

MADISON GAS & ELECTRIC CO  
Form 10-Q  
May 07, 2012

**United States**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**FORM 10-Q**

☒ Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

*For the quarterly period ended:*

**March 31, 2012**

☐ Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

*For the transition period from \_\_\_\_\_ to \_\_\_\_\_*

<b>Commission</b>	<b>Name of Registrant, State of Incorporation, Address</b>	<b>IRS Employer</b>
<b>File No.</b> 000-49965	<b>of Principal Executive Offices, and Telephone No.</b> <b>MGE Energy, Inc.</b>  (a Wisconsin Corporation)  133 South Blair Street  Madison, Wisconsin 53703  (608) 252-7000	<b>Identification No.</b> 39-2040501

000-1125

www.mgeenergy.com  
**Madison Gas and Electric Company**

39-0444025

(a Wisconsin Corporation)

133 South Blair Street

Madison, Wisconsin 53703

(608) 252-7000

www.mge.com

Indicate by check mark whether the registrants (1) have 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) have been subject to such filing requirements for the past 90 days: Yes ☒ No ☐

Indicate by check mark whether the registrants have submitted electronically and posted on their corporate Web sites, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrants were 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 definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

	<b>Large Accelerated Filer</b>	<b>Accelerated Filer</b>	<b>Non-accelerated Filer</b>	<b>Smaller Reporting Company</b>
MGE Energy, Inc. Madison Gas and Electric Company	X		X	

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

MGE Energy, Inc. and Madison Gas and Electric Company: Yes ☐ No ☒

**Number of Shares Outstanding of Each Class of Common Stock as of April 30, 2012**  
MGE Energy, Inc. Common stock, \$1.00 par value, 23,113,638 shares outstanding.

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Madison Gas and Electric  
Company

Common stock, \$1.00 par value, 17,347,894 shares outstanding (all of which are  
owned beneficially and of record by MGE Energy, Inc.).

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## **PART I. FINANCIAL INFORMATION.**

### **Filing Format**

This combined Form 10-Q is being filed separately by MGE Energy, Inc. (MGE Energy) and Madison Gas and Electric Company (MGE). MGE is a wholly owned subsidiary of MGE Energy and represents a majority of its assets, liabilities, revenues, expenses, and operations. Thus, all information contained in this report relates to, and is filed by, MGE Energy. Information that is specifically identified in this report as relating solely to MGE Energy, such as its financial statements and information relating to its nonregulated business, does not relate to, and is not filed by, MGE. MGE makes no representation as to that information. The terms "we" and "our," as used in this report, refer to MGE Energy and its consolidated subsidiaries, unless otherwise indicated.

### **Forward-Looking Statements**

This report, and other documents filed by MGE Energy and MGE with the Securities and Exchange Commission (SEC) from time to time, contain forward-looking statements that reflect management's current assumptions and estimates regarding future performance and economic conditions especially as they relate to future load growth, revenues, expenses, capital expenditures, financial resources, regulatory matters, and the scope and expense associated with future environmental regulation. These forward-looking statements are made pursuant to the provisions of the Private Securities Litigation Reform Act of 1995. Words such as "believe," "expect," "anticipate," "estimate," "could," "should," "intend," and other similar words generally identify forward-looking statements. Both MGE Energy and MGE caution investors that these forward-looking statements are subject to known and unknown risks and uncertainties that may cause actual results to differ materially from those projected, expressed, or implied.

The factors that could cause actual results to differ materially from the forward-looking statements made by a registrant (a) include those factors discussed in the Registrants' 2011 Annual Report on Form 10-K: Item 1A. Risk Factors, as updated by Part II. Item 1A. Risk Factors, Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations, as updated by Part I, Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations in this report, and Item 8. Financial Statements and Supplementary Data Note 18, as updated by Part I, Item 1. Financial Statements Note 8 in this report, and (b) other factors discussed herein and in other filings made by that registrant with the SEC.

Readers are cautioned not to place undue reliance on these forward-looking statements, which apply only as of the date of this report. MGE Energy and MGE undertake no obligation to publicly release any revision to these forward-looking statements to reflect events or circumstances after the date of this report.

### **Where to Find More Information**

The public may read and copy any reports or other information that MGE Energy and MGE file with the SEC at the SEC's public reference room at 100 F Street, NE, Washington, D.C. 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. These documents also are available to the public from commercial document retrieval services, the website maintained by the SEC at <http://www.sec.gov>, MGE Energy's website at <http://www.mgeenergy.com>, and MGE's website at <http://www.mge.com>. Copies may be obtained from our websites free of charge. Information contained on MGE Energy's and MGE's websites shall not be deemed incorporated into, or to be a part of, this report.



## Definitions, Abbreviations, and Acronyms Used in the Text and Notes of this Report

Abbreviations, acronyms, and definitions used in the text and notes of this report are defined below.

AFUDC	Allowance for Funds Used During Construction
ATC	American Transmission Company LLC
BART	Best Available Retrofit Technology
Blount	Blount Station
CAA	Clean Air Act
CAIR	Clean Air Interstate Rule
CAVR	Clean Air Visibility Rule
Codification	Financial Accounting Standards Board Accounting Standards Codification
Columbia	Columbia Energy Center
CSAPR	Cross-State Air Pollution Rule
CWA	Clean Water Act
CWDC	Central Wisconsin Development Corporation
DOE	U.S. Department of Energy
Dth	Dekatherms
Elm Road Units	Elm Road Generating Station
EPA	United States Environmental Protection Agency
ERISA	Employee Retirement Income Security Act
EGU	Electric Generating Unit
FASB	Financial Accounting Standards Board
FTR	Financial Transmission Rights
GHG	Greenhouse Gas
HAPs	Hazardous Air Pollutants
heating degree days (HDD)	Measure of the extent to which the average daily temperature is below 65 degrees Fahrenheit, which is considered an indicator of possible increased demand for energy to provide heating
IRS	Internal Revenue Service
kWh	Kilowatt-hour
MACT	Maximum Achievable Control Technology
MAGAEL	MAGAEL, LLC
MATS	Mercury and Air Toxics Standards
MGE	Madison Gas and Electric Company
MGE Construct	MGE Construct LLC
MGE Energy	MGE Energy, Inc.
MGE Power	MGE Power LLC
MGE Power Elm Road	MGE Power Elm Road, LLC
MGE Power West Campus	MGE Power West Campus, LLC
MGE Transco	MGE Transco Investment LLC
MISO	Midwest Independent System Operator (a regional transmission organization)

MW	Megawatt
MWh	Megawatt-hour
NAAQS	National Ambient Air Quality Standards
NGCC	Natural Gas Combined Cycle
NO <sub>2</sub>	Nitrogen Dioxide
NOV	Notice of Violation
NO <sub>x</sub>	Nitrogen Oxides
NSPS	New Source Performance Standards
OPRB	Other Postretirement Benefits
PGA	Purchased Gas Adjustment clause
PJM	PJM Interconnection, LLC (a regional transmission organization)
PM	Particulate Matter
PPA	Purchased power agreement
PSCW	Public Service Commission of Wisconsin
PSD	Prevention of Significant Deterioration
RICE	Reciprocating Internal Combustion Engine
SEC	Securities and Exchange Commission
SIP	State Implementation Plan
SO <sub>2</sub>	Sulfur Dioxide
Stock Plan	Direct Stock Purchase and Dividend Reinvestment Plan of MGE Energy
UW	University of Wisconsin at Madison
VIE	Variable Interest Entity
WCCF	West Campus Cogeneration Facility
WDNR	Wisconsin Department of Natural Resources
Working capital	Current assets less current liabilities
WPDES	Wisconsin Pollutant Discharge Elimination System
WPL	Wisconsin Power and Light Company
WPSC	Wisconsin Public Service Corporation

**Item 1. Financial Statements.****MGE Energy, Inc.****Consolidated Statements of Income (unaudited)***(In thousands, except per-share amounts)*

	<b>Three Months Ended March 31,</b>	
	<b>2012</b>	<b>2011</b>
<b>Operating Revenues:</b>		
Regulated electric revenues	\$ 89,936	\$ 86,007
Regulated gas revenues	57,019	77,437
Nonregulated revenues	2,304	1,161
<i>Total Operating Revenues</i>	149,259	164,605
<b>Operating Expenses:</b>		
Fuel for electric generation	8,851	11,049
Purchased power	19,546	17,581
Cost of gas sold	34,845	50,947
Other operations and maintenance	42,949	39,413
Depreciation and amortization	9,624	10,016
Other general taxes	5,000	4,701
<i>Total Operating Expenses</i>	120,815	133,707
<b>Operating Income</b>	28,444	30,898
Other income, net	2,570	2,386
Interest expense, net	(5,104)	(4,850)
Income before income taxes	25,910	28,434
Income tax provision	(9,862)	(10,651)
<b>Net Income</b>	\$ 16,048	\$ 17,783
<b>Earnings Per Share of Common Stock</b>		
(basic and diluted)	\$ 0.69	\$ 0.77
Dividends per share of common stock	\$ 0.383	0.375
<b>Average Shares Outstanding</b>		
(basic and diluted)	23,114	23,114

**MGE Energy, Inc.**

**Consolidated Statements of Comprehensive Income (unaudited)**

*(In thousands)*

		<b>Three Months Ended March 31,</b>	
		<b>2012</b>	<b>2011</b>
Net Income	\$	16,048\$	17,783
Other comprehensive income, net of tax:			
Unrealized gain on available-for-sale securities, net of tax (\$5 and \$48)		7	72
<b>Comprehensive Income</b>	\$	16,055\$	17,855

*The accompanying notes are an integral part of the above unaudited consolidated financial statements.*

**MGE Energy, Inc.****Consolidated Statements of Cash Flows (unaudited)***(In thousands)*

		<b>Three Months Ended March 31,</b>	
		<b>2012</b>	<b>2011</b>
<b>Operating Activities:</b>			
Net income	\$	16,048	\$ 17,783
Items not affecting cash:			
Depreciation and amortization		9,624	10,016
Deferred income taxes		8,846	1,622
Provision for doubtful receivables		1,167	1,038
Employee benefit plan expenses		4,682	3,394
Equity earnings in ATC		(2,242)	(2,097)
Other items		660	178
Changes in working capital items:			
Decrease in current assets		12,377	29,753
Decrease in current liabilities		(6,631)	(7,279)
Dividend income from ATC		1,740	1,682
Cash contributions to pension and other postretirement plans		(20,789)	(19,188)
Other noncurrent items, net		(746)	1,135
<i>Cash Provided by Operating Activities</i>		24,736	38,037
<b>Investing Activities:</b>			
Capital expenditures		(15,467)	(9,843)
Capital contributions to investments		(355)	(425)
Purchase of investment - land		(3)	(1,794)
Other		109	(419)
<i>Cash Used for Investing Activities</i>		(15,716)	(12,481)
<b>Financing Activities:</b>			
Cash dividends paid on common stock		(8,843)	(8,670)
Repayment of long-term debt		(667)	(500)
Issuance of long-term debt		-	30,000
Decrease in short-term debt		-	(22,500)
Other		(19)	(311)
<i>Cash Used for Financing Activities</i>		(9,529)	(1,981)
<b>Change in Cash and Cash Equivalents:</b>		(509)	23,575
		41,169	7,110

Cash and cash equivalents at beginning of period

Cash and cash equivalents at end of period	\$	40,660\$	30,685
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**Supplemental disclosures of cash flow information:**

Significant noncash investing activities:

Accrued capital expenditures	\$	4,674\$	1,146
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*The accompanying notes are an integral part of the unaudited consolidated financial statements.*

**MGE Energy, Inc.****Consolidated Balance Sheets (unaudited)***(In thousands)*

		<b>March 31, 2012</b>	<b>December 31, 2011</b>
<b>ASSETS</b>			
<b>Current Assets:</b>			
Cash and cash equivalents	\$	40,660	\$ 41,169
Receivable - margin account		2,500	2,477
Accounts receivable, less reserves of \$3,775 and \$3,662, respectively		38,090	36,744
Other accounts receivable, less reserves of \$636 and \$439, respectively		4,500	5,318
Unbilled revenues		20,706	25,754
Materials and supplies, at average cost		16,047	14,758
Fossil fuel		8,238	5,468
Stored natural gas, at average cost		10,385	19,575
Prepaid taxes		20,118	22,251
Regulatory assets - current		10,665	7,347
Other current assets		7,095	8,270
<i>Total Current Assets</i>		179,004	189,131
Regulatory assets		228,162	205,835
Other deferred assets and other		7,011	8,018
<b>Property, Plant, and Equipment:</b>			
Property, plant, and equipment, net		966,069	961,511
Construction work in progress		40,854	34,055
<i>Total Property, Plant, and Equipment</i>		1,006,923	995,566
Investments		61,197	60,332
<b>Total Assets</b>	<b>\$</b>	<b>1,482,297</b>	<b>\$ 1,458,882</b>
<b>LIABILITIES AND CAPITALIZATION</b>			
<b>Current Liabilities:</b>			
Long-term debt due within one year	\$	2,667	\$ 2,667
Accounts payable		32,000	34,532
Accrued interest and taxes		4,542	4,085
Accrued payroll related items		7,895	9,987
Deferred income taxes		862	3,020
Derivative liabilities		8,198	4,568
Other current liabilities		6,047	4,215
<i>Total Current Liabilities</i>		62,211	63,074
<b>Other Credits:</b>			
Deferred income taxes		210,999	199,850

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Investment tax credit - deferred	1,715	1,780
Regulatory liabilities	18,387	20,463
Accrued pension and other postretirement benefits	165,304	183,622
Derivative liabilities	60,880	34,908
Other deferred liabilities and other	44,388	43,330
<i>Total Other Credits</i>	501,673	483,953
<b>Capitalization:</b>		
Common shareholders' equity	558,164	550,952
Long-term debt	360,249	360,903
<i>Total Capitalization</i>	918,413	911,855
Commitments and contingencies (see Footnote 8)	-	-
<b>Total Liabilities and Capitalization</b>	<b>\$ 1,482,297</b>	<b>\$ 1,458,882</b>

*The accompanying notes are an integral part of the above unaudited consolidated financial statements.*



**MGE Energy, Inc.****Consolidated Statements of Common Equity (unaudited)***(In thousands, except per-share amounts)*

	Common Shares	Stock Value	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive (Loss)/Income	Total
<b>2011</b>						
Beginning balance - December 31, 2010	23,114\$	23,114\$	316,268\$	185,556\$	142\$	525,080
Net income				17,783		17,783
Other comprehensive income					72	72
Common stock dividends declared (\$0.375 per share)				(8,670)		(8,670)
Ending balance - March 31, 2011	23,114\$	23,114\$	316,268\$	194,669\$	214\$	534,265
<b>2012</b>						
Beginning balance - December 31, 2011	23,114\$	23,114\$	316,268\$	211,458\$	112\$	550,952
Net income				16,048		16,048
Other comprehensive income					7	7
Common stock dividends declared (\$0.383 per share)				(8,843)		(8,843)
Ending balance - March 31, 2012	23,114\$	23,114\$	316,268\$	218,663\$	119\$	558,164

*The accompanying notes are an integral part of the above unaudited consolidated financial statements.*



**Madison Gas and Electric Company****Consolidated Statements of Income (unaudited)***(In thousands)*

	<b>Three Months Ended March 31,</b>	
	<b>2012</b>	<b>2011</b>
<b>Operating Revenues:</b>		
Regulated electric revenues	\$ 89,936	\$ 86,007
Regulated gas revenues	57,019	77,437
Nonregulated revenues	2,304	1,161
<i>Total Operating Revenues</i>	149,259	164,605
<b>Operating Expenses:</b>		
Fuel for electric generation	8,851	11,049
Purchased power	19,546	17,581
Cost of gas sold	34,845	50,947
Other operations and maintenance	42,528	39,235
Depreciation and amortization	9,624	10,016
Other general taxes	5,000	4,701
Income tax provision	8,969	9,891
<i>Total Operating Expenses</i>	129,363	143,420
<b>Operating Income</b>	19,896	21,185
<b>Other Income and Deductions:</b>		
AFUDC - equity funds	154	87
Equity in earnings in ATC	2,242	2,097
Income tax provision	(993)	(806)
Other income, net	56	113
<i>Total Other Income and Deductions</i>	1,459	1,491
Income before interest expense	21,355	22,676
<b>Interest Expense:</b>		
Interest on long-term debt	5,197	4,991
Other interest, net	7	(147)
AFUDC - borrowed funds	(63)	(35)
<i>Net Interest Expense</i>	5,141	4,809
<b>Net Income</b>	\$ 16,214	\$ 17,867
Less Net Income Attributable to Noncontrolling Interest, net of tax	(6,072)	(5,933)
<b>Net Income Attributable to MGE</b>	\$ 10,142	\$ 11,934

**Madison Gas and Electric Company****Consolidated Statements of Comprehensive Income (unaudited)***(In thousands)*

		<b>Three Months Ended March 31,</b>	
		<b>2012</b>	<b>2011</b>
Net Income	\$	16,214\$	17,867
Other comprehensive income (loss), net of tax:			
Unrealized gain (loss) on available-for-sale securities, net of tax (\$11 and \$23)		(16)	35
<b>Comprehensive Income</b>	\$	16,198\$	17,902
Less: Comprehensive income attributable to Noncontrolling Interest, net of tax		(6,072)	(5,933)
<b>Comprehensive Income attributable to MGE</b>	\$	10,126\$	11,969

*The accompanying notes are an integral part of the above unaudited consolidated financial statements.*

**Madison Gas and Electric Company****Consolidated Statements of Cash Flows (unaudited)***(In thousands)*

		<b>Three Months Ended March 31,</b>	
		<b>2012</b>	<b>2011</b>
<b>Operating Activities:</b>			
Net income	\$	16,214	\$ 17,867
Items not affecting cash:			
Depreciation and amortization		9,624	10,016
Deferred income taxes		8,768	1,412
Provision for doubtful receivables		1,005	1,038
Employee benefit plan expenses		4,682	3,394
Equity earnings in ATC		(2,242)	(2,097)
Other items		792	390
Changes in working capital items:			
Decrease in current assets		11,542	28,893
Decrease in current liabilities		(6,991)	(7,441)
Dividend income from ATC		1,740	1,682
Cash contributions to pension and other			
postretirement plans		(20,789)	(19,188)
Other noncurrent items, net		(762)	1,110
<i>Cash Provided by Operating Activities</i>		23,583	37,076
<b>Investing Activities:</b>			
Capital expenditures		(15,467)	(9,843)
Capital contributions to investments		(355)	(355)
Other		49	88
<i>Cash Used for Investing Activities</i>		(15,773)	(10,110)
<b>Financing Activities:</b>			
Cash dividends paid to parent by MGE		(6,728)	(6,596)
Distributions to parent from noncontrolling			
interest		-	(33,000)
Equity contribution received by			
noncontrolling interest		355	356
Repayment of long-term debt		(667)	(500)
Issuance of long-term debt		-	30,000
Decrease in short-term debt		-	(3,500)
Other		(9)	(309)
<i>Cash Used for Financing Activities</i>		(7,049)	(13,549)

<b>Change in Cash and Cash Equivalents:</b>	761	13,417
Cash and cash equivalents at beginning of period	13,898	4,494
Cash and cash equivalents at end of period    \$	14,659\$	17,911

**Supplemental disclosures of cash flow information:**

Significant noncash investing activities:

Accrued capital expenditures                      \$	4,674\$	1,146
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*The accompanying notes are an integral part of the unaudited consolidated financial statements.*

**Madison Gas and Electric Company****Consolidated Balance Sheets (unaudited)***(In thousands)*

		<b>March 31, 2012</b>	<b>December 31, 2011</b>
<b>ASSETS</b>			
<b>Current Assets:</b>			
Cash and cash equivalents	\$	14,659\$	13,898
Receivable - margin account		2,500	2,477
Accounts receivable, less reserves of \$3,775 and \$3,662, respectively		37,088	35,765
Affiliate receivables		609	605
Other accounts receivable, less reserves of \$636 and \$439, respectively		4,486	5,301
Unbilled revenues		20,706	25,754
Materials and supplies, at average cost		16,047	14,758
Fossil fuel		8,238	5,468
Stored natural gas, at average cost		10,385	19,575
Prepaid taxes		20,685	21,977
Regulatory assets - current		10,665	7,347
Other current assets		7,080	8,245
<i>Total Current Assets</i>		153,148	161,170
Affiliate receivable long-term		6,751	6,884
Regulatory assets		228,162	205,835
Other deferred assets and other		6,502	7,286
<b>Property, Plant, and Equipment:</b>			
Property, plant, and equipment, net		965,565	961,007
Construction work in progress		40,854	34,055
<i>Total Property, Plant, and Equipment</i>		1,006,419	995,062
Investments		58,386	57,556
<b>Total Assets</b>	\$	1,459,368\$	1,433,793
<b>LIABILITIES AND CAPITALIZATION</b>			
<b>Current Liabilities:</b>			
Long-term debt due within one year	\$	2,667\$	2,667
Accounts payable		32,000	34,532
Affiliate payables		1,822	2,152
Accrued interest and taxes		4,495	4,037
Accrued payroll related items		7,895	9,987
Deferred income taxes		927	3,020
Derivative liabilities		8,198	4,568
Other current liabilities		5,798	3,997

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<i>Total Current Liabilities</i>	63,802	64,960
<b>Other Credits:</b>		
Deferred income taxes	207,541	196,550
Investment tax credit - deferred	1,715	1,780
Regulatory liabilities	18,387	20,463
Accrued pension and other postretirement benefits	165,304	183,622
Derivative liabilities	60,880	34,908
Other deferred liabilities and other	44,388	43,330
<i>Total Other Credits</i>	498,215	480,653
<b>Capitalization:</b>		
Common shareholder's equity	416,324	412,926
Noncontrolling interest	120,778	114,351
<i>Total Equity</i>	537,102	527,277
Long-term debt	360,249	360,903
<i>Total Capitalization</i>	897,351	888,180
Commitments and contingencies (see Footnote 8)	-	-
<b>Total Liabilities and Capitalization</b>	<b>\$ 1,459,368</b>	<b>\$ 1,433,793</b>

*The accompanying notes are an integral part of the above unaudited consolidated financial statements.*



**Madison Gas and Electric Company****Consolidated Statements of Common Equity (unaudited)***(In thousands)*

	Common Stock Shares	Value	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive (Loss)/Income	Non- Controlling Interest	Total
<b>2011</b>							
Beginning balance - Dec. 31, 2010	17,348\$	17,348\$	192,417\$	192,480\$	71\$	141,993\$	544,309
Net income				11,934		5,933	17,867
Other comprehensive income					35		35
Cash dividends paid to parent by MGE				(6,596)			(6,596)
Equity contribution received by noncontrolling interest						356	356
Distributions to parent from noncontrolling interest						(33,000)	(33,000)
Ending balance - March 31, 2011	17,348\$	17,348\$	192,417\$	197,818\$	106\$	115,282\$	522,971
<b>2012</b>							
Beginning balance - Dec. 31, 2011	17,348\$	17,348\$	192,417\$	203,114\$	47\$	114,351\$	527,277
Net income				10,142		6,072	16,214
Other comprehensive loss					(16)		(16)
Cash dividends paid to parent by MGE				(6,728)			(6,728)
Equity contribution received by noncontrolling interest						355	355
Ending balance - March 31, 2012	17,348\$	17,348\$	192,417\$	206,528\$	31\$	120,778\$	537,102

*The accompanying notes are an integral part of the above unaudited consolidated financial statements.*



**MGE Energy, Inc., and Madison Gas and Electric Company**

**Notes to Consolidated Financial Statements (unaudited)**

**March 31, 2012**

**1.**

**Basis of Presentation - MGE Energy and MGE.**

This report is a combined report of MGE Energy and MGE. References in this report to "MGE Energy" are to MGE Energy, Inc., and its subsidiaries. References in this report to "MGE" are to Madison Gas and Electric Company.

MGE Power Elm Road and MGE Power West Campus own electric generating assets and lease those assets to MGE. Both entities are variable interest entities under applicable authoritative guidance. MGE is considered the primary beneficiary of these entities as a result of contractual agreements. As a result, MGE has consolidated MGE Power Elm Road and MGE Power West Campus.

The accompanying consolidated financial statements as of March 31, 2012, and for the three months ended, are unaudited, but include all adjustments that MGE Energy and MGE management consider necessary for a fair statement of their respective financial statements. All adjustments are of a normal, recurring nature except as otherwise disclosed. The year-end consolidated balance sheet information was derived from the audited balance sheet appearing in MGE Energy's and MGE's 2011 Annual Report on Form 10-K, but does not include all disclosures required by accounting principles in the United States of America. These notes should be read in conjunction with the financial statements and the notes on pages 54 through 107 of the 2011 Annual Report on Form 10-K.

**2.**

**Equity and Financing Arrangements - MGE Energy.**

**a.**

**Common Stock.**

MGE Energy purchases stock in the open market for issuance pursuant to its Stock Plan. All MGE Energy common stock issued under the Stock Plan is sold pursuant to a registration statement that has been filed with the SEC and is currently effective.

MGE Energy can issue new shares of its common stock through the Stock Plan. For both the three months ended March 31, 2012 and 2011, MGE Energy did not issue any new shares of common stock under the Stock Plan.

**b.**

**Dilutive Shares Calculation.**

MGE Energy does not hold any dilutive securities.

**3.**

**Investment in ATC - MGE Energy and MGE.**

ATC owns and operates electric transmission facilities primarily in Wisconsin. MGE received an interest in ATC when it, like other Wisconsin electric utilities, contributed its electric transmission facilities to ATC. That interest is presently held by MGE Transco, which is jointly owned by MGE Energy and MGE.

MGE Transco has accounted for its investment in ATC under the equity method of accounting. For the three months ended March 31, 2012 and 2011, MGE Transco recorded equity earnings from the investment in ATC of \$2.2 million and \$2.1 million, respectively. Dividend income received from ATC was \$1.7 million for both the three months ended March 31, 2012 and 2011. In addition, during both the three months ended March 31, 2012 and 2011, MGE Transco made \$0.4 million in capital contributions to ATC.

MGE Energy and MGE's investment in ATC as of March 31, 2012, and December 31, 2011, was \$57.8 million and \$57.0 million, respectively.

At March 31, 2012, MGE is the majority owner, and MGE Energy, the holding company, is the minority owner of MGE Transco. MGE Energy's proportionate share of the equity and net income of MGE Transco is classified within the MGE financial statements as noncontrolling interest.

ATC's summarized financial data for the three months ended March 31, 2012 and 2011, is as follows:

<i>(In thousands)</i>	Three Months Ended	
	March 31,	
	2012	2011
Operating revenues	\$ 147,662	\$ 139,617
Operating expenses	(69,566)	(63,126)
Other expense, net	(500)	(358)
Interest expense, net	(19,501)	(21,897)
Earnings before members' income taxes	\$ 58,095	\$ 54,236

#### 4.

##### **Columbia Environmental Project Construction - MGE Energy and MGE.**

MGE and two other utilities jointly own Columbia, a coal-fired generating facility. WPL is the plant operator and permit holder, and owns 46.2% of Columbia. WPSC owns a 31.8% interest, and MGE owns a 22% interest in Columbia. In early 2011, the PSCW issued a *Certificate and Order* authorizing the construction of scrubbers and bag houses and associated equipment on Columbia Units 1 and 2 to reduce SO<sub>2</sub> and mercury emissions. The scrubbers and bag houses are expected to support compliance obligations for current and anticipated air quality regulations, including CAIR or CSAPR, the Utility MACT Rule and the Wisconsin Mercury Rule. The operator's current estimate shows that MGE's share of the capital expenditures required for this project will be approximately \$140 million. MGE expects to incur capital expenditures as follows: \$43 million for the remainder of 2012, \$68 million in 2013, and \$14 million in 2014. These amounts may change as a result of modifications to the project estimate or timing difference.

As of March 31, 2012, MGE had incurred \$10.5 million (excluding carrying costs) in construction expenditures at Columbia related to its share of the project and had accrued \$4.0 million in incurred but unpaid capital expenditures. At March 31, 2012, \$14.5 million (excluding carrying costs) related to this project is reflected in the Construction Work in Progress balance on MGE and MGE Energy's consolidated balance sheets.

MGE expects that the costs pertaining to this project will be fully recoverable through rates. Additionally, MGE is entitled to a carrying cost on the related construction costs at 100% of the determined AFUDC rate.

#### 5.

**Taxes - MGE Energy and MGE.**

**a.**

**Accounting for Uncertainty in Income Taxes.**

MGE Energy and MGE account for the difference between the tax benefit amount taken on prior year tax returns, or expected to be taken on a current year tax return, and the tax benefit amount recognized in the financial statements as an unrecognized tax benefit.

MGE Energy has adopted a tax method of accounting to accelerate tax deductions for repairs in accordance with Treasury Regulations and case law, as compared to the prior method of claiming tax depreciation on project costs. The method change for electric generation and transmission and distribution repairs was included on the 2009 tax return while the change for gas distribution repairs was included on the 2010 return. During 2011, the IRS issued guidance on the treatment of electric transmission and distribution repairs. This guidance prompted the reversal of a portion of the unrecognized tax benefits for these repairs during 2011. MGE Energy and MGE have an unrecognized tax benefit at March 31, 2012, and December 31, 2011, in the amount of \$2.7 million and \$2.4 million, respectively, for the tax uncertainty primarily related to the change in tax method of accounting for electric generation and gas distribution repairs.

**b.**

**Effective Tax Rate.**

MGE Energy's and MGE's effective income tax rate for the three months ended March 31, 2012, is 38.1%, compared to 37.5% for the same period in 2011. The higher effective tax rate is, in part, attributable to a lower estimated domestic manufacturing deduction.

6.

**Pension and Other Postretirement Plans - MGE Energy and MGE.**

MGE maintains qualified and nonqualified pension plans, health care, and life insurance benefits. Additionally, MGE has defined contribution 401(k) benefit plans.

The following table presents the components of MGE Energy's and MGE's net periodic benefit costs recognized for the three months ended March 31, 2012 and 2011. A portion of the net periodic benefit cost is capitalized within the consolidated balance sheets. The PSCW allowed MGE to defer the 2009 incremental pension and OPRB costs above the amounts recovered in rates. During the three months ended March 31, 2012 and 2011, \$0.3 million and \$0.7 million, respectively, has been recovered in rates.

<i>(In thousands)</i>	Three Months Ended March 31,	
	2012	2011
<b>Pension Benefits</b>		
Components of net periodic benefit cost:		
Service cost	\$ 1,823	\$ 1,540
Interest cost	3,154	3,080
Expected return on assets	(3,818)	(3,531)
Amortization of:		
Prior service cost	108	109
Actuarial loss	2,006	946
Net periodic benefit cost	\$ 3,273	\$ 2,144
<b>Postretirement Benefits</b>		
Components of net periodic benefit cost:		
Service cost	\$ 647	\$ 487
Interest cost	1,125	982
Expected return on assets	(435)	(396)
Amortization of:		
Transition obligation	106	107
Prior service cost	28	27
Actuarial loss	621	111
Net periodic benefit cost	\$ 2,092	\$ 1,318

7.



**Share-Based Compensation - MGE Energy and MGE.**

Under MGE Energy's Performance Unit Plan, eligible participants may receive performance units that entitle the holder to receive a cash payment equal to the value of a designated number of shares of MGE Energy's common stock, plus dividend equivalent payments thereon, at the end of the set performance period.

In addition to units granted in 2008 through 2011, on February 17, 2012, 16,693 units were granted based on the MGE Energy closing stock price as of that date. These units are subject to a five-year graded vesting schedule. On the grant date, MGE Energy and MGE measure the cost of the employee services received in exchange for the award based on the current market value of MGE Energy common stock. The fair value of the awards has been subsequently re-measured at March 31, 2012, as required by applicable accounting standards. Changes in fair value have been recognized as compensation cost. Since this amount is re-measured quarterly throughout the vesting period, the compensation cost is subject to variability.

For nonretirement eligible employees, stock based compensation costs are accrued and recognized using the graded vesting method. Compensation cost for retirement eligible employees or employees that will become retirement eligible during the vesting schedule are recognized on an abridged horizon.

In April 2011, the MGE Energy Board approved an amendment to the outstanding awards under the Performance Unit Plan to provide for the continued vesting of those awards in the event of a bona fide retirement, provided the retired individual does not provide services to a competitor. The amendment did not change the number of performance units covered by any outstanding awards currently held by any of the participants.

During the three months ended March 31, 2012 and 2011, MGE recorded \$0.4 million and \$0.1 million, respectively, in compensation expense as a result of the Performance Unit Plan. In January 2012, cash payments of \$0.6 million were distributed relating to awards that were granted in 2007 and became payable under the Performance Unit Plan. No forfeitures occurred during the three months ended March 31, 2012 or 2011. At March 31, 2012, \$2.6 million of outstanding awards are vested.

8.

**Commitments and Contingencies.**

a.

**Environmental - MGE Energy and MGE.**

**Water quality**

Water quality regulations promulgated by the EPA and WDNR in accordance with the Federal Water Pollution Control Act, or more commonly known as the Clean Water Act (CWA), impose restrictions on emissions of various pollutants into surface waters. The CWA also regulates surface water quality issues that affect aquatic life, such as water temperatures, intake structures, and wetlands filling. The CWA regulates discharges from "point sources" such as power plants by establishing discharge limits in water discharge permits. MGE's power plants operate under Wisconsin Pollution Discharge Elimination System (WPDES) permits to ensure compliance with these discharge limits.

*EPA Cooling Water Intake Rules (Section 316(b))*

In April 2011, the EPA proposed and asked for public comment on standards to reduce entrainment (drawing aquatic life into a plant's cooling system) and impingement (trapping aquatic life on screens) from existing structures designed to take in cooling water for plants such as power plants. This rule is commonly referred to as Phase II of Section 316(b) of the CWA. Both our Blount and Columbia generating plants are subject to the impingement and entrainment aspects of the current proposed rule. Our WCCF plant is subject to the impingement aspect only. Under the current proposed rule, equipment would need to be installed at Blount, WCCF and Columbia to meet these new standards. It is not presently possible to estimate the potential costs associated with the implementation of any of these initiatives because the rule has not been finalized.

WPDES Thermal Discharge Rule

WDNR rules to regulate thermal effluent discharges from point sources in Wisconsin became effective on October 1, 2010. We will need to meet the revised rule requirement as MGE's WPDES permits are issued or renewed. If we are unable to demonstrate that any of MGE's permitted plants (Blount, WCCF, Columbia, Elm Road) are able to comply with its associated WPDES permit requirements, then we may need operational controls and/or incur capital costs associated with plant modifications to meet discharge requirements. Those expenditures could be material.

WPDES Phosphorus Nutrient Standards

In December 2010, the WDNR established water quality standards for phosphorus and effluent limitations for permitted discharges into specific waterbodies. Phosphorus limitations will be added to water effluent discharge permits as they are issued or renewed. The WDNR will be developing site-specific phosphorus limits. MGE's facilities subject to these standards include Blount, Columbia, Elm Road and WCCF. MGE may incur additional capital or operational expenditures and/or need to install additional pollution controls to meet the new phosphorus limits. MGE has, however, identified potential compliance options and believes compliance can be managed without significant capital investments.

**Air quality**

Air quality regulations promulgated by the EPA and the WDNR in accordance with the Federal Clean Air Act and the Clean Air Act Amendments of 1990 impose restrictions on emission of particulates, sulfur dioxide (SO<sub>2</sub>), nitrogen oxides (NO<sub>x</sub>), and other pollutants and require permits for operation of emission sources. These permits have been obtained by MGE and must be renewed periodically.

Various initiatives, including the EPA's recently finalized Cross-State Air Pollution Rule (CSAPR), maximum achievable control technology (MACT) standards, new source performance standards (NSPS) and the Clean Air Visibility Rule (also known as the Regional Haze Rule), as well as state mercury emissions limits, are expected to result in additional operating and capital expenditure costs for electric generating units.

*Maximum Achievable Control Technology (MACT) for Utility Boilers (Also Referred to as the Mercury and Air Toxics Standards or MATS)*

In December 2011, the EPA finalized its Mercury and Air Toxics Standards for coal and oil-burning electric generating unit (EGU) boilers. MATS will require emissions standards for mercury, non-mercury HAPs metals, and acid gases. MGE's Columbia and Elm Road Units are subject to MATS. The Elm Road Unit's current pollution controls and Columbia's planned mercury pollution controls will allow both facilities to comply with the MATS rule (see the discussion regarding Columbia below).

*Reciprocating Internal Combustion Engine (RICE) MACT*

In December 2011, the EPA finalized its RICE MACT standard. RICE MACT applies to combustion turbines that contain a reciprocating internal combustion engine. Under the current RICE MACT, MGE may have to adjust its dispatching of several small generation units used for emergency and backup generation or install pollution controls. In January 2012, the EPA published in the Federal Register an intention to propose a revised RICE MACT based on a settlement agreement with several power companies. MGE will review the revised proposal when it is finalized and continue to evaluate the impacts associated with complying with RICE MACT.

*Stay of EPA's Cross State Air Pollution Rule (CSAPR) and Reinstatement of the Clean Air Interstate Rule (CAIR)*

The CAIR, which became effective in 2009, generally requires NO<sub>x</sub> and SO<sub>2</sub> emission reductions from fossil fuel-fired electric generating units (25 MW or greater) (EGUs) in the eastern half of the United States in two phases and includes a regional cap-and-trade system. The first phase (currently in place) requires annual regional emission reductions from 2003 levels of 55% for NO<sub>x</sub> and 40% for SO<sub>2</sub>. The second phase (beginning in 2015) reduces regional NO<sub>x</sub> and SO<sub>2</sub> emissions further from 2003 levels to 65% and 70%, respectively. MGE owns or has partial ownership in several generation units currently subject to the CAIR: Blount, Columbia, Elm Road, and its combustion turbines located in West Marinette and Fitchburg.

In December 2008, the U.S. Court of Appeals for the D.C. Circuit remanded the CAIR to the EPA for further review. In August 2011, the EPA published the Cross-State Air Pollution Rule (CSAPR) to replace the CAIR. Similar to the CAIR, CSAPR requires NO<sub>x</sub> and/or SO<sub>2</sub> air emissions reductions by fossil fuel-fired EGUs (25 MW or greater) in 28 states in the eastern half of the U.S. CSAPR established state emission restrictions, referred to as budgets, for SO<sub>2</sub> and NO<sub>x</sub> beginning in 2012 (Phase I). Under CSAPR, SO<sub>2</sub> emission budgets in certain states, including Wisconsin, will be lowered further in 2014 (Phase II). CSAPR affects the same electric generation units at MGE as CAIR: Blount, Columbia, Elm Road, and the combustion turbines at West Marinette and Fitchburg. Plants in Wisconsin that are subject to CSAPR have been allocated CSAPR emission allowances and will need to hold sufficient allowances to cover emissions on an annual basis. If CSAPR allowances are not adequate for a given plant, emissions will need to be reduced at the plant level by fuel-switching, installation of controls, curtailment of operations or a combination thereof. MGE's Columbia plant, which is operated by WPL (MGE has a 22% ownership interest), has significantly fewer SO<sub>2</sub> allocations under CSAPR in 2012 and 2013 than recent actual emissions.

In December 2011, the U.S. Court of Appeals for the D.C. Circuit stayed the implementation of CSAPR pending judicial review. The ruling leaves the CAIR in place while the court considers the merits and challenges to CSAPR. MGE expects to hold sufficient emissions allowances under the CAIR for 2012.

If CSAPR is reinstated in 2012 or 2013, the Columbia co-owners will need to evaluate and implement interim strategies to address anticipated SO<sub>2</sub> allowance deficiencies under CSAPR. Current analysis shows that, if reinstated in 2013, additional allowances (if available) may need to be purchased, Columbia generation may need to be reduced to comply with CSAPR limits, or a combination of these two strategies may be employed. These interim measures may increase MGE's costs. MGE expects that the costs pertaining to meeting CSAPR requirements will be fully recoverable through rates. Planned new SO<sub>2</sub> controls at Columbia are expected to be completed by mid 2014 (see the discussion regarding the Columbia Environmental Project below). Once the new environmental control project is completed at Columbia, it is expected that the plant will emit below anticipated CSAPR allocation levels.

#### Clean Air Visibility Rule (CAVR)

Air modeling indicates that SO<sub>2</sub> and NO<sub>x</sub> emissions (and to a lesser extent particulate matter, or PM) from Columbia may impair visibility at certain Class I Scenic Areas and may therefore be subject to the best available retrofit technology (BART) regulations, a subsection of the EPA's Clean Air Visibility Rule (CAVR), which requires pollution retrofits. The EPA has proposed that compliance with CAIR and with CSAPR emissions limitations could also serve as compliance with BART for SO<sub>2</sub> and NO<sub>x</sub> emissions.

However, with the uncertainty regarding the future of CAIR and CSAPR, the future of BART regulation and compliance strategies and costs are also uncertain.

#### Wisconsin State Mercury Rule

Beginning January 1, 2015, phase two of the Wisconsin mercury rule will require large coal-fired electric generating units (larger than 150 MW) to reduce mercury emissions by 90%, or choose a multi-pollutant reduction approach, which allows a stepped approach to mercury reduction while reducing NO<sub>x</sub> and SO<sub>2</sub> emissions at prescribed rates. Elm Road currently meets this requirement. The Columbia co-owners plan to meet the 90% reduction option by installing pollution controls needed to meet this and other rules (see the discussion regarding the Columbia Environmental Project below).

#### National Ambient Air Quality Standards (NAAQS)

The EPA has developed National Ambient Air Quality Standards (NAAQS) for six compounds currently identified as criteria pollutants: nitrogen dioxide (NO<sub>2</sub>), particulate matter (PM), ozone, SO<sub>2</sub>, lead and carbon monoxide. The NAAQS for criteria pollutants establish acceptable ambient air levels based on effects to human health and the environment, and changes to those NAAQS can affect compliance requirements and associated capital and operating costs. The EPA is required to review NAAQS every five years. MGE is currently tracking two NAAQS developments: (1) EPA's five-year review of PM NAAQS that are scheduled to be released by June 2012, and (2) the WDNR' attainment/nonattainment designations associated with the EPA's June 2010 final revisions to its SO<sub>2</sub> NAAQS. These two NAAQS developments could have a potential material effect on capital and maintenance costs at our generating facilities. The magnitude will not be known until the rules are implemented.

#### EPA's Prevention of Significant Deterioration and Title V Greenhouse Gas Tailoring Rule

The EPA's Greenhouse Gas "Tailoring Rule" regulates stationary sources for GHG emissions by "phasing in" over time different types of facilities subject to Prevention of Significant Deterioration (PSD) pre-construction program or Title V permitting (i.e. new facilities and existing facilities with certain qualifying modifications). MGE facilities may become subject to this rule if modifications at any facilities trigger PSD or if MGE invests in new facilities that trigger PSD.

#### GHG New Source Performance Standards for Electric Generating Units (EGU GHG NSPS)

On March 27, 2012, the EPA proposed greenhouse gas (GHG) New Source Performance Standards (NSPS) for coal fired and natural gas combined cycle (NGCC) electric generation units (EGUs). The proposal applies to new EGUs only; the EPA has stated that it does not intend for these rules to apply to modified or existing units at this time. The proposed NSPS may be finalized within 2012 and is not anticipated to significantly affect MGE's existing generation

units.

## **Columbia**

MGE and two other utilities jointly own Columbia, a coal-fired generating facility, which accounts for 225 MW (29%) of MGE's net summer generating capability. WPL is the plant operator and permit holder, and owns 46.2% of Columbia. Wisconsin Public Service Corporation (WPSC) owns a 31.8% interest, and MGE owns a 22% interest in Columbia. Based upon current available information, compliance with various environmental requirements and initiatives is expected to result in significant additional operating and capital expenditures at Columbia.

### *Columbia Environmental Project*

In early 2011, the PSCW issued a *Certificate and Order* authorizing the construction of scrubbers and bag houses and associated equipment on Columbia Units 1 and 2 to reduce SO<sub>2</sub> and mercury emissions. The scrubbers and bag houses are expected to support compliance obligations for current and anticipated air quality regulations, including CAIR or CSAPR, the Utility MACT Rule and the Wisconsin Mercury Rule. The operator's current estimate shows that MGE's share of the capital expenditures required for this project will be approximately \$140 million.

As of March 31, 2012, Columbia has entered into various contractual commitments with vendors for a portion of the \$140 million project. MGE is indirectly a party to these agreements as a result of its joint ownership of Columbia and is also contractually obligated, under the applicable ownership and operating agreements. MGE's share of these commitments is \$109.7 million. These costs are expected to be capitalized and included in the consolidated balance sheets of MGE Energy and MGE. See Footnote 4 for further information regarding the Columbia Environmental construction project.

*Title V Operating Permit Petition*

In September 2008, the WDNR issued a Title V renewal operating permit to WPL for Columbia. A citizen group petitioned the EPA to object to the issuance of the permit renewal. In October 2009, the EPA issued an order granting in part and denying in part the petition and sent the operating permit back to the WDNR for further review based on the EPA order. The WDNR took various preliminary actions and in February 2011, issued a letter stating its determination not to issue either the proposed construction permit or a revised operating permit for Columbia. In February 2011, the citizen group involved filed an action against the EPA in the U.S. District Court for the Western District of Wisconsin seeking to have the EPA take over the permit process. In May 2011, the WDNR proposed a revised operating permit for Columbia. The Columbia owners commented on the WDNR's draft permit and are awaiting the WDNR's response. MGE believes the permits currently in effect for Columbia remain in place at this time. MGE continues to follow these developments and is unable to predict the outcome of this matter and its impact on its financial or operational conditions.

*Columbia Clean Air Act Litigation*

In December 2009, the EPA sent a Notice of Violation (NOV) to MGE as one of the co-owners of Columbia. The NOV alleges that WPL, as operator, and the Columbia co-owners failed to comply with appropriate pre-construction review and permitting requirements and as a result violated the PSD program requirements, Title V Operating Permit requirements of the CAA and the Wisconsin SIP. The parties are exploring possible settlement.

In September 2010, Sierra Club filed a civil lawsuit against WPL alleging violations of the CAA at Columbia and other Wisconsin facilities operated by WPL. The Sierra Club and the co-owners are engaged in settlement discussions. The parties recently requested and received a temporary stay of proceedings to further explore settlement options. The trial date is scheduled for December 2012. During the February 15, 2012 status conference, the Court reaffirmed the December 2012 trial date, but set a pre-trial schedule that allows the parties to continue work toward settlement.

MGE and the other co-owners of Columbia are defending against these allegations while actively pursuing settlement options with the EPA and Sierra Club. WPL has informed MGE that WPL believes the projects at Columbia were routine or not projected to increase emissions and therefore did not violate the permitting requirements of the CAA.

In response to similar EPA CAA enforcement initiatives, certain utilities have elected to settle with the EPA, while others have elected to litigate. If the EPA and/or Sierra Club successfully prove their claims that projects completed in the past at Columbia required either state or federal CAA permits, MGE may, under the applicable statutes, be required to pay civil penalties in amounts of up to \$37,500 per day for each violation and/or complete actions for injunctive relief. Payment of fines and/or injunctive relief could be included in a settlement outcome. Injunctive relief contained in settlements or court-ordered remedies for other utilities in similar matters required the installation of pollution control technology, changed operating conditions (including use of alternative fuels other than coal),



surrender of excess emission trading allowances, caps for emissions and limitations on generation (including retirement of generating units) and other beneficial environmental projects. If similar remedies are required for final resolution of these matters at Columbia, MGE would likely incur additional capital and operating expenditures. At this time, MGE is unable to predict with certainty the impact of these claims on its financial condition or results of operations but believes that should there ultimately be an adverse outcome, it could have a significant effect.

**b.**

**Chattel Paper Agreement and Other Guarantees - MGE Energy and MGE.**

MGE makes available to qualifying customers a financing program for the purchase and installation of energy-related equipment that will provide more efficient use of utility service at the customer's property. MGE is party to a chattel paper purchase agreement with a financial institution under which it can sell or finance an undivided interest with recourse, in up to \$10.0 million of the financing program receivables, until July 31, 2012. At March 31, 2012, MGE has outstanding a \$4.2 million interest in these receivables. MGE retains the servicing responsibility for these receivables. As of March 31, 2012, the servicing asset recognized by MGE is \$0.2 million.

MGE accounts for servicing rights under the amortization method. Initial determination of the servicing asset fair value is based on the present value of the estimated future cash flows. The discount rate is based on the PSCW authorized weighted cost of capital.

MGE would be required to perform under its guarantee if a customer defaulted on its loan. The energy-related equipment installed at the customer sites is used to secure the customer loans. The loan balances outstanding at March 31, 2012, approximate the fair value of the energy-related equipment acting as collateral. The length of the MGE guarantee to the financial institution varies from one to ten years depending on the term of the underlying customer loan. Principal payments for the remainder of 2012 and the next four years on the loans are:

<i>(In thousands)</i>		2012	2013	2014	2015	2016
Chattel Paper	\$	422\$	646\$	461\$	772\$	695

c.

**Other Legal Matters - MGE Energy and MGE.**

MGE is involved in various other legal matters that are being defended and handled in the normal course of business. MGE maintains accruals for such costs that are probable of being incurred and subject to reasonable estimation. MGE has accrued for such matters in the financial statements. The ultimate outcomes of such matters are uncertain and may have an adverse effect on MGE Energy's and MGE's results of operations, financial position, or cash flows.

d.

**Smart Grid Investment Grant - MGE Energy and MGE.**

MGE was approved in 2010 by the U.S. Department of Energy (DOE) under the federal stimulus program for a \$5.5 million grant for smart grid projects. The DOE grant requires MGE to match the grant funding, bringing the total cost of the projects to more than \$11 million. The projects involve the installation of technologies to boost efficiency, enhance service and improve reliability for customers. The stimulus grant is being used to fund the following projects: advanced metering infrastructure, plug-in hybrid electric vehicles support, and distribution management. As of March 31, 2012, MGE has spent \$6.8 million related to these projects and has outstanding agreements to purchase \$0.8 million in smart grid related products for the remainder of 2012.

e.

**Other Commitments - MGE Energy.**

On January 31, 2012, MGE Energy entered a subscription agreement to invest in a nonpublic venture capital fund. From time to time, this entity will require capital infusions from its investors. MGE Energy has committed to contribute \$2.0 million in capital for such infusions. The timing of these infusions is dependent on the needs of the investee and is therefore uncertain at this time.

**9.**

**Derivative and Hedging Instruments - MGE Energy and MGE.**

**a.**

**Purpose.**

As part of its regular operations, MGE enters into contracts, including options, swaps, futures, forwards, and other contractual commitments, to manage its exposure to commodity prices and gas revenues. To the extent that these contracts are derivatives, MGE assesses whether or not the normal purchases or normal sales exclusion applies. For contracts to which this exclusion cannot be applied, MGE Energy and MGE recognize such derivatives in the consolidated balance sheets at fair value. The majority of MGE's derivative activities are conducted in accordance with its electric and gas risk management program, which is approved by the PSCW and limits the volume MGE can hedge with specific risk management strategies. The maximum length of time over which cash flows related to energy commodities can be hedged is four years. If the derivative qualifies for regulatory deferral, the derivatives are marked to fair value and are offset with a corresponding regulatory asset or liability. The deferred gain or loss is recognized in earnings in the delivery month applicable to the instrument. Gains and losses related to hedges qualifying for regulatory treatment are recoverable in gas rates through the PGA or in electric rates as a component of the fuel rules mechanism.

**b.**

**Notional Amounts.**

The gross notional volume of open derivatives is as follows:

	March 31, 2012	December 31, 2011
Commodity derivative contracts	451,750 MWh	482,545 MWh
Commodity derivative contracts	2,970,000 Dth	4,030,000 Dth
FTRs	962 MW	2,382 MW

**c.**

**Financial Statement Presentation.**

MGE Energy and MGE offset fair value amounts recognized for the right to reclaim collateral (a receivable) or the obligation to return collateral (a payable) against fair value amounts recognized for derivative instruments executed with the same counterparty under a master netting agreement. At March 31, 2012, and December 31, 2011, MGE Energy and MGE had \$2.0 million and \$3.0 million, respectively, in collateral that was netted against the net derivative positions with counterparties.

MGE purchases and sells exchange-traded and over-the-counter options, swaps, and future contracts. These arrangements are primarily entered into to help stabilize the price risk associated with gas or power purchases. These transactions are employed by both MGE's gas and electric segments. Additionally, as a result of the firm transmission agreements that MGE holds on transmission paths in the MISO and PJM markets, MGE holds FTRs. An FTR is a financial instrument that entitles the holder to a stream of revenues or charges based on the differences in hourly day-ahead energy prices between two points on the transmission grid. The fair values of these instruments are reflected as a regulatory asset/liability depending on whether they are in a net loss/gain position. Depending on the nature of the instrument, the gain or loss associated with these transactions will be reflected as cost of gas sold, fuel for electric generation, or purchased power expense in the delivery month applicable to the instrument. At March 31, 2012, and December 31, 2011, the cost basis of exchange traded derivatives and FTRs exceeded their fair value by \$2.5 million and \$2.8 million, respectively.

MGE has also entered into a ten-year purchased power agreement that provides MGE with firm capacity and energy during a base term from June 1, 2012, through May 31, 2022. The agreement also allows MGE an option to extend the

contract after the base term. The agreement is accounted for as a derivative contract and is recognized at its fair value on the balance sheet. However, the derivative qualifies for regulatory deferral and is recognized with a corresponding regulatory asset or liability depending on whether the fair value is in a loss or gain position. The fair value of the contract at March 31, 2012, and December 31, 2011, reflects a loss position of \$69.0 million and \$39.5 million, respectively. The actual fuel cost will be recognized in purchased power expense in the month of purchase.

The following table summarizes the fair value of the derivative instruments on the balance sheet. All derivative instruments in this table are presented on a gross basis and are calculated prior to the netting of instruments with the same counterparty under a master netting agreement as well as the netting of collateral. For financial statement purposes, MGE Energy and MGE have netted instruments with the same counterparty under a master netting agreement as well as the netting of collateral.

(In thousands)	Asset Derivatives		Liability Derivatives	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
<b>March 31, 2012</b>				
Commodity derivative contracts	Other current assets \$	266	Derivative liability (current) \$	2,723
Commodity derivative contracts	Other deferred charges	153	Derivative liability (long-term)	160
FTRs	Other current assets	-	Derivative liability (current)	40
Ten-year PPA	N/A	N/A	Derivative liability (current)	8,130
Ten-year PPA	N/A	N/A	Derivative liability (long-term)	60,880
<b>December 31, 2011</b>				
Commodity derivative contracts	Other current assets \$	177	Derivative liability (current) \$	3,060
Commodity derivative contracts	Other deferred charges	92	Derivative liability (long-term)	231
FTRs	Other current assets	186	Derivative liability (current)	-
Ten-year PPA	N/A	N/A	Derivative liability (current)	4,600
Ten-year PPA	N/A	N/A	Derivative liability (long-term)	34,920

The following tables summarize the unrealized and realized gains (losses) related to the derivative instruments on the balance sheet at March 31, 2012 and 2011, and the income statement for the three months ended March 31, 2012 and 2011 (a).

(In thousands)	2012		2011	
	Current and long-term regulatory asset	Other current assets	Current and long-term regulatory asset	Other current assets
<b>Three Months Ended March 31:</b>				
Balance at January 1,	\$ 42,356	\$ 1,604	\$ 19,230	\$ 1,411
Change in unrealized loss	33,310	-	3,047	-
Realized loss reclassified to a deferred account	(2,658)	2,658	(663)	663

Realized gain (loss) reclassified to  
income

statement		(1,494)	(3,590)	63	(1,569)
Balance at March 31,	\$	71,514\$	672	\$ 21,677\$	505

Realized losses (gains)

		Regulated	Fuel for electric	Cost of
		gas revenues	generation/ purchased power	gas sold
<i>(In thousands)</i>				
<b>Three Months Ended March 31, 2012:</b>				
Commodity derivative contracts	\$	-\$	1,928\$	3,090
FTRs		-	66	-
Ten-year PPA		-	-	-
<b>Three Months Ended March 31, 2011:</b>				
Commodity derivative contracts	\$	-\$	254\$	1,315
FTRs		-	(63)	-
Ten-year PPA		-	-	-

(a)

*MGE's commodity derivative contracts, FTRs, and ten-year PPA are subject to regulatory deferral. These derivatives are marked to fair value and are offset with a corresponding regulatory asset or liability. Realized gains and losses are deferred on the balance sheet and are recognized in earnings in the delivery month applicable to the instrument. As a result of the above described treatment, there are no unrealized gains or losses that flow through earnings.*

The ten-year PPA has a provision that may require MGE to post collateral if MGE's debt rating falls below investment grade (i.e., below BBB-) once MGE begins purchasing energy under the contract in 2012. The amount of collateral that it may be required to post varies from \$20.0 million to \$40.0 million, depending on MGE's nominated capacity amount. Certain counterparties extend MGE a credit limit. If MGE exceeds these limits, the counterparties may require collateral to be posted. As of March 31, 2012, certain counterparties were in a net liability position of \$0.4 million. As of December 31, 2011, no counterparties were in a net liability position.

Nonperformance of counterparties to the non-exchange traded derivatives could expose MGE to credit loss. However, MGE enters into transactions only with companies that meet or exceed strict credit guidelines, and it monitors these counterparties on an ongoing basis to mitigate nonperformance risk in its portfolio. As of March 31, 2012, no counterparties have defaulted.

## **10.**

### **Rate Matters - MGE Energy and MGE.**

#### **a.**

#### **Rate Proceedings.**

On March 23, 2012, MGE filed an application with the PSCW requesting a 5.8% increase to electric rates and a 2.6% increase to gas rates. The proposed electric increase will cover costs for new environmental equipment at Columbia, final construction costs for the Elm Road Units, transmission reliability enhancements, and purchased power costs. MGE has requested that these rates become effective January 1, 2013.

On December 15, 2011, under a limited reopener of MGE's last rate order, the PSCW authorized MGE to increase 2012 rates for retail electric customers by 4.3% or \$15.7 million and to increase gas rates by 0.3% or \$0.6 million. The change in retail electric rates was driven by MGE's electric fuel and purchased power costs, increased transmission costs, an update to the Elm Road Units' costs, and an increase for energy efficiency programs. The PSCW also approved deferral of CSAPR costs.

On January 12, 2011, the PSCW authorized MGE to increase 2011 rates for retail electric customers by 2.3% or \$8.0 million and to increase gas rates by 1.0% or \$1.9 million. The increase in retail electric rates is driven by costs for MGE's share of the Elm Road Units. Pursuant to the provisions of this rate order, the fuel rules bandwidth



effective January 1, 2011, will be plus or minus 2%. See below for further description of fuel rules. Authorized return on common stock equity was set at 10.3% based on a 58.1% utility common equity.

**b.**

**Fuel Rules.**

The PSCW approved new fuel rules that became effective January 1, 2011. The new rules require the PSCW and Wisconsin utilities to automatically defer electric fuel-related costs that fall outside a symmetrical cost tolerance band. Any over/under recovery of the deferred costs is determined on an annual basis and will be adjusted in future billings to electric retail customers. Under fuel rules, MGE would defer costs, less any excess revenues, if its actual electric fuel costs exceeded 102% of the electric fuel costs allowed in its latest rate order. Excess revenues are defined as revenues in the year in question that provide MGE with a greater return on common equity than authorized by the PSCW in MGE's latest rate order. Conversely, MGE is required to defer the benefit of lower costs if actual electric fuel costs were less than 98% of the electric fuel costs allowed in that order. As of March 31, 2012, MGE did not defer any electric fuel-related costs.

**c.**

**Purchased Gas Adjustment Clause.**

MGE's natural gas rates are subject to a fuel adjustment clause designed to recover or refund the difference between the actual cost of purchased gas and the amount included in rates. Differences between the amounts billed to customers and the actual costs recoverable are deferred and recovered or refunded in future periods by means of prospective monthly adjustments to rates. At March 31, 2012, and December 31, 2011, MGE had over collected \$3.3 million and \$0.9 million, respectively. These amounts were recorded in other current liabilities on the consolidated balance sheet.

11.

**Fair Value of Financial Instruments - MGE Energy and MGE.**

**a.**

**Fair Value of Financial Assets and Liabilities Recorded at the Carrying Amount.**

At March 31, 2012, and December 31, 2011, the carrying amount of cash, cash equivalents, and outstanding commercial paper approximates fair market value due to the short maturity of those investments and obligations. The estimated fair market value of MGE Energy's and MGE's long-term debt is based on quoted market prices for similar financial instruments at March 31, 2012, and December 31, 2011. The estimated fair market value of MGE Energy's and MGE's financial instruments are as follows:

	March 31, 2012		December 31, 2011	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<i>(In thousands)</i>				
<b>MGE Energy</b>				