11.1)
Noncash Investing and Financing Activities		
Decrease in Accounts Payable for Capital Additions to Property, Plant and Equipment	\$(13.1)	\$(14.8)
AFUDC – Equity	\$3.4	\$1.7

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NOTE 1. OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES (Continued)

Accounts Receivable. Accounts receivable are reported on the Consolidated Balance Sheet net of an allowance for doubtful accounts. The allowance is based on our evaluation of the receivable portfolio under current conditions, overall portfolio quality, review of specific problems and such other factors that, in our judgment, deserve recognition in estimating losses. In the third quarter of 2011, one of Minnesota Power's Large Power Customers, NewPage Corporation (NewPage), filed for Chapter 11 bankruptcy protection. Minnesota Power had a pre-bankruptcy petition receivable of \$3.2 million as of September 30, 2012. In September 2012, NewPage submitted a motion to the bankruptcy court to approve amended and restated service agreements and payment of the pre-petition amount, which was approved on October 16, 2012. The agreement is now pending approval by the MPUC, at which time the pre-petition amount will be paid.

Based on our assessment of the facts and circumstances existing as of September 30, 2012, we have determined that it is not probable that the pre-petition receivable has been impaired. This customer's operations have continued without interruption and we continue to provide electric and steam service to this customer. We have received payment of scheduled post-petition receivable balances and we expect continued payment of all other post-petition receivables.

Subsequent Events. The Company performed an evaluation of subsequent events for potential recognition and disclosure through the time of the financial statements issuance.

New Accounting Standards.

Fair Value. In May 2011, the FASB issued an accounting standards update on fair value measurement. This update requires disclosure of a sensitivity analysis for fair value measurements within Level 3 and the valuation process used. No retrospective application of this guidance is required. If we utilize Level 3 fair value measurements in the future, this guidance would significantly increase our disclosures in this area. This guidance was effective beginning with the quarter ended March 31, 2012, and did not have a material impact on our consolidated financial position, results of operations or cash flows.

Statement of Comprehensive Income. In June 2011, the FASB issued an accounting standards update on the presentation of comprehensive income. This guidance was effective beginning with the quarter ended March 31, 2012, and modified our presentation of other comprehensive income, moving it from the footnotes to the face of the financial statements in a separate Consolidated Statement of Comprehensive Income immediately following the Consolidated Statement of Income. The components of net income and other comprehensive income are unchanged and earnings per share continues to be based on net income.

NOTE 2. BUSINESS SEGMENTS

Regulated Operations includes our regulated utilities, Minnesota Power and SWL&P, as well as our investment in ATC, a Wisconsin-based utility that owns and maintains electric transmission assets in parts of Wisconsin, Michigan, Minnesota and Illinois. Investments and Other is comprised primarily of BNI Coal, our coal mining operations in North Dakota, ALLETE Properties, our Florida real estate investment, and ALLETE Clean Energy, aimed at developing or acquiring capital projects that create energy solutions via wind, solar, biomass, hydro, natural gas/liquids, shale resources, clean coal and other clean energy innovations. The Investments and Other segment also includes a small amount of non-rate base generation, approximately 5,500 acres of land available-for-sale in Minnesota, and earnings on cash and investments.

	Consolidated	Regulated Operations	Investments and Other
Millions			
For the Quarter Ended September 30, 2012			
Operating Revenue	\$248.8	\$226.4	\$22.4
Fuel and Purchased Power Expense	79.5	79.5	—
Operating and Maintenance Expense	98.7	76.4	22.3
Depreciation Expense	25.0	23.5	1.5
Operating Income (Loss)	45.6	47.0	(1.4)
Interest Expense	(12.3)	(10.2)	(2.1)
Equity Earnings in ATC	4.9	4.9	—
Other Income	1.5	1.5	—
Income (Loss) Before Non-Controlling Interest and Income Taxes	39.7	43.2	(3.5)
Income Tax Expense (Benefit)	10.3	13.9	(3.6)
Net Income	29.4	29.3	0.1
Less: Non-Controlling Interest in Subsidiaries	—	—	—
Net Income Attributable to ALLETE	\$29.4	\$29.3	\$0.1
	Consolidated	Regulated Operations	Investments and Other
Millions			
For the Quarter Ended September 30, 2011			
Operating Revenue	\$226.9	\$207.4	\$19.5
Fuel and Purchased Power Expense	74.8	74.8	—
Operating and Maintenance Expense	90.5	70.4	20.1
Depreciation Expense	22.7	21.4	1.3
Operating Income (Loss)	38.9	40.8	(1.9)
Interest Expense	(10.9)	(9.2)	(1.7)
Equity Earnings in ATC	4.7	4.7	—
Other Income (Expense)	0.5	0.6	(0.1)
Income (Loss) Before Non-Controlling Interest and Income Taxes	33.2	36.9	(3.7)
Income Tax Expense (Benefit)	12.7	13.1	(0.4)
Net Income (Loss)	20.5	23.8	(3.3)
Less: Non-Controlling Interest in Subsidiaries	—	—	—
Net Income (Loss) Attributable to ALLETE	\$20.5	\$23.8	\$(3.3)

NOTE 2. BUSINESS SEGMENTS (Continued)

	Consolidated	Regulated Operations	Investments and Other
Millions			
For the Nine Months Ended September 30, 2012			
Operating Revenue	\$705.2	\$642.0	\$63.2
Fuel and Purchased Power Expense	228.7	228.7	—
Operating and Maintenance Expense	294.8	230.6	64.2
Depreciation Expense	74.4	70.1	4.3
Operating Income (Loss)	107.3	112.6	(5.3)
Interest Expense	(33.4)	(29.7)	(3.7)
Equity Earnings in ATC	14.3	14.3	—
Other Income (Expense)	3.4	3.5	(0.1)
Income (Loss) Before Non-Controlling Interest and Income Taxes	91.6	100.7	(9.1)
Income Tax Expense (Benefit)	23.4	32.6	(9.2)
Net Income	68.2	68.1	0.1
Less: Non-Controlling Interest in Subsidiaries	—	—	—
Net Income Attributable to ALLETE	\$68.2	\$68.1	\$0.1
As of September 30, 2012			
Total Assets	\$3,138.1	\$2,830.9	\$307.2
Property, Plant and Equipment – Net	\$2,239.9	\$2,180.8	\$59.1
Accumulated Depreciation	\$1,146.7	\$1,091.5	\$55.2
Capital Additions	\$318.3	\$312.6	\$5.7
	Consolidated	Regulated Operations	Investments and Other
Millions			
For the Nine Months Ended September 30, 2011			
Operating Revenue	\$689.0	\$632.2	\$56.8
Fuel and Purchased Power Expense	229.8	229.8	—
Operating and Maintenance Expense	276.3	218.8	57.5
Depreciation Expense	67.1	63.5	3.6
Operating Income (Loss)	115.8	120.1	(4.3)
Interest Expense	(32.6)	(26.9)	(5.7)
Equity Earnings in ATC	13.7	13.7	—
Other Income	2.3	1.8	0.5
Income (Loss) Before Non-Controlling Interest and Income Taxes	99.2	108.7	(9.5)
Income Tax Expense (Benefit)	24.7	28.2	(3.5)
Net Income (Loss)	74.5	80.5	(6.0)
Less: Non-Controlling Interest in Subsidiaries	(0.2)	—	(0.2)
Net Income (Loss) Attributable to ALLETE	\$74.7	\$80.5	\$(5.8)
As of September 30, 2011			
Total Assets	\$2,754.4	\$2,436.0	\$318.4
Property, Plant and Equipment – Net	\$1,902.1	\$1,847.1	\$55.0
Accumulated Depreciation	\$1,079.0	\$1,028.6	\$50.4
Capital Additions	\$143.5	\$128.4	\$15.1

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NOTE 3. INVESTMENTS

Investments. Our long-term investment portfolio includes the real estate assets of ALLETE Properties, debt and equity securities consisting primarily of securities held to fund employee benefits and land available-for-sale in Minnesota.

Investments	September 30, 2012	December 31, 2011
Millions		
ALLETE Properties	\$91.1	\$91.3
Available-for-sale Securities	27.9	24.7
Other	20.7	16.3
Total Investments	\$139.7	\$132.3

ALLETE Properties	September 30, 2012	December 31, 2011
Millions		
Land Inventory Beginning Balance (January 1, 2012 and 2011, respectively)	\$86.0	\$86.0
Deeds to Collateralized Property	0.5	1.8
Land Impairment	—	(1.7)
Capitalized Improvements and Other	0.1	0.2
Cost of Real Estate Sold	(0.2)	(0.3)
Land Inventory Ending Balance	86.4	86.0
Long-Term Finance Receivables (net of allowances of \$0.6 and \$0.6)	1.4	2.0
Other	3.3	3.3
Total Real Estate Assets	\$91.1	\$91.3

Land Inventory. Land inventory is accounted for as held for use and is recorded at cost, unless the carrying value is determined not to be recoverable in accordance with the accounting standards for property, plant and equipment, in which case the land inventory is written down to fair value. Land values are reviewed for impairment on a quarterly basis and no impairments were recorded for the nine months ended September 30, 2012 (\$1.7 million as of December 31, 2011). In the fourth quarter of 2011, an impairment analysis of estimated future undiscounted cash flows was conducted and indicated that the cash flows were not adequate to recover the carrying basis of certain properties not strategic to our three major development projects. Consequently, we reduced the cost basis to estimated fair value resulting in a pretax impairment charge of \$1.7 million. Fair value was determined based on property tax assessed values, discounted cash flow analysis, or a combination thereof.

Long-Term Finance Receivables. As of September 30, 2012, long-term finance receivables were \$1.4 million net of allowance (\$2.0 million net of allowance as of December 31, 2011). Long-term finance receivables are collateralized by property sold, accrue interest at market-based rates and are net of an allowance for doubtful accounts. As of September 30, 2012, we had an allowance for doubtful accounts of \$0.6 million (\$0.6 million as of December 31, 2011).

NOTE 4. DERIVATIVES

During the third quarter of 2011, we entered into a variable-to-fixed interest rate swap (Swap), designated as a cash flow hedge, in order to manage the interest rate risk associated with a \$75.0 million Term Loan. The Term Loan has a variable interest rate equal to the one-month LIBOR plus 1.00 percent, has a maturity of August 25, 2014, and represents approximately 8 percent of the Company's outstanding long-term debt as of September 30, 2012. (See Note 8. Short-Term and Long-Term Debt.) The Swap agreement has a notional amount equal to the underlying debt principal and matures on August 25, 2014. The Swap agreement involves the receipt of variable rate amounts in exchange for fixed rate interest payments over the life of the agreement without an exchange of the underlying notional amount. The variable rate of the Swap is equal to the one-month LIBOR and the fixed rate is equal to 0.825 percent. Cash flows from the interest rate swap are expected to be highly effective in offsetting the variable interest expense of the debt attributable to fluctuations in the one-month LIBOR interest rate over the life of the Swap. If it is determined that a derivative is not or has ceased to be effective as a hedge, the Company prospectively discontinues hedge accounting with respect to that derivative. The shortcut method is used to assess hedge effectiveness. At inception, all shortcut method requirements were satisfied; thus changes in the value of the Swap are deemed 100 percent effective. As a result, there was no ineffectiveness recorded for the quarter and nine months ended September 30, 2012. The mark-to-market fluctuation on the cash flow hedge was recorded in accumulated other comprehensive income on the Consolidated Balance Sheet. As of September 30, 2012, the fair value of the Swap was a \$0.8 million liability (a \$0.4 million liability as of December 31, 2011) and is included in other non-current liabilities on the Consolidated Balance Sheet. Cash flows from derivative activities are presented in the same category as the item being hedged on the Consolidated Statement of Cash Flows. Amounts recorded in other comprehensive income related to cash flow hedges will be recognized in earnings when the hedged transactions occur or when it is probable that the hedged transactions will not occur. Gains or losses on interest rate hedging transactions are reflected as a component of interest expense on the Consolidated Statement of Income.

NOTE 5. FAIR VALUE

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (exit price). We utilize market data or assumptions that market participants would use in pricing the asset or liability, including assumptions about risk and the risks inherent in the inputs to the valuation technique. These inputs can be readily observable, market corroborated or generally unobservable. We primarily apply the market approach for recurring fair value measurements and endeavor to utilize the best available information. Accordingly, we utilize valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs. These inputs, which are used to measure fair value, are prioritized through the fair value hierarchy. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurement) and the lowest priority to unobservable inputs (Level 3 measurement). Descriptions of the three levels of the fair value hierarchy are discussed in Note 9. Fair Value to the consolidated financial statements in our 2011 Form 10-K.

The following tables set forth by level within the fair value hierarchy our assets and liabilities that were accounted for at fair value on a recurring basis as of September 30, 2012 and December 31, 2011. Each asset and liability is classified based on the lowest level of input that is significant to the fair value measurement. Our assessment of the significance of a particular input to the fair value measurement requires judgment and may affect the valuation of fair value assets and liabilities and their placement within the fair value hierarchy levels. The estimated fair value of cash and cash equivalents listed on the Consolidated Balance Sheet approximates the carrying amount and therefore are excluded from the recurring fair value measures in the table below.

NOTE 5. FAIR VALUE (Continued)

Recurring Fair Value Measures Millions	Fair Value as of September 30, 2012			
	Level 1	Level 2	Level 3	Total
Assets:				
Investments				
Available-for-sale – Equity Securities	\$19.1	—	—	\$19.1
Available-for-sale – Corporate Debt Securities	—	\$8.8	—	8.8
Cash Equivalents	16.6	—	—	16.6
Total Fair Value of Assets	\$35.7	\$8.8	—	\$44.5
Liabilities:				
Deferred Compensation	—	\$14.8	—	\$14.8
Derivatives – Interest Rate Swap	—	0.8	—	0.8
Total Fair Value of Liabilities	—	\$15.6	—	\$15.6
Total Net Fair Value of Assets (Liabilities)	\$35.7	\$(6.8)	—	\$28.9

Recurring Fair Value Measures Millions	Fair Value as of December 31, 2011			
	Level 1	Level 2	Level 3	Total
Assets:				
Investments				
Available-for-sale – Equity Securities	\$17.6	—	—	\$17.6
Available-for-sale – Corporate Debt Securities	—	\$8.2	—	8.2
Cash Equivalents	11.4	—	—	11.4
Total Fair Value of Assets	\$29.0	\$8.2	—	\$37.2
Liabilities:				
Deferred Compensation	—	\$12.8	—	\$12.8
Derivatives – Interest Rate Swap	—	0.4	—	0.4
Total Fair Value of Liabilities	—	\$13.2	—	\$13.2
Total Net Fair Value of Assets (Liabilities)	\$29.0	\$(5.0)	—	\$24.0

Recurring Fair Value Measures Activity in Level 3	Debt Securities Issued by States of the United States (ARS)	
Millions		
Balance as of December 31, 2011 and 2010, respectively	—	\$6.7
Redeemed During the Period (a)	—	(6.7)
Balance as of September 30, 2012 and 2011, respectively	—	—
(a) The remaining ARS were redeemed at carrying value on January 5, 2011.		

The Company's policy is to recognize transfers in and transfers out of a given hierarchy level as of the actual date of the event or of the change in circumstances that caused the transfer. For the nine months ended September 30, 2012 and 2011, there were no transfers in or out of Levels 1, 2 or 3.

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NOTE 5. FAIR VALUE (Continued)

Fair Value of Financial Instruments. With the exception of the item listed below, the estimated fair value of all financial instruments approximates the carrying amount. The fair value for the item listed below was based on quoted market prices for the same or similar instruments (Level 2).

Financial Instruments	Carrying Amount	Fair Value
Millions		
Long-Term Debt, Including Current Portion		
September 30, 2012	\$1,014.9	\$1,144.9
December 31, 2011	\$863.3	\$966.4

NOTE 6. REGULATORY MATTERS

Electric Rates. Entities within our Regulated Operations segment file for periodic rate revisions with the MPUC, the FERC or the PSCW.

2010 Minnesota Rate Case. Minnesota Power's current retail rates are based on a 2011 MPUC retail rate order, effective June 1, 2011, that allowed for a 10.38 percent return on common equity and a 54.29 percent equity ratio.

In February 2011, Minnesota Power appealed the MPUC's interim rate decision in the Company's 2010 rate case with the Minnesota Court of Appeals. The Company appealed the MPUC's finding of exigent circumstances in the interim rate decision with the primary arguments that the MPUC exceeded its statutory authority, made its decision without the support of a body of record evidence and that the decision violated public policy. The Company desires to resolve whether the MPUC's finding of exigent circumstances was lawful for application in future rate cases. In December 2011, the Minnesota Court of Appeals concluded that the MPUC did not err in finding exigent circumstances and properly exercised its discretion in setting interim rates. On January 4, 2012, the Company filed a petition for review at the Minnesota Supreme Court (Court). On February 14, 2012, the Court granted the petition for review and oral arguments were held before the Court on October 9, 2012. A decision is expected in early 2013; however, we cannot predict the outcome at this time.

FERC-Approved Wholesale Rates. Minnesota Power's non-affiliated municipal customers consist of 16 municipalities in Minnesota and 1 private utility in Wisconsin. SWL&P, a wholly-owned subsidiary of ALLETE, is also a private utility in Wisconsin and a customer of Minnesota Power. Minnesota Power's formula-based contract with the City of Nashwauk is effective April 1, 2013 through June 30, 2024, and the restated formula-based contracts with the remaining 15 Minnesota municipal customers and SWL&P are effective through June 30, 2019. The rates included in these contracts are calculated using a cost-based formula methodology that is set each July 1, using estimated costs and a rate of return that is equal to our authorized rate of return for Minnesota retail customers (currently 10.38 percent). The formula-based rate methodology also provides for a yearly true-up calculation for actual costs incurred. The contract terms include a termination clause requiring a three-year notice to terminate. Under the City of Nashwauk contract, no termination notice may be given prior to July 1, 2021. Under the restated contracts, no termination notices may be given prior to June 30, 2016. A two-year cancellation notice is required for the one private non-affiliated utility in Wisconsin, and on December 31, 2011, this customer submitted a cancellation notice with termination effective on December 31, 2013. The 17 MW of average monthly demand provided to this customer is expected to be used to supply energy to prospective additional load customers beginning in 2014.

2012 Wisconsin Rate Case. SWL&P's current retail rates are based on a 2010 PSCW retail rate order, effective January 1, 2011, that allowed for a 10.9 percent return on common equity. In May 2012, SWL&P filed a rate increase request with the PSCW seeking an average overall increase of 2.5 percent for retail customers (a 1.2 percent increase

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in electric rates, a 0.7 percent increase in natural gas rates, and a 13.4 percent increase in water rates). The rate filing seeks an overall return on equity of 10.9 percent, and a capital structure consisting of approximately 55 percent equity and 45 percent debt. On an annualized basis, the requested rate increase would generate approximately \$1.8 million in additional revenue. Evidentiary and public hearings were held on September 17, 2012. The Company anticipates new rates will take effect during the first quarter of 2013. We cannot predict the level of rates that may be approved by the PSCW.

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NOTE 6. REGULATORY MATTERS (Continued)

ALLETE Clean Energy. In August 2011, the Company filed with the MPUC for approval of certain affiliated interest agreements between ALLETE and ALLETE Clean Energy. These agreements relate to various relationships between the parties, including the accounting for certain shared services, as well as the transfer of transmission and wind development rights in North Dakota to ALLETE Clean Energy. These transmission and wind development rights are separate and distinct from those needed by Minnesota Power to meet Minnesota's renewable energy standard requirements. On July 23, 2012, the MPUC issued an order approving certain administrative items related to accounting for shared services as well as the approval of the transfer of meteorological towers, while deferring decisions related to transmission and wind development rights pending the MPUC's further review of Minnesota Power's future retail electric service needs.

The Patient Protection and Affordable Care Act of 2010 (PPACA). In March 2010, the PPACA was signed into law. One of the provisions changed the tax treatment for retiree prescription drug expenses by eliminating the tax deduction for expenses that are reimbursed under Medicare Part D, beginning January 1, 2013. Based on this provision, we are subject to additional taxes in the future and were required to reverse previously recorded tax benefits which resulted in a non-recurring charge to net income of \$4.0 million in 2010. In October 2010, we submitted a filing with the MPUC requesting deferral of the retail portion of the tax charge taken in 2010 resulting from the PPACA. On May 24, 2011, the MPUC approved our request for deferral until the next rate case and as a result we recorded an income tax benefit of \$2.9 million and a related regulatory asset of \$5.0 million in the second quarter of 2011.

Pension. In December 2011, the Company filed a petition with the MPUC requesting a mechanism to recover the cost of capital associated with the prepaid pension asset (or liability) created by the required contributions under the pension plan in excess of (or less than) annual pension expense. The Company further requested a mechanism to defer pension expenses in excess of (or less than) those currently being recovered in base rates. If our petition is successful, the impact would be deferred in a regulatory asset (or liability) for recovery (or refund) in the Company's next general rate case. We cannot predict the outcome at this time.

Regulatory Assets and Liabilities. Our regulated utility operations are subject to the accounting guidance for Regulated Operations. We capitalize incurred costs which are probable of recovery in future utility rates as regulatory assets. Regulatory liabilities represent amounts expected to be refunded or credited to customers in rates. No regulatory assets or liabilities are currently earning a return.

Regulatory Assets and Liabilities	September 30, 2012	December 31, 2011
Millions		
Current Regulatory Assets (a)		
Deferred Fuel	\$18.2	\$17.5
Total Current Regulatory Assets	18.2	17.5
Non-Current Regulatory Assets		
Future Benefit Obligations Under		
Defined Benefit Pension and Other Postretirement Benefit Plans	276.6	292.8
Income Taxes	28.2	28.6
Asset Retirement Obligation	11.5	9.8
Cost Recovery Riders (b)	11.4	0.7
PPACA Income Tax Deferral	5.0	5.0
Other (c)	1.9	9.0
Total Non-Current Regulatory Assets	334.6	345.9
Total Regulatory Assets	\$352.8	\$363.4

Non-Current Regulatory Liabilities

Income Taxes	\$19.8	\$21.9
Plant Removal Obligations	17.5	15.0
Wholesale and Retail Contra AFUDC	11.1	1.5
Other	6.4	5.1
Total Non-Current Regulatory Liabilities	\$54.8	\$43.5

(a) Current regulatory assets are included in prepayments and other on the Consolidated Balance Sheet.

(b) The increase in cost recovery rider regulatory assets is primarily due to higher capital expenditures related to our Bison projects.

(c) The decrease in Other is primarily due to the Conservation Improvement Program incentive recorded in 2011 and collected in 2012.

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NOTE 7. INVESTMENT IN ATC

Our wholly-owned subsidiary, Rainy River Energy, owns approximately 8 percent of ATC, a Wisconsin-based utility that owns and maintains electric transmission assets in parts of Wisconsin, Michigan, Minnesota and Illinois. ATC rates are FERC-approved and are based on a 12.2 percent return on common equity dedicated to utility plant. We account for our investment in ATC under the equity method of accounting. As of September 30, 2012, our equity investment in ATC was \$105.5 million (\$98.9 million at December 31, 2011). In the first nine months of 2012, we invested \$3.9 million in ATC, and on October 30, 2012, we invested an additional \$0.8 million. We do not expect to make any additional investments in 2012.

ALLETE's Investment in ATC

Millions

Equity Investment Balance as of December 31, 2011	\$98.9
Cash Investments	3.9
Equity in ATC Earnings	14.3
Distributed ATC Earnings	(11.6)
Equity Investment Balance as of September 30, 2012	\$105.5

ATC's summarized financial data for the quarters and nine months ended September 30, 2012 and 2011, is as follows:

ATC Summarized Financial Data	Quarter Ended		Nine Months Ended	
	September 30,		September 30,	
Income Statement Data	2012	2011	2012	2011
Millions				
Revenue	\$150.3	\$142.8	\$450.1	\$420.6
Operating Expense	68.8	66.4	210.1	192.5
Other Expense	21.0	19.7	62.1	61.6
Net Income	\$60.5	\$56.7	\$177.9	\$166.5
ALLETE's Equity in Net Income	\$4.9	\$4.7	\$14.3	\$13.7

NOTE 8. SHORT-TERM AND LONG-TERM DEBT

Short-Term Debt. As of September 30, 2012, total short-term debt outstanding was \$67.6 million (\$6.5 million as of December 31, 2011) and consisted of long-term debt due within one year and notes payable. Short-term debt increased from year end primarily due to \$60 million of long-term debt maturing in April 2013, which is classified as short-term as of September 30, 2012.

Long-Term Debt. As of September 30, 2012, total long-term debt outstanding was \$947.6 million (\$857.9 million as of December 31, 2011).

On July 2, 2012, we issued \$160.0 million of the Company's First Mortgage Bonds (Bonds) in the private placement market in two series as follows:

Issue Date	Maturity Date	Principal Amount	Interest Rate
July 2, 2012	July 15, 2026	\$75 Million	3.20%
July 2, 2012	July 15, 2042	\$85 Million	4.08%

NOTE 8. SHORT-TERM AND LONG-TERM DEBT (Continued)

We have the option to prepay all or a portion of the 3.20 percent Bonds at our discretion at any time prior to January 15, 2026, subject to a make-whole provision, and at any time on or after January 15, 2026, at par, including, in each case, accrued and unpaid interest. We also have the option to prepay all or a portion of the 4.08 percent Bonds at our discretion at any time prior to January 15, 2042, subject to a make-whole provision, and at any time on or after January 15, 2042, at par, including, in each case, accrued and unpaid interest. The Bonds are subject to the additional terms and conditions of our utility mortgage. In July 2012, we used a portion of the proceeds from the sale of the Bonds to redeem \$6.0 million of our 6.50 percent Industrial Development Revenue Bonds and to repay \$14.0 million in outstanding borrowings on our \$150.0 million line of credit. The remaining proceeds will be used to fund utility capital expenditures and/or for general corporate purposes. The Bonds were sold in reliance on an exemption from registration under Section 4(a)(2) of the Securities Act of 1933, as amended, to certain institutional accredited investors.

Financial Covenants. Our long-term debt arrangements contain customary covenants. In addition, our lines of credit and letters of credit supporting certain long-term debt arrangements contain financial covenants. Our compliance with financial covenants is not dependent on debt ratings. The most restrictive financial covenant requires ALLETE to maintain a ratio of Indebtedness to Total Capitalization (as the amounts are calculated in accordance with the respective long-term debt arrangements) of less than or equal to 0.65 to 1.00, measured quarterly. As of September 30, 2012, our ratio was approximately 0.46 to 1.00. Failure to meet this covenant would give rise to an event of default if not cured after notice from a lender, in which event ALLETE may need to pursue alternative sources of funding. Some of ALLETE's debt arrangements contain "cross-default" provisions that would result in an event of default if there is a failure under other financing arrangements to meet payment terms or to observe other covenants that would result in an acceleration of payments due. As of September 30, 2012, ALLETE was in compliance with its financial covenants.

NOTE 9. OTHER INCOME (EXPENSE)

	Quarter Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Millions				
AFUDC – Equity	\$1.5	\$0.6	\$3.4	\$1.7
Investment and Other Income (Expense)	—	(0.1)	—	0.6
Total Other Income	\$1.5	\$0.5	\$3.4	\$2.3

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NOTE 10. INCOME TAX EXPENSE

	Quarter Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Millions				
Current Tax Expense				
Federal (a)	—	—	—	—
State (a)	—	\$(0.1)	—	\$0.1
Total Current Tax Expense (Benefit)	—	(0.1)	—	0.1
Deferred Tax Expense (Benefit)				
Federal (b)	\$10.5	8.5	\$24.2	19.3
State (b)	(0.7)	4.5	(1.9)	6.0
Change in Valuation Allowance (c)	0.7	—	1.7	—
Investment Tax Credit Amortization	(0.2)	(0.2)	(0.6)	(0.7)
Total Deferred Tax Expense	10.3	12.8	23.4	24.6
Total Income Tax Expense	\$10.3	\$12.7	\$23.4	\$24.7

For the quarter and nine months ended September 30, 2012, the federal and state current tax expense of zero and zero, respectively, (\$0.1 million and \$0.1 million for the quarter and nine months ended September 30, 2011) is (a) due to a net operating loss (NOL) which resulted primarily from the bonus depreciation provision of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. The 2012 and 2011 federal and state NOLs will be carried forward to offset future taxable income.

For the quarter and nine months ended September 30, 2012, the state deferred tax benefit of \$0.7 million and \$1.9 million, respectively, is due to state renewable tax credits earned which will be carried forward to offset future state tax expense. The nine months ended September 30, 2011, included a second quarter income tax benefit of (b) \$2.9 million related to the MPUC approval of our request to defer the retail portion of the tax charge taken in 2010 resulting from the PPACA, and a first quarter benefit for the reversal of a \$6.2 million deferred tax liability related to a revenue receivable that Minnesota Power agreed to forgo as part of a stipulation and settlement agreement in its 2010 rate case.

(c) For the quarter and nine months ended September 30, 2012, the valuation allowance is due to state renewable tax credits earned in 2012 which are not expected to be utilized within their allowable tax carryforward period.

For the nine months ended September 30, 2012, the effective tax rate was 25.5 percent (24.9 percent for the nine months ended September 30, 2011; the effective tax rate for the nine months ended September 30, 2011, was lowered by 6.2 percentage points due to the non-recurring reversal of the deferred tax liability related to a revenue receivable that Minnesota Power agreed to forgo as part of a stipulation and settlement agreement in its 2010 rate case, and by 2.9 percentage points due to the non-recurring income tax benefit related to the MPUC approval of our request to defer the retail portion of the tax charge taken in 2010 resulting from the PPACA). The increase in the effective tax rate from the effective tax rate for the nine months ended September 30, 2011, was primarily due to the 2011 non-recurring items above, partially offset by increased renewable tax credits in 2012. The effective tax rate deviated from the statutory rate of approximately 41 percent primarily due to deductions for AFUDC – Equity, investment tax credits, renewable tax credits and depletion, and in 2011, for the non-recurring items discussed above.

Uncertain Tax Positions. As of September 30, 2012, we had gross unrecognized tax benefits of \$2.7 million (\$11.4 million as of December 31, 2011). The \$8.7 million decrease in the unrecognized tax benefits balance for the nine months ended September 30, 2012, was primarily due to the resolution of a federal audit matter for prior years' activity. Of the total gross unrecognized tax benefits, \$0.5 million represents the amount of unrecognized tax benefits included in the Consolidated Balance Sheet, that, if recognized, would favorably impact the effective income tax rate.

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ALLETE's IRS exam for tax years 2005 through 2009 is currently under review at the IRS appeals office. If the IRS appeals process is completed during the next twelve months, substantially all of the unrecognized tax benefits as of September 30, 2012, could be reversed. The unrecognized tax benefits are primarily due to tax positions which are timing in nature and therefore would have an immaterial impact on our effective tax rate if recognized.

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NOTE 11. EARNINGS PER SHARE AND COMMON STOCK

The difference between basic and diluted earnings per share, if any, arises from outstanding stock options and performance share awards granted under our Executive and Director Long-Term Incentive Compensation Plans. For the quarters and nine months ended September 30, 2012 and 2011, 0.2 million and 0.4 million options, respectively, to purchase shares of common stock were excluded from the computation of diluted earnings per share because the option exercise prices were greater than the average market prices; therefore, their effect would have been anti-dilutive.

Reconciliation of Basic and Diluted Earnings Per Share Millions Except Per Share Amounts For the Quarter Ended September 30,	Basic	2012 Dilutive Securities	Diluted	Basic	2011 Dilutive Securities	Diluted
Net Income Attributable to ALLETE	\$29.4		\$29.4	\$20.5		\$20.5
Average Common Shares	37.7	0.1	37.8	35.6	0.1	35.7
Earnings Per Share	\$0.78		\$0.78	\$0.57		