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

FORM 10-K

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

For the fiscal year ended:
December 31, 2004

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

For the transition period from _____ to _____

| Commission File No. | Name of Registrant, State of Incorporation, Address of Principal Executive Offices, and Telephone No. | IRS Employer Identification No. |
|------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------|
| 000-49965 | MGE Energy, Inc. (a Wisconsin Corporation) 133 South Blair Street Madison, Wisconsin 53703 (608) 252-7000 www.mgeenergy.com | 39-2040501 |
| 000-1125 | Madison Gas and Electric Company (a Wisconsin Corporation) 133 South Blair Street Madison, Wisconsin 53703 (608) 252-7000 www.mge.com | 39-0444025 |

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

None.

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

| | Title of Class |
|----------------------------------------|------------------------------------------------------|
| MGE Energy, Inc. | Common Stock, \$1 Par Value Per Share |
| Madison Gas and Electric Company | Cumulative Preferred Stock, \$25 Par Value Per Share |

Indicate by checkmark 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 registrants were required to file such reports) and (2) have been subject to such filing requirements for the past 90 days. Yes No

Indicate by checkmark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrants' knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by checkmark whether the registrants are accelerated filers (as defined in Rule 12b-2 of the Act).

| | | |
|----------------------------------------|-----------------------------------------|----------------------------------------|
| MGE Energy, Inc. | Yes <input checked="" type="checkbox"/> | No <input type="checkbox"/> |
| Madison Gas and Electric Company | Yes <input type="checkbox"/> | No <input checked="" type="checkbox"/> |

The aggregate market value of the voting and nonvoting common equity held by nonaffiliates of each registrant as of June 30, 2004, was as follows:

| | |
|----------------------------------------|---------------|
| MGE Energy, Inc. | \$613,248,000 |
| Madison Gas and Electric Company | \$0 |

The number of shares outstanding of each registrant's common stock as of February 1, 2005, were as follows:

| | |
|----------------------------------------|------------|
| MGE Energy, Inc. | 20,432,998 |
| Madison Gas and Electric Company | 17,347,889 |

Documents Incorporated by Reference

Portions of MGE Energy, Inc.'s definitive proxy statement to be filed prior to April 29, 2005, relating to its annual meeting of shareholders, are incorporated by reference into Part III of this annual report on Form 10-K.

Madison Gas and Electric Company meets the conditions set forth in General Instruction (I)(1)(a) and (b) of Form 10-K and is therefore omitting (i.) the information otherwise required by Item 601 of Regulation S-K relating to a list of subsidiaries of the registrant as permitted by General Instruction (I)(2)(b), (ii.) the information otherwise required by Item 6 relating to Selected Financial Data, (iii.) the information otherwise required by Item 10 relating to Directors and Executive Officers as permitted by General Instruction (I)(2)(c), (iv.) the information otherwise required by Item 11 relating to executive compensation as permitted by General Instruction (I)(2)(c), (v.) the information otherwise required by Item 12 relating to Security Ownership of Certain Beneficial Owners and Management, and (vi.) the information otherwise required by Item 13 relating to Certain Relationships and Related Transactions.

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Filing Format

This combined Form 10-K 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 substantial portion 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.

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. 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. Some of those risks and uncertainties include:

- Weather, which enters into the calculation of MGE's rates for service and which affects the demand for electricity and gas and the projected and actual need for electric generation capacity to serve customers.
- Economic and market conditions in MGE's service territory, which affect demand for electricity and gas and, consequently, our revenues and expenses as well as capital investment requirements to extend, improve, or reinforce the existing electricity and gas distribution systems.
- Magnitude and timing of capital expenditures, which affect capital needs, financing costs, and operating expenses.
- Regulatory environment in which we operate, which can affect the way in which we do business as well as the accounting treatment of expenses that we incur and our ability to continue carrying specified assets and liabilities on our books.
- Environmental regulation, which can affect the way in which we operate, our operating expenses, and our capital expenditures.
- Availability and cost of power supplies, which affect operating expenses and capital expenditure decisions with respect to sources of new generation.
- Completion of the West Campus Cogeneration Facility at the University of Wisconsin-Madison, which provides MGE Energy with an opportunity if construction is completed on or ahead of schedule, but exposes it to liquidated damages if construction is delayed or the facility fails to operate according to specifications.

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 450 Fifth Street, NW, 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 are also available to the public from commercial document retrieval services, the Web site maintained by the SEC at <http://www.sec.gov>, MGE Energy's Web site at <http://www.mgeenergy.com>, and MGE's Web site at <http://www.mge.com>. Copies may be obtained from our Web sites free of charge.

Definitions

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

| | |
|----------------------------|----------------------------------------------------------------------------------------------------------------------------|
| AEP | American Electric Power Company Inc. |
| AFUDC | allowance for funds used during construction |
| Alliant | Alliant Energy Corporation |
| AMR | automated meter reading |
| ANR | ANR Pipeline Company |
| APB | Accounting Principles Board |
| APBO | Accumulated Postretirement Benefit Obligation |
| ATC | American Transmission Company LLC |
| Blount | Blount Station |
| BOCM | Banc One Capital Markets, Inc. |
| CO ₂ | carbon dioxide |
| Columbia | Columbia Energy Center |
| ComEd | Commonwealth Edison Company, a unit of Chicago-based Exelon Corp. |
| cooling degree days | Measure of the extent to which the average daily temperature is above 65 degrees Fahrenheit, increasing demand for cooling |
| CPCN | Certificate of Public Convenience and Necessity |
| CWDC | Central Wisconsin Development Corporation |
| DNR | Wisconsin Department of Natural Resources |
| DOA | Wisconsin Department of Administration |
| DOE | U.S. Department of Energy |
| Dth | dekatherms |
| EITF | Emerging Issues Task Force |
| EPA | U.S. Environmental Protection Agency |
| EPC | Engineering, Procurement, and Construction |
| FASB | Financial Accounting Standards Board |
| FERC | Federal Energy Regulatory Commission |
| FIN | FASB Interpretation No. |
| FSP | FASB Staff Position No. |
| FTR | Financial Transmission Rights |
| GCIM | gas cost incentive mechanism |
| heating degree days or HDD | Measure of the extent to which the average daily temperature is below 65 degrees Fahrenheit, increasing demand for heating |
| interconnection agreement | Generation-Transmission Interconnection Agreement |
| Kewaunee | Kewaunee Nuclear Power Plant |
| kV | kilovolt |
| kWh | kilowatt-hour |
| LMP | Locational Marginal Pricing |
| MACT | Maximum available control technology |
| MAGAEL | MAGAEL, LLC |

| | |
|--------------------------|------------------------------------------------------------------------------------------------------------------------|
| MAIN | Mid-America Interconnected Network, Inc. |
| MAPP | Mid-Continent Area Power Pool |
| 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 |
| Midwest ISO | Midwest Independent System Operator |
| Moody's | Moody's Investors Service, Inc. |
| MW | megawatt |
| MWh | megawatt-hour |
| Nasdaq | The Nasdaq Stock Market |
| NNG | Northern Natural Gas Company |
| NO _x | nitrogen oxide |
| NO _x SIP Call | Nitrogen oxide State Implementation Plan (federal rule 40 CFR Part 96, commonly known as the NO _x SIP Call) |
| PGA | Purchased Gas Adjustment clause |
| PSCW | Public Service Commission of Wisconsin |
| RTC | Regional Transmission Committee |
| RTO | Regional Transmission Organization |
| S&P | Standard & Poor's Ratings Group, a division of McGraw-Hill Companies |
| SAB | Staff Accounting Bulletin |
| SEC | Securities and Exchange Commission |
| SFAS | Statement of Financial Accounting Standards (issued by the FASB) |
| SO ₂ | sulfur dioxide |
| the State | State of Wisconsin |
| UW | University of Wisconsin at Madison |
| VIE | Variable Interest Entity |
| VOC | volatile organic compounds |
| WCCF | West Campus Cogeneration Facility |
| WDOJ | Wisconsin Department of Justice |
| WELA | Wisconsin Environmental Law Advocates |
| Working capital | current assets less current liabilities |
| WPDES | Wisconsin Pollutant Discharge Elimination System |
| WPL | Wisconsin Power and Light Company |
| WPSC | Wisconsin Public Service Corporation |

PART I.

Item 1. Business.

MGE Energy operates in three business segments:

- Electric utility operations—generating and distributing electricity through MGE.
- Gas utility operations—purchasing and distributing natural gas through MGE.
- Nonregulated energy operations—constructing and owning new electric generating capacity through its wholly owned subsidiaries MGE Construct, MGE Power, and MGE Power West Campus.

MGE Energy became the holding company for MGE on August 12, 2002, when shareholders exchanged their shares of MGE common stock for shares of MGE Energy common stock. The share exchange had no accounting effect on MGE's recorded assets, liabilities, revenues, or expenses.

MGE's utility operations represent a substantial portion of the assets, liabilities, revenues, expenses, and operations of MGE Energy. MGE Energy's nonregulated energy operations currently relate to the development of a cogeneration project on the UW-Madison campus.

MGE Energy was organized as a Wisconsin corporation in 2001. MGE was organized as a Wisconsin corporation in 1896. Their principal offices are located at 133 South Blair Street, Madison, Wisconsin 53703.

As a public utility, MGE is subject to regulation by the PSCW and the FERC. The PSCW has authority to regulate most aspects of MGE's business including rates, accounts, issuance of securities, and plant and transmission line siting. FERC has jurisdiction, under the Federal Power Act, over certain accounting practices and certain other aspects of MGE's business.

MGE is also subject to regulation under local, state, and federal laws regarding air and water quality and solid waste disposal. See "Environmental" below.

MGE's business fluctuates based on changes in weather conditions, with gas revenues generally higher during the winter months due to heating needs and electricity revenues generally higher in the summer months due to cooling needs.

Electric Utility Operations

MGE generates and distributes electricity in a service area covering the 250-square-mile area of Dane County, Wisconsin. Its service area includes the city of Madison, Wisconsin.

At December 31, 2004, MGE supplied electric service to nearly 134,000 customers, with approximately 119,000 located in the cities of Fitchburg, Madison, Middleton, and Monona and 15,000 in adjacent areas. Of the total number of customers, approximately 116,000 were residential and 18,000 were commercial or industrial. Electric revenues for both 2004 and 2003 were comprised of residential (35%), commercial (49%), industrial (6%), sales to public authorities including the UW (8%), and sales to other utilities and other (2%). Electric operations accounted for approximately 59%, 60%, and 65% of MGE's total 2004, 2003, and 2002 revenues, respectively.

See Item 2, Properties, for a description of MGE's electric utility plant.

MGE is a member of MAIN, a regional reliability group. MAIN members work together to utilize better reserve generating capacity and coordinate long-range system planning and day-to-day operations. MAIN seeks to maintain adequate planning reserve margins for generation in the region.

MGE is part owner of ATC, a for-profit transmission company resulting from Reliability 2000 legislation enacted in Wisconsin. Part of that legislation mandated the creation of a statewide transmission company to own the investor-owned utilities' transmission assets. ATC's purpose is to provide reliable, economic transmission service to all customers in a fair and equitable manner. ATC plans, constructs, operates, maintains, and expands transmission facilities that it owns to provide adequate and reliable transmission of power.

Effective January 1, 2001, MGE transferred all of its electric utility transmission assets to ATC in exchange for an ownership interest. ATC is owned and governed by the utilities that contributed facilities or capital in accordance with Wisconsin Act 9. At December 31, 2004, MGE had approximately a 5% ownership interest in ATC. ATC is regulated by FERC for all rate terms and conditions of service and is a transmission-owning member of the Midwest ISO. MGE is a nontransmission-owning member of the Midwest ISO.

On February 1, 2002, MGE started taking network transmission service from the Midwest ISO. Midwest ISO is a nonprofit RTO approved by FERC. The Midwest ISO is responsible for monitoring the electric transmission system that delivers power from generating plants to wholesale power transmitters. Its role is to ensure equal access to the transmission system and to maintain or improve electric system reliability in the Midwest.

In connection with its role as a FERC-approved RTO, the Midwest ISO is developing a bid-based energy market, which is expected to be implemented on April 1, 2005. In connection with the development of this energy market, the Midwest ISO is developing a market-based platform for valuing transmission congestion premised upon the LMP system that has been implemented in other states. It is expected that the LMP system will include the ability to mitigate or eliminate congestion costs through the use of FTRs. During December 2004 and January 2005, the Midwest ISO completed the initial allocation of FTRs. The FTRs will be available through an auction-based system run by the Midwest ISO. It is unknown at this time what financial impact the LMP congestion pricing system will have on MGE.

Fuel supply and generation

MGE's net kWh requirements, for 2004, were provided from the following sources: 64.7% from fossil-fueled steam plants, 33.6% from power purchases, and 1.7% from a combination of wind turbines, diesel generators, and combustion turbines. Sources used depended on generating unit availability, weather, and customer demand.

MGE has a 22% ownership interest in two 512-MW coal-burning units at Columbia. The coal inventory supply for the units decreased from 45 days on December 31, 2003, to 41 days on December 31, 2004. The co-owners' current goal is to maintain approximately a 35-day inventory. The units burn low-sulfur coal obtained (pursuant to long-term contracts) from the Powder River Basin coal fields located in Wyoming and Montana.

Wind Power Purchase Agreement

On July 16, 2004, MGE signed a 20-year power purchase agreement for 40 MW of wind energy to be located near Waupun, Wisconsin. The agreement would increase MGE's wind power output capacity from 12 MW to 52 MW. This project is pending approval from the PSCW which is expected to be granted in 2005.

Gas Utility Operations

MGE transports and distributes natural gas in a service area covering 1,350 square miles in seven south-central Wisconsin counties. Its service area includes the city of Madison, Wisconsin.

On December 31, 2004, MGE supplied natural gas service to nearly 133,000 customers in the cities of Elroy, Fitchburg, Lodi, Madison, Middleton, Monona, Prairie du Chien, Verona, and Viroqua; 24 villages; and all or parts of 45 townships. Of the total number of customers, approximately 118,000 were residential and 15,000 were commercial or industrial. Gas revenues for 2004 were comprised of residential (57%), commercial (38%), industrial (2%), and transportation service and other (3%). Gas revenues for 2003 were comprised of residential (58%), commercial (37%), industrial (2%), and transportation service and other (3%). Gas operations accounted for approximately 41%, 40%, and 35% of MGE's total 2004, 2003, and 2002 revenues, respectively.

MGE can curtail gas deliveries to its interruptible customers. Approximately 5% of gas sold in 2004 was to interruptible customers.

Gas supply

MGE has physical interconnections with ANR and NNG. MGE's primary service territory, which includes Madison and the surrounding area, receives deliveries at one NNG and four ANR gate stations. MGE also receives deliveries at NNG gate stations located in Elroy, Prairie du Chien, Viroqua, and Crawford County. Interconnections with two major pipelines provide competition in interstate pipeline service and a more reliable and economical gas supply mix, which includes gas from Canada and from the mid-continent and Gulf/offshore regions in the United States.

During the winter months, when customer demand is high, MGE is primarily concerned with meeting its obligation to firm customers. MGE meets customer demand by using firm supplies under contracts finalized before the heating season, supplies in storage (injected during the summer), and other firm supplies purchased during the winter period.

By contract, a total of 4,950,770 Dth can be injected into ANR's storage fields from April 1 through October 31. These gas supplies are then available for withdrawal during the subsequent heating season, November 1 through March 31. ANR's storage fields are located in Michigan. Using storage allows MGE to buy gas supplies during the summer season, when prices are normally lower, and withdraw these supplies during the winter season, when prices are typically higher. Storage also gives MGE more flexibility in meeting daily load fluctuations. Storage quantities were close to planned levels on December 31, 2004.

MGE's contracts for firm transportation service include winter maximum daily quantities of:

- 147,650 Dth (including 86,078 Dth of storage withdrawals) on ANR.
- 56,818 Dth on NNG.
- 2,790 Dth into Viroqua's NNG gate station.

Winter maximum daily quantities under these contracts are scheduled to increase an additional 13,500 Dth by November 2005.

Nonregulated Energy Operations

MGE Energy, through subsidiaries, is seeking to develop generation sources that will assist MGE in meeting the electricity needs of its customers. It is currently engaged in the construction of a cogeneration facility on the UW-Madison campus and, with MGE, is examining other potential sources of electricity including new coal-fired plants through an initiative known as Power the Future.

Decisions on the type of energy source and its size, timing, ownership, and financing depend upon a number of factors including the growth of customer demand in MGE's service area and surrounding areas, the effectiveness of customer demand management efforts, the costs and availability of alternative power sources, the availability of transmission capacity, issues associated with siting power generation sources, available financing and ownership structures, regulatory treatment and recovery, construction lead times and risks, and other factors. The decisions tend to involve long-time horizons due to the lead time involved in siting and constructing new generation sources and the associated transmission infrastructure.

WCCF

MGE Energy, through MGE Power, MGE Power West Campus, and MGE Construct, is building a natural gas-fired cogeneration facility on the UW campus. As planned, the facility will have capacity to produce 20,000 tons of chilled water, 500,000 pounds per hour of steam, and approximately 150 MW of electricity. The UW and MGE Power West Campus will jointly own the facility. The UW will own a controlling interest in the chilled-water and steam plants in accordance with the EPC Agreement. This interest will be used to help meet the UW's growing need for air-conditioning and steam-heat capacity. MGE Power West Campus will own a controlling interest in the electric generation plant, which will be used to provide electricity to MGE's customers. MGE entered into a lease with MGE Power West Campus to lease the assets owned by MGE Power West Campus, and MGE will operate the entire facility. MGE Construct is responsible for the construction of the facility. A PSCW order approving the issuance of a CPCN for the WCCF was received on October 9, 2003. Construction on the project commenced in October 2003, and the project is expected to be completed by the second quarter of 2005.

The cost to construct WCCF is expected to be approximately \$185 million in total, of which MGE Power West Campus' portion will be \$105 million. As of December 31, 2004, MGE Power West Campus had incurred \$95.7 million of costs on the project, which is reflected in construction work in progress on MGE Energy's and MGE's consolidated balance sheets. In 2004, MGE Construct received a total service fee of \$2.7 million (pretax) from the State in relation to its role as EPC contractor for WCCF. The total fee of \$5.0 million will be recognized as services are rendered and will be collected over a 22-month period that ends June 15, 2005.

MGE Energy, MGE Power West Campus, and MGE Construct have assumed certain risks related to some of the executed agreements. In the EPC Agreement, MGE Power West Campus is responsible for cost overruns and MGE Construct is responsible for the construction process of the entire facility, paying liquidated damages relating to failure to achieve the Mechanical Completion Date Guarantee and/or the Acceptance Test Capacity Guarantee. MGE Energy is the guarantor of MGE Construct's obligations under the EPC Agreement.

Power the Future Generation

On February 23, 2001, MGE secured an option to own a portion of the advanced technology, coal-fired base-load generation facilities proposed in We Energies' Power the Future plan. Pursuant to an amended agreement reached on January 31, 2003, MGE has the option to acquire an undivided 8.33% (16.66% under certain conditions) ownership interest in each of the proposed coal plants or up to approximately 50 MW per unit. The PSCW issued an order in November 2003, approving We Energies' request for CPCN for two units totaling approximately 1,200 megawatts. The PSCW also issued an order on June 25, 2004, approving MGE's participation in each unit (should MGE choose to exercise its options) and approving a facility lease agreement between MGE Power Elm Road (a nonregulated subsidiary of MGE Energy) and MGE. The financial terms of the facility lease include a capital structure of 55% equity and 45% long-term debt, and return on equity of 12.7%, a lease term of 30 years, and a 5% rent reduction in the first five years. If the options on Units 1 and 2 are exercised, MGE Energy's share of capital costs for an 8.33% ownership interest in both units would be an estimated \$183 million.

On November 29, 2004, the Dane County Circuit Court ruled on several lawsuits which challenged the PSCW's order authorizing We Energies to build two coal-fired generating facilities on the site of their existing Oak Creek Power Plant. The Dane County Circuit Court vacated the order and remanded the order back to the PSCW for additional proceedings. The Court determined that the PSCW committed errors in determining the completeness and approving the application filed by Wisconsin Energy Corporation on several different points.

On January 5, 2005, the Supreme Court of Wisconsin granted We Energies' December 14, 2004 request for a direct, expedited review of the lower court decision and agreed to consider all issues raised. The Court set a briefing schedule for February and March and set March 30, 2005, as the date for oral argument. A final decision is expected in the second quarter of 2005.

The resolution of this proceeding may adversely affect the construction of the units. At present, Unit 1 is scheduled to begin operating in 2009 and Unit 2 is scheduled to begin operating in 2010. MGE anticipates making a decision on whether to exercise the options by the second quarter of 2005, pending the final ruling by the Court.

Environmental

MGE is subject to local, state, and federal regulations concerning air quality, water quality, and solid waste disposal. The EPA administers certain federal statutes relating to such matters. The DNR administers certain state statutes as to such matters and has primary jurisdiction over standards relating to air and water quality and solid and hazardous waste. Those regulations affect the manner in which MGE conducts its operations, the costs of those operations, as well as some capital and operating expenditures. It can also affect the siting, timing, and cost of new projects or other significant actions affecting the environment. MGE is not able to predict the direction of future regulations or if compliance with any such regulations will involve additional expenditures for pollution control equipment, plant modifications, or curtailment of operations. Such actions could reduce capacity or efficiency at existing plants or delay the construction and operation of future generating facilities.

Air quality

Air quality regulations promulgated by the EPA and the DNR in accordance with the Federal Clean Air Act and the Clean Air Act Amendments of 1990 impose restrictions on emission of particulates, sulfur dioxide, nitrogen oxides and other pollutants and require permits for operation of emission sources. Such permits have been obtained by MGE and must be renewed periodically. Various initiatives, including the proposed Clean Air Interstate Rules, the MACT standards and existing and proposed mercury emissions limits, may affect operating and capital expenditure costs at Blount and Columbia.

In January 2004, the EPA proposed Clean Air Interstate Rules that would mitigate the transport of fine particulate matter and ozone pollution by imposing emission reduction requirements on SO₂ and NO_x in 29 eastern states and the District of Columbia. These reductions would be implemented in two phases through a cap-and-trade system. SO₂ emissions would be reduced in 2010 by approximately 40% below current levels and by approximately 70% below current levels by 2015. Emissions of NO_x would be cut in 2010 by approximately 55% below current levels and in 2015 by approximately 65% below current levels.

The Clean Air Act Amendments also require the EPA to develop standards to control major sources of hazardous air pollutants to levels consistent with the lowest-emitting facilities in similar source categories. The EPA has adopted final MACT standards for industrial, commercial, and institutional boilers, which will apply to MGE in 2007 (although no additional controls are anticipated). MGE operates several other emissions sources in its electric generations operations that may be subject to new MACT standards including electric utility steam generating units; combustion turbines; and reciprocating internal combustion engines. All sources, except the Blount and Columbia coal-fired units, are expected to be exempt from implementing additional emission-control strategies. WCCF is subject to the MACT standard for combustion turbines, but no additional controls are anticipated beyond those being constructed as a part of the facility. Complying with the MACT standards may increase capital expenditures and operating and maintenance expenses.

The EPA has proposed, and the DNR has adopted, rules aimed at reducing mercury emissions from utility boilers. The EPA rule contains several control options and must be finalized by March 15, 2005, under applicable legal requirements. The DNR rule requires a 40% reduction in mercury emissions by 2010, and a 75% reduction by 2015, for investor-owned Wisconsin public utilities emitting 100 pounds or more of mercury annually on a system-wide basis. The DNR rule allows each affected utility to average its mercury emission reduction requirement across its entire system of coal-fired boilers. As a joint owner of Columbia, MGE may have increased capital expenditures and operating and maintenance expenses if the Columbia owners choose to control mercury emissions at Columbia.

In 1998, the EPA issued a rule that imposed a NO_x emission budget for emission sources in Wisconsin. In 2000, the Court of Appeals for the District of Columbia struck a portion of the rule as applied to Wisconsin; however, the Court stayed that portion of the challenge concerning Wisconsin's alleged impacts on downwind, eight-hour ozone nonattainment areas. EPA has also stayed that portion of the rule concerning Wisconsin alleged impacts on downwind eight-hour ozone nonattainment areas. If that portion of the rule concerning eight-hour ozone nonattainment areas is upheld, the resulting NO_x emission budget for Wisconsin could potentially affect the level of permissible NO_x emissions from Blount, Columbia, and WCCF. The new NO_x limits could increase capital expenditures and operating and maintenance expenses at those facilities.

In December 2000, February 2001, June 2002, and January 2003, Alliant received requests from the EPA seeking information concerning Columbia's compliance with the Clean Air Act. The requests appear to be part of an industry-wide EPA initiative to assess the regulatory consequences of past investments in utility generation, energy efficiency, maintenance, and environmental protection. Alliant, the plant operator, has responded to all requests. Alliant has not informed MGE of any definitive increase in capital expenditures or operating and maintenance expenses arising from the EPA's inquiry.

Water quality

MGE is subject to water quality regulations issued by the DNR. These regulations include categorical-effluent discharge standards, which require the use of effluent-treatment processes equivalent to categorical "best practicable" or "best available" technologies under compliance schedules established under the Federal Water Pollution Control Act. The DNR has published categorical regulations for chemical and thermal discharges from electric-steam generating plants. The regulations limit discharges from MGE's plants into Lake Monona and other Wisconsin waters. The State has also proposed rules regarding thermal discharge which are subject to comment and further modification. Depending on the terms of the final rules, MGE may be required to make additional capital expenditures.

Pursuant to a court order, the EPA on July 9, 2004, promulgated final rules addressing cooling water intake structures for existing large power plants. The rule is currently being challenged by a coalition of states and environmental groups. Pursuant to the provisions of the rule, MGE, in its current WPDES renewal for Blount, has been granted an extension to no later than January 7, 2008, to comply with the various requirements. The new rules may result in additional capital expenditures; however, MGE is unable to determine the timing or amount, if any, of that impact.

Solid waste

MGE is listed as one of several potentially responsible parties under the Comprehensive Environmental Response, Compensation and Liability Act for cleanup costs at a site in Lemont, Illinois, known as the Lenz Oil Site, which was used for storing and processing waste oil for several years. MGE estimates its share of future expense to cleanup this site could range from \$0.1 million to \$0.3 million. At December 31, 2004, MGE accrued a \$0.1 million liability for this matter. Insurance may cover a portion of the cleanup costs. Management believes that the cleanup costs not covered by insurance will be recoverable in current and future rates.

As a result of the Blount 69-kV transmission substation expansion, coal tar-contaminated soil and debris within the excavation zone are being removed and disposed of in accordance with a DNR-approved "Removal Action Work Plan." MGE has paid \$1.5 million through December 31, 2004 in connection with this cleanup, and expects to recover cleanup costs in future electric rates.

Global climate change

The ongoing issue of global warming could result in significant costs to reduce CO₂ emissions from fossil fuel-fired generation sources such as coal. MGE does not yet know the amounts of these expenditures or the period of time over which they may be required.

Environmental Cooperative Agreement

On September 26, 2002, MGE and the DNR signed an Environmental Cooperative Agreement under which MGE committed to work toward superior environmental performance at Blount. Among other things, the five-year agreement requires MGE to evaluate combustion efficiency improvements, enhance new pollution controls on Boiler 8, increase use of alternative fuels, attempt to increase beneficial reuse of fly ash and bottom ash, study cogeneration possibilities, and upgrade MGE's environmental management system to be consistent with ISO 14001 standards. Implementing these and other actions required by the agreement are expected to increase capital expenditures and operating and maintenance expenses over the next five years. In addition, MGE conducts voluntary audits of Blount's compliance with various environmental laws. In January 2005, the auditors identified some possible compliance exceptions which were timely addressed and disclosed pursuant to a state statute that provides for qualified civil enforcement immunity. MGE believes that it has adequately responded to the audit's findings and does not anticipate any enforcement action by the state regulators.

Employees

As of December 31, 2004, MGE had 738 employees. MGE employs 262 employees who are covered by a collective bargaining agreement with Local Union 2304 of the International Brotherhood of Electrical Workers, and 104 employees who are covered by a collective bargaining agreement with Local Union No. 39 of the Office and Professional Employees International Union. Both of these collective bargaining agreements expire on May 1, 2006. There are also five employees covered by a collective bargaining agreement with Local Union No. 7-0111 of The Paper, Allied-Industrial, Chemical and Energy Workers International Union. This collective bargaining agreement expires on October 29, 2006.

Financial Information About Segments

See Footnote 20 of the Notes to Consolidated Financial Statements for financial information relating to MGE Energy's and MGE's business segments.

Executive Officers of the Registrants

| Executive | Title | Effective Date | Service Years as an Officer |
|------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------|-----------------------------|
| Gary J. Wolter* Age: 50 | Chairman of the Board, President and Chief Executive Officer President and Chief Executive Officer Senior Vice President - Administration and Secretary | 02/01/2002 02/01/2000 05/01/1995 | 15 |
| Lynn K. Hobbie** Age: 46 | Senior Vice President Vice President - Marketing | 02/01/2000 05/01/1996 | 9 |
| Mark T. Maranger** Age: 56 | Senior Vice President, MGE President and CEO, Wisconsin Fuel and Light Company | 04/09/2001 1996-2001 | 3 |
| James G. Bidlingmaier** Age: 58 | Vice President - Admin. and Chief Information Officer Executive Director - Information Management Systems | 02/01/2000 09/01/1994 | 5 |
| Kristine A. Euclide** Age: 52 | Vice President and General Counsel, MGE Partner in the law firm of Stafford Rosenbaum LLP Executive Assistant to County Executive of Dane County, Wisconsin, in which capacity she served as a senior policy advisor to the chief-elected official in Dane County. | 11/15/2001 1982-1997 1999-2001 1997-1999 | 3 |
| Terry A. Hanson* Age: 53 | Vice President, Chief Financial Officer and Secretary Vice President and Chief Financial Officer Vice President - Finance | 10/01/2001 05/01/2000 11/01/1997 | 13 |
| Scott A. Neitzel** Age: 44 | Vice President- Energy Supply Policy Vice President - Business Development and Fuels Vice President- Gas Rates and Fuels Assistant Vice President- Gas Rates and Fuels | 07/01/2002 09/22/2000 02/01/2000 08/04/1997 | 7 |
| Jeffrey C. Newman* Age: 42 | Vice President and Treasurer Treasurer | 01/01/2001 11/01/1997 | 7 |
| Peter J. Waldron** Age: 47 | Vice President - Energy Supply Operations Vice President - Power Supply Vice President - Power Supply Operations & Engineering Assistant Vice President - Power Supply Operations & Engineering | 07/01/2002 04/24/1998 04/23/1997 05/01/1996 | 8 |

Note: Ages, years of service, and positions as of December 31, 2004.

*Executive officer of MGE Energy and MGE

**Executive officer of MGE

Available Information

Our Internet site addresses are www.mgeenergy.com and www.mge.com. On our sites, we have made available, free of charge, our most recent annual report on Form 10-K and proxy statement. We also provide, free of charge, our other filings with the SEC as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC.

Item 2. Properties.

MGE's net generating capability in service at December 31, 2004, was as follows:

| <u>Plants</u> | <u>Location</u> | <u>Commercial Operation Date</u> | <u>Fuel</u> | <u>Net Capability (MW)</u> | <u>No. of Units</u> |
|-------------------------------|-------------------------------------------|--------------------------------------|-----------------|------------------------------------|-------------------------|
| Steam plants: | | | | | |
| Columbia | Portage, WI | 1975 & 1978 | Low-sulfur coal | 225 ^(1,2) | 2 |
| Blount | Madison, WI | 1957 & 1961 | Coal/gas | 97 | 2 |
| | | 1938 & 1943 | Gas | 39 | 2 |
| | | 1949 | Coal/gas | 22 | 1 |
| | | 1964-1968 | Gas/oil | 35 | 4 |
| Combustion turbines | Madison, WI Marinette, WI | 1964-2000 | Gas/oil | 174 | 6 |
| Portable generators | Madison, WI | 1998-2001 | Diesel | 51 | 55 |
| Wind turbines | Townships of Lincoln and Red River, WI | 1999 | Wind | 2 | 17 |
| Total | | | | <u>645</u> | |

(1) *Baseload generation.*

(2) *MGE's 22% share of two 512-MW units. The other owners are Alliant, which operates Columbia, and WPSC.*

Major electric distribution lines and substations in service at December 31, 2004, are as follows:

| Distribution lines: | <u>Miles</u> | |
|-------------------------|--------------------|---------------------------------|
| | <u>Overhead</u> | <u>Underground</u> |
| 69 kV | 7 | 1 |
| 13.8 kV and under . . . | 950 | 947 |
| Distribution: | <u>Substations</u> | <u>Installed Capacity (kVA)</u> |
| 69-13.8 kV | 23 | 809,000 |
| 13.8-4 kV | 32 | 308,000 |

As required by Wisconsin law, MGE and other Wisconsin electric utilities transferred their electric transmission assets to ATC on January 1, 2001. MGE received an approximate 5.0% ownership interest in ATC in exchange for its transmission plant and related deferred taxes and deferred investment tax credits. MGE receives a return on its investment in ATC that is approximately equal to the return it would have earned by retaining its transmission facilities. A small portion of the 69 kV lines and substations has been classified as distribution assets.

Gas facilities include 2,277 miles of distribution mains.

Item 3. Legal Proceedings.

MGE Energy and MGE

MGE Energy and MGE from time to time are involved in various legal proceedings that are handled and defended in the ordinary course of business. While MGE Energy and MGE are unable to predict the outcome of these matters, management does not believe, based upon currently available facts, that the ultimate resolution of any of such proceedings would have a material adverse effect on their overall financial condition or results of operations.

MGE

On April 30, 2004, a jury verdict in the Charing Cross matter was received in favor of MGE. The plaintiffs moved to have the trial judge set aside the jury verdict and find in favor of the plaintiffs. On October 18, 2004, the trial judge denied the plaintiffs' motion to set aside the verdict and entered a verdict in favor of MGE. On December 3, 2004, the time for the plaintiffs to appeal expired and no appeal was filed.

Also see "Environmental" under Item 1, Business, for a description of several environmental proceedings involving MGE.

Item 4. Submission of Matters to a Vote of Security Holders.

MGE Energy and MGE

None.

PART II.

Item 5. Market for Registrants' Common Equity, Related Stockholder Matters, and Issuer Purchases of Equity Securities.

MGE Energy

MGE Energy common stock is traded on Nasdaq under the symbol MGEE. On March 1, 2005, there were approximately 19,283 registered shareholders of record. The following table shows high and low sale prices for the common stock on Nasdaq for each quarter over the past two years.

| | Common stock price range | |
|--------------------------|--------------------------|---------|
| | High | Low |
| 2004 | | |
| First quarter | \$32.30 | \$29.89 |
| Second quarter | \$33.79 | \$27.60 |
| Third quarter | \$33.49 | \$30.97 |
| Fourth quarter | \$36.40 | \$31.10 |
| 2003 | | |
| First quarter | \$29.95 | \$25.00 |
| Second quarter | \$33.65 | \$26.40 |
| Third quarter | \$35.84 | \$28.65 |
| Fourth quarter | \$33.00 | \$30.26 |

MGE

As of March 1, 2005, there were 17,347,889 outstanding shares of common stock, all of which were held by MGE Energy. There is no public trading market for shares of common stock of MGE.

Dividends

The following table sets forth MGE Energy's quarterly cash dividends paid during 2004 and 2003:

| <i>(Per share)</i> | 2004 | | | | 2003 | | | |
|----------------------|----------|----------|----------|----------|----------|----------|----------|----------|
| | 1st Qtr. | 2nd Qtr. | 3rd Qtr. | 4th Qtr. | 1st Qtr. | 2nd Qtr. | 3rd Qtr. | 4th Qtr. |
| MGE Energy | \$0.338 | \$0.338 | \$0.342 | \$0.342 | \$0.336 | \$0.336 | \$0.338 | \$0.338 |

The following table sets forth MGE's quarterly cash dividends paid during 2004 and 2003:

| <i>(In thousands)</i> | 2004 | | | | 2003 | | | |
|-----------------------|----------|----------|----------|----------|----------|----------|----------|----------|
| | 1st Qtr. | 2nd Qtr. | 3rd Qtr. | 4th Qtr. | 1st Qtr. | 2nd Qtr. | 3rd Qtr. | 4th Qtr. |
| MGE | \$6,171 | \$6,230 | \$6,348 | \$6,409 | \$11,804 | \$5,977 | \$6,074 | \$5,830 |

See "Liquidity and Capital Resources - Capital Requirements and Investing Activities for MGE Energy and MGE" under Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, for a description of restrictions applicable to dividend payments by MGE.

Item 6. Selected Financial Data.

MGE Energy

(In thousands, except per-share amounts)

| Summary of Operations | For the years ended December 31, | | | | |
|---------------------------------------------------------------------------------------|----------------------------------|-----------|-----------|-----------|-----------|
| | 2004 | 2003 | 2002 | 2001 | 2000 |
| Operating revenues: | | | | | |
| Regulated electric | \$250,386 | \$241,745 | \$224,987 | \$203,178 | \$203,176 |
| Regulated gas | 171,763 | 159,802 | 122,109 | 130,533 | 120,932 |
| Nonregulated | 2,732 | 1,023 | - | - | - |
| Total | 424,881 | 402,570 | 347,096 | 333,711 | 324,108 |
| Operating expenses | 350,213 | 330,124 | 278,105 | 274,340 | 258,411 |
| Other general taxes | 12,715 | 11,592 | 10,861 | 10,864 | 10,180 |
| Operating income | 61,953 | 60,854 | 58,130 | 48,507 | 55,517 |
| Other income | 3,977 | 1,500 | 2,476 | 8,586 | 1,796 |
| Interest expense, net | (11,434) | (11,813) | (12,686) | (13,790) | (14,206) |
| Income before taxes | 54,496 | 50,541 | 47,920 | 43,303 | 43,107 |
| Income tax provision | (20,656) | (19,901) | (18,727) | (15,941) | (15,752) |
| Income before cumulative effect of a change in accounting principle | 33,840 | 30,640 | 29,193 | 27,362 | 27,355 |
| Cumulative effect of a change in accounting principle, net of tax benefit of \$78* | - | - | - | (117) | - |
| Net income | \$ 33,840 | \$ 30,640 | \$ 29,193 | \$ 27,245 | \$ 27,355 |
| Average shares outstanding | 19,119 | 17,894 | 17,311 | 16,819 | 16,382 |
| Earnings per share before cumulative effect of a change in accounting principle | \$1.77 | \$1.71 | \$1.69 | \$1.63 | \$1.67 |
| Cumulative effect of a change in accounting principle | - | - | - | (.01) | - |
| Basic and diluted earnings per share | \$1.77 | \$1.71 | \$1.69 | \$1.62 | \$1.67 |
| Dividends paid per share | \$1.36 | \$1.35 | \$1.34 | \$1.33 | \$1.32 |
| Assets | | | | | |
| Electric | \$478,436 | \$448,904 | \$421,771 | \$381,135 | \$415,522 |
| Gas | 176,573 | 166,731 | 154,806 | 147,820 | 139,266 |
| Assets not allocated | 74,663 | 55,200 | 52,819 | 39,903 | 52,496 |
| Nonregulated | 111,759 | 54,624 | 20,798 | - | - |
| Eliminations | (14,060) | (301) | (179) | | |
| Total | \$827,371 | \$725,158 | \$650,015 | \$568,858 | \$607,284 |
| Capitalization including Short-Term Debt | | | | | |
| Common shareholders' equity | \$338,197 | \$263,070 | \$227,370 | \$216,292 | \$200,312 |
| Long-term debt** | 202,257 | 222,204 | 192,149 | 177,600 | 183,637 |
| Short-term debt | 53,275 | 31,680 | 34,298 | 9,500 | 44,000 |
| Total Capitalization | \$593,729 | \$516,954 | \$453,817 | \$403,392 | \$427,949 |

*The change in accounting principle in 2001 is due to MGE's adoption of SFAS No. 133.

**Includes current maturities.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

General

MGE Energy is a holding company operating through subsidiaries in three business segments: electric utility operations, gas utility operations, and nonregulated energy operations. Our principal subsidiary is MGE, which conducts our electric utility and gas utility operations. MGE generates and distributes electricity to nearly 134,000 customers in Dane County, Wisconsin, including the city of Madison, and purchases and distributes natural gas to nearly 133,000 customers in the Wisconsin counties of Columbia, Crawford, Dane, Iowa, Juneau, Monroe, and Vernon. Other subsidiaries, which constitute our nonregulated energy operations, have been formed to own and construct new electric generating capacity. Those subsidiaries are currently undertaking the construction of a 150 MW, electricity, steam, and chilled-water cogeneration facility on the UW-Madison campus.

We became the holding company for MGE on August 12, 2002, when MGE shareholders exchanged their shares of MGE common stock for shares of our common stock. The share exchange had no accounting effect on MGE's recorded assets, liabilities, revenues, or expenses.

MGE's electric and gas utility operations represent a substantial part of our assets, liabilities, revenues, and expenses. Our nonregulated operations, relating to the development of a cogeneration project on the UW-Madison campus, are limited to service fees received from the State by MGE Construct as the facility remains under construction. Operations on this facility are expected to begin during the second quarter of 2005. Consequently, the following discussion focuses mainly on the results of operations and financial condition of MGE.

Executive Summary

In 2004, our utility operations experienced an increase in electric and gas revenues. Additionally, operation and maintenance expenses increased due to higher fees for outside professional services due to the Sarbanes-Oxley Act, higher distribution costs, and higher overall customer service and administrative costs. This increase was slightly offset by lower pension and benefit expenses, lower transmission expenses, and a decrease in interest expense as a result of generally lower levels of short- and long-term debt during the latter portion of 2004.

Our liquidity and capital position remained strong during 2004. On September 15, 2004, MGE Energy completed the sale of 1,265,000 shares of common stock at a net sale price of \$30.815 per share. The Company's proceeds, net of underwriters' fees and other expenses, were approximately \$39.0 million. These funds were utilized to repay short-term borrowing incurred during the year to finance the construction of WCCF and for general corporate purposes. We anticipate relying on short- and long-term borrowings to support the remaining construction and capital expenditures for the cogeneration facility that MGE Power West Campus is constructing on the UW-Madison campus.

Our primary focus today and for the foreseeable future is our core utility customers at MGE. MGE continues to face the challenge of providing its customers with reliable power at competitive prices. It plans to meet this challenge by building more efficient generation projects and continuing its efforts to control its operational costs. We believe it is critical to continue maintaining a strong credit standing and financial strength in MGE as well as the parent company in order to accomplish these goals.

Results of Operations

Earnings Overview - MGE Energy

In 2004, our earnings were \$33.8 million, or \$1.77 per share. Gas retail deliveries declined slightly, but retail electric sales increased 1.6%. MGE's increase in base rates to cover, in large part rising fuel costs, led to an increase in utility revenues. Operations and maintenance costs increased due to higher fees for outside professional services, overall customer service and administrative costs, and higher distribution costs. During 2004, MGE Energy benefited from lower pension and benefit expenses, lower transmission costs, and decreased interest costs due to lower levels of short and long-term debt during the latter portion of 2004.

In 2003, our earnings were \$30.6 million, or \$1.71 per share. Electric retail sales declined slightly, but retail gas deliveries increased 6.4%. During 2003, MGE's increase in base rates, which were primarily due to rising fuel costs, led to an increase in utility revenues. Operations and maintenance costs increased due to higher costs for employee benefits (health care, pension, etc.), transmission wheeling charges, distribution costs, and maintenance. These costs were somewhat offset by a decrease in depreciation costs, as MGE was no longer required to contribute to the decommissioning fund for Kewaunee in 2003. Also, MGE Energy benefited from lower interest costs due to refinancing a large portion of its long-term debt in 2002, and the lower interest rates on its variable rate and short-term debt in 2003.

In 2002, MGE Energy's earnings were \$29.2 million, or \$1.69 per share. MGE's 5.5% increase in electric retail sales, coupled with an increase in base rates to cover rising fuel costs, contributed to a 10.7% increase in electric revenues. Purchased power costs increased substantially. 2002 was the first full year MGE purchased 90 MW of capacity and energy to replace its share of generation lost from Kewaunee. MGE sold its interest in Kewaunee to WPSC in September 2001. As a result, MGE's operations and maintenance costs were lower in 2002. MGE's gas margin increased \$4.2 million, due to growth in gas deliveries.

Electric Utility Operations

Electric sales and revenues

The following table compares MGE's electric retail revenues and electric kWh sales by customer class during each of the years ended December 31:

| <i>(In thousands)</i> | Revenues | | | kWh Sales | | |
|----------------------------------|------------------|------------------|------------------|------------------|------------------|------------------|
| | 2004 | 2003 | 2002 | 2004 | 2003 | 2002 |
| Residential | \$ 87,326 | \$ 85,164 | \$ 81,258 | 785,537 | 800,535 | 839,005 |
| Commercial | 123,295 | 119,585 | 108,842 | 1,686,473 | 1,651,578 | 1,640,190 |
| Industrial | 14,806 | 14,555 | 12,949 | 309,603 | 299,449 | 296,220 |
| Other - retail/municipal | 18,884 | 17,975 | 16,585 | 342,628 | 324,188 | 323,380 |
| Total retail | 244,311 | 237,279 | 219,634 | 3,124,241 | 3,075,750 | 3,098,795 |
| Sales for resale | 944 | 5,184 | 2,659 | 19,941 | 106,569 | 59,616 |
| Other revenues | 5,131 | (718) | 2,694 | - | - | - |
| Total | <u>\$250,386</u> | <u>\$241,745</u> | <u>\$224,987</u> | <u>3,144,182</u> | <u>3,182,319</u> | <u>3,158,411</u> |
| Cooling degree days (normal 629) | | | | 450 | 555 | 752 |

Electric operating revenues were up 3.6% and 7.4% in 2004 and 2003, due to the following:

| <i>(In millions)</i> | 2004 | 2003 |
|----------------------|--------------|---------------|
| Rate changes | \$3.3 | \$19.3 |
| Sales for resale | (4.2) | 2.5 |
| Volume | 3.7 | (1.6) |
| Other effects | 5.8 | (3.4) |
| Total | <u>\$8.6</u> | <u>\$16.8</u> |

- *Rates.* The PSCW authorized increases in MGE's electric rates effective January 14, 2004, to cover

rising fuel costs and increased system demands. In 2004, MGE recorded a reduction to electric revenues of \$3.4 million, to reflect a fuel credit refund due to customers as a result of a PSCW proceeding initiated on August 10, 2004. Of this amount, \$1.8 million has been included in customers' 2004 bills and \$1.6 million was refunded to customers in January 2005.

The 2003 retail revenues reflect a fuel credit in the amount of \$4.0 million. Of this amount, \$1.2 million was reflected in customers' 2003 bills and \$2.8 million was refunded to customers in the first quarter of 2004. An additional \$0.4 million was recorded and refunded to customers' in January 2004, related to the 2003 proceedings. The liability for this fuel credit was previously accrued from August 2003 through January 2004, as a decrease to other electric revenues.

The PSCW also authorized increases in MGE's electric rates effective March 1, 2003, and January 1, 2002, to cover rising fuel costs, increased system demands, and the installation of an AMR system. Revenues in 2003 also reflect a surcharge of 2% on electric rates, effective October 24, 2002, and ending October 23, 2003, which the PSCW authorized to recover deferred costs associated with forming ATC and ongoing incremental transmission costs.

- *Volume.* During 2004, there was a 1.6% increase in total retail sales volumes. This increase is primarily attributable to additional commercial and industrial users coming on-line in 2004, and business growth at some of MGE's preexisting, large commercial and industrial users.

In 2003, electric retail sales volumes decreased 0.7% due to cooler-than-normal summer temperatures.

- *Other effects.* Other electric revenues increased \$5.8 million for the year ended December 31, 2004, compared to the prior year. This increase is due to the reversal of the 2003 fuel credit liability, which was refunded to customers in the first quarter of 2004.

In 2003, the fuel credit liability was recorded in other electric revenues. However, the 2004 fuel credit liability was allocated directly to the appropriate customer classes rather than in other electric effects. The actual fuel refund decreased retail revenues and is offset by an increase in other electric revenues.

- *Sales for resale.* During 2004, sales for resale decreased \$4.2 million. The decrease in sales for resale represents lower sales volume due to the expiration of a contract with Alliant to sell 25 MW of electric capacity. The contract was in effect from January 2003 through August 2003. Sales for resale also includes transactions conducted on the PJM market since the establishment and involvement in the PJM market on May 1, 2004.

On May 1, 2004, PJM began managing the flow of wholesale electricity over ComEd transmission lines and administering open, competitive wholesale electricity trading markets. MGE has three purchase power agreements that are impacted by ComEd's integration in the PJM market. MGE has recorded certain transactions on the PJM market on a net basis resulting in a \$3.2 million reduction to sales for resale and purchased power expense for the year ended December 31, 2004.

Electric fuel and purchased power

In 2004, fuel used for electric generation increased \$2.0 million, or 4.8%, compared to 2003. This increase is due to an increase in the year-to-date electric generation at MGE's baseload plants (\$1.7 million) and a slight increase in rates (\$0.3 million). MGE's internal generation increased 4.2% during 2004, when compared to 2003, mainly due to a 16.5% increase during the first quarter of 2004. This large increase was the result of the Columbia facility being off line during a portion of the first quarter of 2003, but back on line for the first quarter of 2004. The per-unit cost of internal generation increased 0.6% for the year ended December 31, 2004, when compared to the same period in the prior year.

Purchased power expense increased by \$2.5 million, or 5.1%, for 2004, compared to 2003. This increase represents a 18.7% increase in the per-unit-cost offset by a 11.3% decrease in the volume of purchased power.

These fluctuations include a \$3.2 million reduction to purchased power expense in 2004, which resulted from the netting of transactions in the PJM market in which we were buying and selling power within the same period to meet our electric energy delivery requirements.

In 2003, fuel used for electric generation increased \$3.3 million, or 8.8%, primarily due to a rise in the cost of natural gas used at certain MGE generating plants. MGE's internal generation increased 2.5% in 2003. Purchased power expense increased \$4.9 million, or 11.0%, primarily due to an increase in the cost of natural gas (\$6.4 million). The average price for purchased power was \$39.31 per MWh in 2003, compared to \$34.21 in 2002, an increase of 14.9%. The increase in purchased power expense was partially offset by a 3.4% decrease in volume (\$1.5 million) resulting from the expiration of a 90-MW purchased power agreement with WPSC in September 2003.

Electric operating expenses

Electric operating expense decreased \$0.3 million, or (0.4%), in 2004, and increased \$13.3 million, or 35.4%, in 2003. The following changes contributed to the net change in electric operating expenses for the indicated year:

| <i>(In millions)</i> | <u>2004</u> | <u>2003</u> |
|-----------------------------------------------------------------------------------------|----------------|---------------|
| (Decreased) increased transmission costs | \$(0.7) | \$ 3.5 |
| Amortization of deferred costs related to ATC | - | 2.8 |
| (Decreased) increased health and pension expenses | (0.7) | 3.7 |
| Increased distribution costs | 0.2 | 0.7 |
| Increased regulatory expenses due to filing a CPCN for authority to build WCCF | - | 0.6 |
| Increased outside professional services | 1.7 | - |
| Increased miscellaneous steam power expenses | - | 0.5 |
| (Decreased) increased other general and administrative expenses | (0.4) | 1.5 |
| Decreased customer services, promotions, and account costs | (0.4) | - |
| Total electric operating expenses | <u>\$(0.3)</u> | <u>\$13.3</u> |

Maintenance expense

In 2004, electric maintenance expense increased \$0.4 million, or 2.8%. This is primarily due to an increase in the maintenance of production assets, including turbine and generator overhauls (\$0.6 million). This increase was offset by a \$0.2 million decrease in maintenance of distribution assets.

In 2003, electric maintenance expense increased \$3.6 million, or 30.8%. This increase is due to the following factors:

- Increase in maintenance of distribution assets (\$2.1 million), including substation work, transformers, and overhead and underground lines. Maintenance and system upgrades help to improve the reliability of MGE's electric distribution system.
- Increase in other maintenance sources, including electric generating assets and Columbia (\$1.5 million).

Depreciation

Electric depreciation expense increased \$1.1 million in 2004, and decreased \$6.6 million in 2003. The increase in electric depreciation expense in 2004 reflects higher levels of electric plant assets.

The decrease in 2003 electric depreciation expense reflects lower decommissioning expense (\$8.2 million) as a result of the sale of Kewaunee, offset in part by \$1.6 million of increased depreciation associated with an increase in electric plant assets.

Gas Utility Operations

Gas deliveries and revenues

The following table compares MGE's gas retail revenues and gas delivered by customer class during each of the years ended December 31:

| <i>(In thousands)</i> | Revenues | | | Therms delivered | | |
|----------------------------------------------|------------------|------------------|------------------|------------------|----------------|----------------|
| | 2004 | 2003 | 2002 | 2004 | 2003 | 2002 |
| Residential | \$ 98,212 | \$ 92,472 | \$ 71,341 | 91,841 | 97,767 | 91,470 |
| Commercial/industrial | 68,480 | 62,025 | 46,248 | 80,988 | 82,580 | 78,010 |
| Total retail | 166,692 | 154,497 | 117,589 | 172,829 | 180,347 | 169,480 |
| Gas transportation | 3,263 | 3,394 | 3,238 | 48,783 | 50,012 | 55,614 |
| Other revenues | 1,808 | 1,911 | 1,282 | - | - | - |
| Total | <u>\$171,763</u> | <u>\$159,802</u> | <u>\$122,109</u> | <u>221,612</u> | <u>230,359</u> | <u>225,094</u> |
| Heating degree days (normal 7,209) | | | | 6,934 | 7,366 | 6,957 |

Gas revenues increased 7.5% in 2004 and 30.9% in 2003 due to the following:

| <i>(In millions)</i> | 2004 | 2003 |
|-----------------------------------------------------------|---------------|---------------|
| Gas costs/rates | \$18.6 | \$29.4 |
| Gas deliveries | (6.4) | 7.5 |
| Gas transportation | (0.1) | 0.1 |
| Other effects | (0.1) | 0.7 |
| Total | <u>\$12.0</u> | <u>\$37.7</u> |
| Average rate per therm of residential customers | \$1.07 | \$0.95 |

- *Gas costs/rates.* The PSCW authorized increases in MGE's gas rates effective January 14, 2004, and March 1, 2003, to cover increased system demands. Gas costs increased significantly in both 2004 and 2003. The average rate per therm for residential customers in 2004 increased 12.6%. Additionally in 2003, the average rate per therm for residential customers increased 23%. See Footnote 16 of the Notes to Consolidated Financial Statements for additional information on gas base rates.
- *Retail gas deliveries.* In 2004, retail gas deliveries decreased 4.2%. This decrease is attributable to warmer-than-normal temperatures as reflected by the 5.9% decrease in heating degree days. In 2003, there was a 6.4% increase in retail gas deliveries. This increase was due to colder-than-normal temperatures, as reflected in the 5.9% increase in heating degree days.
- *Gas transportation.* In 2004 and 2003, there was a 2.5% and 10.1% decrease in deliveries, respectively. These decreases represent customers switching from gas to other fuel options, due to the higher price of gas.

- *Other effects.* Other effects decreased \$0.1 million in 2004. This decrease relates to decreases in miscellaneous gas income. In 2003, there was a \$0.7 million increase in other effects. This increase reflects a \$0.6 million increase in the GCIM and other miscellaneous increases totaling \$0.1 million.

Natural gas purchased

In 2004, natural gas purchased increased \$10.4 million, or 10.0%. This increase is primarily due to higher average wellhead prices. Natural gas prices (cost per therm) increased 14.8% in 2004. A PGA clause allows MGE to pass along to customers the cost of gas, subject to certain limited incentives. The PGA is authorized by the PSCW. A similar effect was felt in 2003 when natural gas purchased increased \$30.7 million, or 41.8%. Natural gas prices (cost per therm) increased more than 33% in 2003.

Gas operating expenses

Gas operating expense increased \$3.2 million, or 11.4%, in 2004, and increased \$2.3 million, or 21.4%, in 2003. The following changes contributed to the net change in gas operating expense for the indicated year:

| <i>(In millions)</i> | <u>2004</u> | <u>2003</u> |
|--------------------------------------------------------------|---------------|--------------|
| Increased production costs | \$ 0.1 | \$0.2 |
| Increased distribution costs | 0.5 | 0.3 |
| Increased customer services, promotions, account costs | 0.9 | 0.1 |
| Increased outside professional services | 0.9 | - |
| (Decreased) increased health and pension expenses | (0.1) | 1.7 |
| Increased other administrative and general expenses | 0.9 | - |
| Total gas operating expenses | <u>\$ 3.2</u> | <u>\$2.3</u> |

Depreciation

Gas depreciation expense increased \$0.5 million and \$0.6 million in 2004 and 2003, respectively, as a result of additional gas plant assets.

Gas cost incentives

Under MGE's GCIM, if actual gas commodity costs are above or below a benchmark set by the PSCW, then MGE's gas sales service customers and shareholders share equally in any increased costs or savings. The PSCW allows MGE to resell gas pipeline capacity reserved to meet peak demands but not needed every day to serve customers. Revenues from capacity release that exceed or fall short of PSCW-targeted levels are shared equally. Beginning February 1, 2004, the PSCW lowered the formula used in establishing the benchmark for gas commodity costs. The benchmark moved to 99.5% of what it would have been under the prior formula. This change was intended to better reflect market conditions. In 2004, MGE shareholders benefited \$1.4 million from capacity release revenues and commodity savings under the GCIM.

In 2003, MGE shareholders benefited \$1.4 million from capacity release revenues and commodity savings under the GCIM.

Other General Taxes

MGE Energy's other general taxes increased 9.7% in 2004 primarily because MGE's license fee tax increased. The annual license fee tax expense is based on adjusted operating revenues of the prior year. Tax rates have not increased.

Income Taxes

MGE Energy's effective income tax rate is 37.9% for 2004 compared to 39.4% in 2003. The lower effective income tax rate is primarily due to accounting for the Medicare Part D federal subsidy and the favorable resolution of a tax contingency, for which a liability had been established.

The 2003 effective income tax rate of 39.4% was up slightly from the 2002 rate of 39.1% due to constant amounts of tax credits (amortized investment tax credits and credit for electricity from wind energy) in relation to pretax income.

Other Nonregulated Operating Income

MGE Construct received service fees of \$2.7 million and \$1.0 million from the State in 2004 and 2003, respectively. The service fees covered MGE Construct's role as EPC contractor for WCCF. This amount is classified as revenue from nonregulated operations within MGE Energy's financial statements. The total fee of \$5.0 million will be recognized as services are rendered and will be collected over a 22-month period.

Other operations and maintenance expense increased \$0.2 million in 2004 for MGE Power West Campus. This is primarily related to higher administrative and general expenses.

Other Nonoperating Items

Other income increased \$2.5 million in 2004 due to a \$0.9 million gain on the sale of assets, an increase in ATC earnings of \$0.6 million, a decrease in charitable contributions of \$0.7 million, and \$0.3 million in additional tax settlements.

In 2003, other income decreased \$1.0 million because charitable contributions were higher.

Interest Expense

In 2004, interest expense decreased \$0.4 million, or 3.2%, due to the following factors:

- Lower levels of long-term debt outstanding during the third and fourth quarters.
- Lower levels of short-term debt in the third quarter as a result of the proceeds raised in the equity offering.

In 2003, interest expense decreased \$0.9 million, or 6.9%, due to the following factors:

- MGE refinanced a large portion of its long-term debt in 2002.
- Lower short-term interest rates coupled with reduced borrowing levels.

Liquidity and Capital Resources

Cash Flows

The following summarizes cash flows for MGE Energy and MGE during 2004, 2003, and 2002:

| <i>(In thousands)</i> | MGE Energy | | | MGE | | |
|--------------------------------|------------|-----------|-----------|-----------|-----------|-----------|
| | 2004 | 2003 | 2002 | 2004 | 2003 | 2002 |
| Cash provided by/(Used for): | | | | | | |
| Operating activities | \$ 62,314 | \$ 67,731 | \$ 56,246 | \$ 60,483 | \$ 72,291 | \$ 53,500 |
| Investing activities | (100,215) | (92,603) | (86,709) | (100,881) | (53,388) | (67,857) |
| Financing activities | 39,442 | 26,207 | 30,709 | 40,918 | (18,921) | 14,136 |

Cash Provided by Operating Activities

MGE Energy

MGE Energy's consolidated net cash provided by operating activities is derived mainly from the electric and gas operations of its principal subsidiary, MGE.

Cash provided by operating activities was \$62.3 million in 2004. Working capital increased \$18.5 million. This resulted from a \$26.5 million increase in current asset balances and an \$8.0 million rise in current liability balances. Current assets were up due to increases in trade and other receivables (\$16.8 million), stored natural gas (\$4.8 million), unbilled revenues (\$3.2 million), and prepayments (\$1.7 million). Current liabilities were up due to increases in accounts payable (\$8.4 million). This increase in accounts payable was offset by a \$0.3 million decrease in other current liabilities. A change in other noncurrent items, net, of \$4.0 million, also contributed to the increase in cash provided by operating activities. During 2004, the receivable from ATC for funds advanced in connection with WCCF transmission system upgrades became current. This resulted in a \$10.7 million change in the special billing projects-ATC balance.

In 2003, cash provided by operating activities increased \$11.5 million, or 20.4%. Working capital increased \$7.7 million primarily due to increases in unbilled revenues (\$3.1 million), stored natural gas (\$5.2 million), prepayments (\$3.7 million), and accounts receivable (\$1.4 million) and a decrease in accrued interest and taxes (\$0.4 million). These changes were offset by higher accounts payable of \$2.5 million and other current liabilities of \$3.7 million.

Deferred income taxes increased \$8.1 million in 2003, due to the impact of 50% additional bonus depreciation, which went into effect in May 2003. An increase in other noncurrent items, net, of \$9.9 million also contributed to the increase in cash provided by operating activities.

MGE

Cash provided by operating activities was \$60.5 million for 2004. Working capital increased \$19.1 million. This resulted from a \$24.5 million increase in current asset balances and a \$5.4 million increase in the current liabilities balances. Current assets rose due to increases in trade and other receivables (\$14.1 million), stored natural gas (\$4.8 million), unbilled revenues (\$3.2 million), and prepayments (\$2.3 million). Current liabilities were higher due to increases in accounts payable (\$5.9 million), offset by a \$0.4 million decrease in other current liabilities. A change in other noncurrent items, net, of \$3.9 million also contributed to the increase in cash provided by operating activities. During 2004, the receivable from ATC for funds advanced in connection with WCCF transmission system upgrades became current. This resulted in a \$10.7 million change in the special billing projects-ATC balance.

In 2003, cash provided by operating activities increased \$18.8 million, or 35.1%. Working capital increased \$4.2 million in 2003. Other current assets, such as unbilled revenues, inventories, and prepayments, increased a total of \$12.4 million. In 2003, there was a decrease in accounts receivable of \$1.8 million and increases in accounts payable of \$3.1 million. Other current liabilities increased \$3.6 million and accrued interest and taxes decreased \$0.4 million. Deferred income taxes increased \$8.1 million in 2003. Other noncurrent items, net, increased \$11.3 million, which contributed to the increase in cash provided by operating activities.

Capital Requirements and Investing Activities

MGE Energy

In 2004, MGE Energy's cash used for investing activities increased \$7.6 million. This increase is primarily attributable to an increase in capital expenditures and additional capital contributions made to ATC during 2004. Capital expenditures related to WCCF increased \$18.7 million for the year ended December 31, 2004, compared to the same period in the prior year. However, MGE utility plant additions decreased \$5.9 million

during 2004 compared to 2003. During 2004 MGE also made \$3.5 million in additional capital contributions to ATC. These increases in investing activities were offset by decreases in the advance to ATC related to WCCF (\$6.9 million), proceeds from the sale of property (\$1.6 million), and other investing activities (\$0.1 million).

In 2003, MGE Energy's cash used for investing activities increased \$5.9 million. Capital expenditures increased \$6.0 million in 2003. Utility plant additions decreased \$3.4 million, while capital expenditures related to the WCCF increased \$9.4 million over last year. MGE's advance to ATC in connection with the installation of equipment and system upgrades for WCCF increased \$7.9 million in 2003. In 2002, MGE was still contributing to the decommissioning fund for Kewaunee.

MGE

Cash used for investing activities was \$100.9 million for 2004, compared to \$53.4 million in the prior year. As of December 31, 2003, MGE Power West Campus is being consolidated into MGE in accordance with FIN 46(R). Therefore, for all of 2004, MGE's cash used for investing activities includes the capital expenditures related to WCCF. MGE also made capital contributions to ATC totaling \$3.5 million. These increases are offset by a decrease in capital expenditures related to MGE utility plant in the amount of \$5.9 million, a decrease in the advance made to ATC related to WCCF (\$6.9 million), proceeds from the sale of property (\$1.0 million), and a decrease in cash used for other investing activities (0.1 million).

In 2003, MGE's cash used for investing activities decreased \$14.5 million from \$67.9 million in 2002, to \$53.4 million in 2003. This decrease is related to a \$14.4 million decrease in capital expenditures and the decrease in the nuclear decommissioning fund (\$7.8 million). In 2002, MGE was still contributing to the decommissioning fund for Kewaunee. Additionally, there was a \$0.2 million decrease in cash used for other investing activities. These decreases are offset by a \$7.9 million increase in the advance made to ATC related to WCCF.

The following table shows MGE Energy's estimated capital expenditures for 2005, actual for 2004, and the three-year average for 2001 to 2003:

| <i>(In thousands)</i> | 2005 | | 2004 | | Three-Year Average | |
|-----------------------------------------|-----------------|---------------|-----------------|---------------|--------------------|---------------|
| For the years ended December 31 | (Estimated) | | (Actual) | | (2001 to 2003) | |
| Electric: | | | | | | |
| Production | \$14,034 | 23.3% | \$10,565 | 11.0% | \$10,310 | 15.3% |
| Distribution and general | 24,194 | 40.2% | 22,152 | 23.1% | 22,218 | 33.1% |
| Nuclear fuel | - | - | - | - | 848 | 1.2% |
| Total electric | 38,228 | 63.5% | 32,717 | 34.1% | 33,376 | 49.6% |
| Gas | 8,484 | 14.2% | 9,848 | 10.3% | 8,123 | 12.1% |
| Common | 3,088 | 5.1% | 6,168 | 6.5% | 10,536 | 15.7% |
| Utility plant total | 49,800 | 82.8% | 48,733 | 50.9% | 52,035 | 77.4% |
| Nonregulated (WCCF and Other) | 10,323 | 17.2% | 47,042 | 49.1% | 15,181 | 22.6% |
| Eliminations | - | - | (28) | 0% | - | - |
| MGE Energy total | <u>\$60,123</u> | <u>100.0%</u> | <u>\$95,747</u> | <u>100.0%</u> | <u>\$67,216</u> | <u>100.0%</u> |

MGE Energy's and MGE's liquidity are primarily affected by their construction requirements. We allocate common plant for the financial statements and Footnotes based on a prescribed formula (60% (electric) and 40% (gas). MGE Energy's major 2004 capital projects include WCCF and the implementation of a new general ledger, purchasing, accounts payable, and inventory system. During 2004, \$47.0 million in capital additions were made for the construction of WCCF. This amount includes \$2.1 million of interest capitalized in accordance with the provisions set forth in SFAS No. 34, *Capitalization of Interest Cost*.

MGE Energy used funds received as dividend payments from MGE as well as short- and long-term external financing to meet its 2004 capital requirements and cash obligations, including dividend payments. External

financing included short-term financing under existing lines of credit. Additionally, MGE utilized longer-term equity financing. On September 15, 2004, MGE Energy completed the issuance of 1,265,000 shares of its common stock through an equity offering. MGE also issued 781,000 shares of common stock pursuant to a Distribution Agreement with BOCM and the Dividend Reinvestment and Direct Stock Purchase Plan. While dividends from MGE will remain a significant source for the cash needs of MGE Energy, we expect that revenues from the WCCF will supplement those dividends starting in 2005, when the plant becomes operational. In the interim, MGE Energy expects to continue using existing lines of credit and to issue additional long-term debt and shares of common stock, in addition to cash dividends from MGE, to meet its capital requirements and other cash obligations, including dividends.

Dividend payments by MGE to MGE Energy are subject to restrictions arising under a January 12, 2004, PSCW rate order and, to a lesser degree, MGE's First Mortgage Bonds. The covenants contained in MGE's first Mortgage Bonds restrict the payment of dividends or any other distribution or purchase of shares to the existing earned surplus (retained earnings) on MGE common stock. The PSCW order also limits the amount of dividends that MGE may pay MGE Energy when its common equity ratio, calculated in the manner used in the rate proceeding, is less than 55%. Under those circumstances, MGE may not pay dividends in excess of \$25.7 million— plus dividends on shares issued in excess of the shares issued in the rate proceeding forecast— if the proceeds are invested in MGE. MGE's common equity ratio at December 31, 2004, is estimated to be 55.2% as determined under the calculation used in the rate proceeding. The rate proceeding calculation includes as indebtedness imputed amounts for MGE's outstanding purchase power capacity payments and other PSCW adjustments and excludes the indebtedness associated with MGE Power West Campus, which is consolidated in accordance with FIN 46(R) into MGE's financial statements.

In addition, MGE has covenanted with the holders of its First Mortgage Bonds not to declare or pay any dividend or make any other distribution on or purchase any shares of its common stock unless, after giving effect thereto, the aggregate amount of all such dividends and distributions and all amounts applied to such purchases, after December 31, 1945, shall not exceed the earned surplus (retained earnings) accumulated subsequent to December 31, 1945. As of December 31, 2004, approximately \$149 million was available for the payment of dividends under this covenant.

MGE used internally generated funds, short-term debt, and proceeds from common stock issued to satisfy most of its 2004 capital requirements. In 2005, MGE expects to use internally generated funds and short-term debt. For larger capital investments, MGE would expect to finance these with additional short- and long-term debt and capital contributions from MGE Energy, if necessary.

Financing Activities and Capitalization Matters

MGE Energy

Cash provided by MGE Energy's financing activities was \$39.4 million for 2004, compared to \$26.2 million for 2003. This increase is related to an increase in the proceeds from the issuance of common stock and the reduction of long-term net borrowings during 2004. Proceeds from the issuance of common stock increased \$40.0 million for 2004 when compared to the prior year. This increase is a result of the equity issuance completed September 15, 2004. Proceeds received under this issuance were primarily utilized to repay short-term obligations. Additional equity was issued under the Distribution Agreement through BOCM and through the Dividend Reinvestment and Direct Stock Purchase Plan. During 2004, MGE Energy made \$20.0 million in repayments on pre-existing long-term facilities. No additional long-term debt was issued during 2004. However, there was a \$21.6 million increase in the short-term debt balance. Cash dividends for 2004 increased \$1.8 million and cash received from other financing activities increased \$0.8 million compared to the prior year.

In 2003, cash provided by MGE Energy's financing activities was \$26.2 million. On September 30, 2003, MGE Energy's subsidiary, MGE Power West Campus, issued \$30 million in private-placement debt, increasing long-term debt and using the proceeds from this issue to pay off short-term debt. MGE Energy was temporarily financing the capital expenditures for WCCF with short-term debt. MGE refinanced \$20.0 million of its 7.70%, 2028 Series, First Mortgage Bonds with lower-cost debt.

Proceeds from the issuance of common stock increased \$9.6 million in 2003. In addition to its Dividend Reinvestment and Direct Stock Purchase Plan, MGE Energy also sold additional shares of stock through BOCM under a Distribution Agreement.

Short-term debt decreased \$2.6 million in 2003. MGE Energy, through its affiliate MGE Construct, received a reimbursement of \$19.4 million in November from the State for its share of the capital expenditures related to WCCF. This reimbursement was used to pay down MGE Energy's bank loan.

MGE

During 2004, cash provided by MGE's financing activities was \$40.9 million compared to cash used for financing activities of \$18.9 million in 2003. This change resulted from consolidating MGE Power West Campus into MGE in accordance with FIN 46(R). MGE's financing activities include an equity contribution made from MGE Energy to WCCF for \$40.4 million and \$0.4 million of affiliate financing for WCCF. Cash dividends to the parent decreased \$4.5 million, and equity contributions from the parent increased \$0.9 million. During 2004, short-term borrowings increased \$24.8 million, \$20.0 million in long-term debt was repaid, and no new long-term debt was issued. Additionally, there was a \$0.3 million decrease in cash used by other financing activities.

In 2003, MGE's cash used for financing activities was \$18.9 million. In conformity with FIN 46(R), MGE includes the consolidation of MGE Power West Campus (see Footnote 2 of the Notes to Consolidated Financial Statements). MGE Power West Campus had \$10.5 million of affiliate loans for the financing of WCCF. MGE benefited from \$19.6 million in equity contributions from its parent, which was offset by \$29.7 million in cash dividends paid to parent. MGE's short-term debt increased \$2.0 million.

MGE Energy's capitalization ratios were as follows:

| | <u>MGE Energy</u> | |
|-----------------------------------|-------------------|-------------|
| | <u>2004</u> | <u>2003</u> |
| Common shareholders' equity | 56.9% | 50.9% |
| Long-term debt* | 34.1% | 43.0% |
| Short-term debt | 9.0% | 6.1% |

**Includes the current portion of long-term debt*

Below is a table of MGE's current credit ratings. MGE Energy is not rated because it has not issued any debt securities.

| | <u>Standard & Poor's</u> | <u>Moody's</u> |
|----------------------------|------------------------------|----------------|
| First Mortgage Bonds | AA | Aa2 |
| Unsecured Debt | AA- | Aa3 |
| Commercial paper | A1+ | P1 |

MGE's access to the capital markets, including the commercial paper market, and its financing costs in those markets are dependent on its securities' ratings. None of MGE's borrowing is subject to default or prepayment due to downgrading of securities' ratings.

Contractual Obligations and Commercial Commitments for MGE Energy and MGE

MGE Energy's and MGE's contractual obligations as of December 31, 2004, representing cash obligations that are considered to be firm commitments, are as follows:

| | <i>(In thousands)</i> | Total | Payment due within: | | | Due after |
|------------------------------------------|-----------------------|------------------|---------------------|-----------------|------------------|------------------|
| | | | 1 Year | 2-3 Years | 4-5 Years | 5 Years |
| MGE Energy | | | | | | |
| Long-term debt (a) | | \$203,500 | \$ - | \$15,000 | \$ 30,000 | \$158,500 |
| Short-term debt (b) | | 53,275 | 53,275 | - | - | - |
| Interest Expense (c) | | 216,954 | 11,821 | 24,472 | 22,014 | 158,647 |
| Operating leases (d) | | 15,743 | 2,159 | 3,387 | 2,537 | 7,660 |
| Purchase obligations (e) | | 186,325 | 31,912 | 54,622 | 47,107 | 52,684 |
| Other long-term obligations (f) | | 1,374 | 1,046 | 328 | - | - |
| Purchase obligations-WCCF (g) | | 15,942 | 15,942 | - | - | - |
| Total MGE Energy contractual obligations | | <u>\$693,113</u> | <u>\$116,155</u> | <u>\$97,809</u> | <u>\$101,658</u> | <u>\$377,491</u> |
| MGE | | | | | | |
| Long-term debt (a) | | \$203,500 | \$ - | \$15,000 | \$30,000 | \$158,500 |
| Short-term debt (b) | | 40,275 | 40,275 | - | - | - |
| Interest expense (c) | | 182,889 | 10,685 | 21,064 | 18,606 | 132,534 |
| Operating leases (d) | | 15,743 | 2,159 | 3,387 | 2,537 | 7,660 |
| Purchase obligations (e) | | 186,325 | 31,912 | 54,622 | 47,107 | 52,684 |
| Other long-term obligations (f) | | 774 | 446 | 328 | - | - |
| Total MGE contractual obligations | | <u>\$629,506</u> | <u>\$85,477</u> | <u>\$94,401</u> | <u>\$98,250</u> | <u>\$351,378</u> |

For additional information about:

- (a) Long-term debt consisting of secured First Mortgage Bonds, unsecured medium-term notes, and debt held by MGE Power West Campus, see Footnote 10 of the Notes to Consolidated Financial Statements.
- (b) Short-term debt consisting of commercial paper, see Footnote 11 of the Notes to Consolidated Financial Statements.
- (c) Amount represents interest expense on long-term facilities. See Footnote 10 of the Notes to Consolidated Financial Statements for further discussion of the long term debt outstanding at December 31, 2004.
- (d) Operating leases, see Footnote 17 of the Notes to Consolidated Financial Statements.
- (e) Purchase obligations for MGE consist of the purchase of electricity and the purchase and transport of natural gas. The Waupun wind power purchase agreement is not reflected in these figures as MGE is not currently able to estimate the related commitment as the site has not yet been constructed. See Footnote 17 of the Notes to Consolidated Financial Statements for additional discussion.
- (f) Other long-term obligations are related to a special assessment for decontaminating and decommissioning of nuclear facilities, see Footnotes 4 and 7 of the Notes to Consolidated Financial Statements, and additional capital contributions to limited partnerships.
- (g) Purchase obligations for MGE Energy related to contracts for equipment and services related to the construction of WCCF, see Footnote 17 of the Notes to Consolidated Financial Statements.

The above amounts do not include any contributions that may be made for MGE's pension and postretirement plans. There are no required contributions for the 2005 plan year; however, MGE may be legally required per IRS standards to make contributions to the Plans in years subsequent to 2005. Due to uncertainties in the future economic performance of plan assets, discount rates, and other key assumptions, management is unable to estimate these amounts at this time.

MGE made a \$4 million contribution in 2005, related to the 2004 plan year. This payment was made strictly at MGE's discretion as there are no contributions required for 2004 or 2005.

MGE Energy's and MGE's commercial commitments as of December 31, 2004, representing commitments triggered by future events and including financing arrangements to secure obligations of MGE Energy and MGE, and guarantees by MGE, are as follows:

| <i>(In thousands)</i> | Total | Expiration within: | | | Due after |
|-----------------------------------------|---------|--------------------|-----------|-----------|-----------|
| | | 1 Year | 2-3 Years | 4-5 Years | 5 Years |
| MGE Energy | | | | | |
| Bank letter of credit (a) | \$ 300 | \$ 300 | \$ - | \$ - | \$ - |
| Available lines of credit (b) | 115,000 | 70,000 | 45,000 | - | - |
| Guarantees (c) | 6,406 | 866 | 1,706 | 2,298 | 1,536 |
| MGE | | | | | |
| Bank letter of credit (a) | \$ 300 | \$ 300 | \$ - | \$ - | \$ - |
| Available lines of credit (d) | 55,000 | 10,000 | 45,000 | - | - |
| Guarantees (e) | 6,038 | 805 | 1,460 | 2,237 | 1,536 |

- (a) MGE has a letter of credit with a commercial bank established as collateral for equipment purchases that ATC will make to provide necessary system upgrades for WCCF.
- (b) Amount includes those facilities discussed in (d) plus an additional line of credit. Namely, MGE Energy has available at any time a \$60 million line of credit, expiring at the end of September 2005. At December 31, 2004, MGE Energy's line of credit was \$30 million. The line of credit increased on January 1, 2005, to \$45 million and will increase to \$60 million on April 1, 2005.
- (c) Amounts include those guarantees described in (e) as well as guarantees held by MGE Energy. Namely, MGE Energy has guaranteed debt service payments on a development project.
- (d) Lines of credit consisting of a three-year, \$45 million committed revolving credit facility expiring in July 2007, and an additional \$10 million credit facility that matures on March 29, 2005. Each credit facility is used to support commercial paper issuances. At December 31, 2004, there were no borrowings under either credit facility. Additionally, at December 31, 2004, there was \$40.3 million of commercial paper outstanding.
- (e) MGE has guaranteed repayment of certain receivables it sold to a financial institution under a chattel paper agreement. See Footnotes 1 and 17 of the Notes to Consolidated Financial Statements.

Other Factors

Due to the performance of the United States debt and equity markets, the value of assets held in trusts to satisfy the obligations of pension and postretirement benefit plans may vary.

Business and Regulatory Environment

Electric Transmission - ATC

On January 1, 2001, MGE transferred substantially all of its electric transmission facilities to ATC in exchange for approximately a 5.0% interest in this joint venture. ATC is comprised of Wisconsin investor-owned utilities and some Wisconsin municipal utilities, cooperatives, and power supply agencies.

The PSCW authorized an electric rate surcharge of \$4.5 million, or 2.0%, over a twelve-month period ended October 23, 2003, for MGE to recover deferred costs associated with ATC's formation and ongoing incremental transmission costs during 2001 and 2002.

On November 21, 2002, MGE and ATC entered into an interconnection agreement related to transmission system upgrades for WCCF. MGE issued to ATC a "Notice to Proceed for the Procurement of the Equipment" for the system upgrades. MGE has advanced funds for construction of transmission equipment and work done by ATC related to WCCF in the amounts of \$2.3 million and \$9.2 million in 2004 and 2003, respectively. Total funds advanced to ATC for this project are \$12.8 million. MGE does not expect to make any additional advances to ATC in 2005. MGE will be reimbursed by ATC for all previously advanced funds upon completion of the project.

Regulatory Issues - Transmission

In connection with its role as a FERC-approved RTO, the Midwest ISO is developing a bid-based energy market, which is expected to be implemented on April 1, 2005. In connection with the development of this energy market, the Midwest ISO is developing a market-based platform for valuing transmission congestion premised upon the LMP system that has been implemented in other states. It is expected that the LMP system will include the ability to mitigate or eliminate congestion costs through the use of FTRs. During December 2004 and January 2005, the Midwest ISO completed the initial allocation of FTRs. The FTRs will be available through an auction-based system run by the Midwest ISO. It is unknown at this time what financial impact the LMP congestion pricing system will have on MGE.

Kewaunee Sale

MGE sold to WPSC its 17.8% ownership interest in Kewaunee in September 2001. On the closing date, MGE also transferred its qualified decommissioning fund (\$65.0 million, fair market value) and nonqualified decommissioning fund (\$28.1 million, fair market value), which decreased accumulated depreciation by an equal amount. Under the Kewaunee sale agreement, MGE was obligated to continue collecting decommissioning costs from its customers during 2002, and to remit those amounts, net of trust investment expenses and taxes on investment income, to the WPSC nonqualified decommissioning fund, which it did on January 3, 2003.

The federal government is responsible for the disposition and storage of spent nuclear fuel. Federal legislation is being considered to establish an interim storage facility. Spent nuclear fuel is currently stored at Kewaunee. Minor plant modifications to the spent fuel pools in 2001 should ensure Kewaunee has sufficient fuel-storage capacity until the end of its licensed life in 2013. MGE retained spent fuel obligations for all fuel burned at Kewaunee for its share of the generation from the opening of the plant to the transaction closing date. WPSC took title to such fuel at the closing date.

A surcharge imposed by the National Energy Policy Act of 1992 requires nuclear power companies to fund the decontamination and decommissioning of U.S. Department of Energy facilities that process nuclear fuel. As a result, the Kewaunee co-owners are required to pay a surcharge on uranium enrichment services purchased from the federal government prior to October 23, 1992. On an inflation-adjusted basis, MGE's portion of the obligation related to Kewaunee is approximately \$0.6 million at December 31, 2004. MGE is required to continue paying its portion of this annual assessment.

As allowed under the Kewaunee sale agreement, MGE exercised an option to purchase 90 MW of electric capacity and energy at a fixed price from September 24, 2001, through September 23, 2003, to help meet customers' electric needs.

Wind Power Purchase Agreement

On July 16, 2004, MGE signed a 20-year power purchase agreement for 40 MW of wind energy to be located near Waupun, Wisconsin. The agreement would increase MGE's wind power output capacity from 12 MW to 52 MW. This project is pending approval from the PSCW which is expected to be granted in 2005.

Nonregulated Energy Outlook

WCCF

MGE Energy, through MGE Power, MGE Power West Campus, and MGE Construct, is building a natural gas-fired cogeneration facility on the UW campus. As planned, the facility will have capacity to produce 20,000 tons of chilled water, 500,000 pounds per hour of steam, and approximately 150 MW of electricity. The UW and MGE Power West Campus will jointly own the facility. The UW will own a controlling interest in the chilled-water and steam plants in accordance with the EPC Agreement. This interest will be used to help meet the UW's growing need for air-conditioning and steam-heat capacity. MGE Power West Campus will own a controlling interest in the electric generation plant, which will be used to provide electricity to MGE's customers. MGE entered into a lease with MGE Power West Campus to lease the assets owned by MGE Power West Campus, and MGE will operate the entire facility. MGE Construct is responsible for the construction of the facility. A PSCW order approving the issuance of a CPCN for the WCCF was received on October 9, 2003. Construction on the project commenced in October 2003, and the project is expected to be completed by 2nd quarter 2005.

For the year ended December 31, 2004, MGE Construct received a total service fee of \$2.7 million (pretax) from the State in relation to its role as EPC contractor for WCCF. This amount is classified as revenue from nonregulated operations within MGE Energy's financial statements. The total fee of \$5.0 million will be recognized as services are rendered and will be collected over a 22-month period.

In accordance with the WCCF lease between MGE Power West Campus and MGE, MGE Power West Campus began billing MGE for carrying costs on WCCF. The carrying costs billed to MGE started on January 29, 2004, the date MGE received approval from the PSCW to defer these costs, and will continue through construction of the project. Carrying costs totaled \$8.3 million for the year ended December 31, 2004.

MGE Energy, MGE Power West Campus, and MGE Construct have assumed certain risks related to some of the executed agreements. In the EPC Agreement, MGE Power West Campus is responsible for cost overruns and MGE Construct is responsible for the construction process of the entire facility, paying liquidated damages relating to failure to achieve the Mechanical Completion Date Guarantee and/or the Acceptance Test Capacity Guarantee. MGE Energy is the guarantor of MGE Construct's obligations under the EPC Agreement.

The cost to construct WCCF is expected to be approximately \$185 million in total, of which MGE Power West Campus' portion will be \$105 million. As of December 31, 2004, MGE Power West Campus had incurred \$95.7 million of costs on the project, which is reflected in construction work in progress on MGE Energy's and MGE's consolidated balance sheets. These costs represent amounts paid for equipment as well as other costs associated with construction of the facility.

Power the Future Generation

On February 23, 2001, MGE secured an option to own a portion of the advanced technology, coal-fired baseload generation facilities proposed in We Energies' Power the Future plan. Pursuant to an amended agreement reached on January 31, 2003, MGE has the option to acquire an undivided 8.33% (16.66% under certain conditions) ownership interest in each of the proposed coal plants or up to approximately 50 MW per unit. The PSCW issued an order in November 2003, approving We Energies' request for CPCN for two units totaling approximately 1,200 megawatts. The PSCW also issued an order on June 25, 2004, approving MGE's participation in each unit (should MGE choose to exercise its options) and approving a facility lease agreement between MGE Power Elm Road (a nonregulated subsidiary of MGE Energy) and MGE. The financial terms of the facility lease include a capital structure of 55% equity and 45% long-term debt, and return on equity of 12.7%, a lease term of 30 years, and a 5% rent reduction in the first five years. If the options on Units 1 and 2 are exercised, MGE Energy's share of capital costs for an 8.33% ownership interest in both units would be an estimated \$183 million.

On November 29, 2004, the Dane County Circuit Court ruled on several lawsuits which challenged the PSCW's order authorizing We Energies to build two coal-fired generating facilities on the site of their existing Oak Creek Power Plant. The Dane County Circuit Court vacated the order and remanded the order back to the PSCW for additional proceedings. The Court determined that the PSCW committed errors in determining the completeness of and approving the application filed by Wisconsin Energy Corporation on several different points.

On January 5, 2005, the Supreme Court of Wisconsin granted We Energies' December 14, 2004 request for a direct, expedited lower court decision and agreed to consider all issues raised. The Court set a briefing schedule for February and March and set March 30, 2005, as the date for oral argument. A final decision is expected in the second quarter of 2005.

The resolution of this proceeding may adversely affect the construction of the units. At present, Unit 1 is scheduled to begin operating in 2009, and Unit 2 is scheduled to begin operating in 2010. MGE anticipates making a decision on whether to exercise the options by the second quarter of 2005, pending the final ruling by the Court.

Critical Accounting Policies - MGE Energy and MGE

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to unbilled revenues, pension obligations, income taxes, derivatives, and regulatory assets and liabilities. We base our estimates on historical experience and on various assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. We believe the following critical accounting policies affect its more significant judgments and estimates used in the preparation of our consolidated financial statements.

Unbilled Revenues

Revenues from the sale of electricity and gas to customers are recorded when electricity/gas is delivered to those customers. The quantity of those sales is measured by customers' meters. Due to the large volume of those meters, it is impractical to read all of them at month end. Meters are read on a systematic basis throughout the month based on established meter-reading schedules. Consequently, at the end of any month, there exists a quantity of electricity and gas that has been delivered to customers but has not been captured by the meter readings. As a result, management must estimate revenue related to electricity and gas delivered to customers between their meter-read dates and the end of the period. These estimates include:

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- The amount of electricity expected to be lost in the process of its transmission and distribution to customers (line loss) and the amount of electricity actually delivered to customers.
 - The mix of sales between customer rate classes, which is based upon historical utilization assumptions.

During 2003, many of MGE's largest customers were shifted to a calendar-month bill. As a result of this shift, the majority of these customers' electricity usage is now accounted for in the unbilled calculation. The unbilled amounts are based on actual usage billed the following month. Due to this billing shift, MGE has seen the ratio of unbilled receivables to total electric sales climb. The ratio has settled into a range of 45% to 65%, and MGE will continue to monitor and track this range.

Pension Plans

MGE provides employees with certain retirement (pension) and postretirement (health care and life insurance) benefits. In order to measure the expense and obligations associated with these benefits, management must make a variety of estimates, including discount rates used to value certain liabilities, the expected return on plan assets set aside to fund these costs, the rate of compensation increase, employee turnover rates, retirement rates, health care trends, mortality rates, and other factors. These accounting estimates bear the risk of change due to the uncertainty attached to the estimate as well as the fact that these estimates are difficult to measure. Different estimates used by management could result in recognizing different amounts of expense over different periods of time.

We use third-party specialists to assist management in evaluating our assumptions as well as appropriately measure the costs and obligations associated with these retirement benefits. The discount rate and expected return on plan assets are based primarily on investment yields available and the historical performance of our plan assets. They are critical accounting estimates because they are subject to management's judgment and can materially affect net income.

- *Assumed return on assets.* This assumption represents the rate of return on plan assets reflecting the average rate of earnings expected on the funds invested (or to be invested) to provide for the benefits included in the projected benefit obligation. For 2004, MGE used a 9.0% assumed return on assets. One of the approaches MGE used in determining its assumed return on assets is based on historical returns. As of December 31, 2004, the ten-year historical return was 12.9%. It is reasonably possible that we could have used a different estimate for the rate of return on plan assets in calculating pension expense. Holding other assumptions constant, for every 1% reduction in the expected rate of return on plan assets, annual pension expense would increase by approximately \$1.0 million, before taxes.
- *Discount rate.* The discount rate represents the rate at which pension obligations could effectively be settled on a present-value basis. MGE uses high-grade bond yields plus a premium as a benchmark. The premium is based on the relatively long duration of MGE's pension plan liabilities and the fact that certain benefit payments are in the form of an annuity. Moody's Aa Corporate Bond Yield was 5.66% on December 31, 2004. As such, this approach generated a 5.85% discount rate (i.e., 5.66% + 0.19%).
- *Medical trend assumptions.* The health care cost trend rate is the assumed rate of increase in per-capita health care charges. For 2004, the health trend was reset to 10% with the ultimate trend of 5% reached in 2012. The health trend assumption for 2005 was reset from 12% to 10% as a result of an expanded relationship with a managed care health provider with a greater emphasis on preventive care, provider discounts and better utilization management.

Income Tax Provision

MGE Energy's and MGE's income tax provisions, including both current and deferred components, are based on estimates, assumptions, calculations, and interpretation of tax statutes for the current and future years. Determination of current-year federal and state income tax will not be settled for years.

Management regularly makes assessments of tax return outcomes relative to financial statement tax provisions and adjusts the tax provisions in the period when facts become final.

Additionally, in determining our current income tax provision we assess temporary differences resulting from differing treatments of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are recorded in our balance sheets. When we maintain deferred tax assets we must assess the likelihood that these assets will be recovered through adjustments to future taxable income. To the extent we believe recovery is not likely, we establish a valuation allowance. We record an allowance reducing the asset to a value we believe will be recoverable based on our expectation of future taxable income. We believe the accounting estimate related to the valuation allowance is a critical accounting estimate because it is highly susceptible to change from period to period as it requires management to make assumptions about our future income over the lives of the deferred tax assets, and the impact of increasing or decreasing the valuation allowance is potentially material to our results of operations.

Accounting for Derivative Instruments

MGE accounts for derivative financial instruments under SFAS No. 133, *Accounting for Derivatives and Hedging Activities*, and SFAS No. 149, *Amendment of SFAS No. 133 on Derivative Instruments and Hedging Activities*. Under the provisions of SFAS No. 133, all derivatives except those qualifying for the normal purchase normal sale exception are recognized on the balance sheet at their fair value. Fair value is determined using current quoted market prices. If a contract is designated as a cash flow hedge, the change in its market value is generally deferred as a component of other comprehensive income until the transaction it is hedging is completed. Conversely, the change in the market value of a derivative not designated as a cash flow hedge is recorded in current period earnings. A cash flow hedge is a hedge of a forecasted transaction or the variability of cash flows to be received or paid related to a recognized asset or liability.

In the third quarter of 2002, MGE received approval from the PSCW to establish a regulatory asset or liability for the deferral of the effects of mark-to-market accounting as required by SFAS No. 133 on contracts related to MGE's regulated operations.

Regulatory Assets/Liabilities

Regulatory assets represent costs that have been deferred to future periods when it is probable that the regulator will allow future recovery of those costs through rates. MGE bases its assessment of recovery by precedents established by the regulatory body. Regulatory liabilities represent previous collections from customers to fund future expected costs or amounts received in rates that are expected to be refunded to customers in future periods. These costs typically include deferral of energy costs, the normalization of income taxes, and the deferral of losses incurred on debt retirements. The accounting for these regulatory assets and liabilities is in accordance with the provisions of SFAS No. 71.

MGE continually assesses whether the regulatory assets meet the criteria for probability of future recovery. This assessment considers factors such as changes in the regulatory environment, recent rate orders to other regulated entities under the same jurisdiction, and the status of any pending or potential deregulation legislation. If future recovery of costs becomes no longer probable, the assets and liabilities would be recognized as current-period revenues or expenses.

Amortization of regulatory assets is provided over the recovery period as allowed in the related regulatory agreement.

Adoption of Accounting Principles and Recently Issued Accounting Pronouncements - MGE Energy and MGE

SFAS No. 143

Effective January 1, 2003, we adopted SFAS No. 143 which requires entities to recognize the estimated fair value of legal liabilities for asset retirements in the period in which they are incurred. SFAS No. 143 applies to such things as the removal of an electric substation, a combustion turbine generating unit, wind generating facilities, and the photovoltaic generating facilities, all of which are located on property not owned by MGE and would be removed upon the ultimate end of the lease. At December 31, 2004, this liability is estimated at \$1.5 million and is included in other deferred liabilities.

At the point the liability for asset retirement is incurred, SFAS No. 143 requires capitalization of the costs to the related asset, property, plant, and equipment, net. For asset retirement obligations existing at the time of adoption, the statement requires capitalization of costs at the level that existed at the point of incurring the liability. These capitalized costs are depreciated over the same period as the related property. At the date of adoption, the depreciation expense for past periods was recorded as a regulatory asset in accordance with SFAS No. 71 because MGE believes the PSCW will allow it to recover these costs in future rates. Current depreciation of the asset retirement cost is also being deferred as a regulatory asset under SFAS No. 71.

The initial liability is accreted to its present value each period. MGE defers this accretion as a regulatory asset based on its determination that these costs can be collected from customers. MGE also may have asset retirement obligations relating to various assets, such as combustion turbine generating units, small distributed generating units, above-ground and underground storage tanks, facilities located at Columbia (co-owned with Alliant and WPSC), and certain electric and gas distribution facilities. These facilities are generally located on property owned by third parties, on which MGE is permitted to operate by lease, permit, easement, license, or service agreement, but also include some facilities located on property owned by MGE. The asset retirement obligations associated with these facilities cannot be reasonably determined due to the indeterminate life of the related assets.

The pro forma asset retirement obligation MGE would have recognized as of January 1, 2002, had MGE implemented SFAS No. 143 as of that date, was approximately \$1.2 million based on the information, assumptions, and interest rates as of January 1, 2003, used to determine the \$1.4 million liability recognized upon initial adoption of SFAS No. 143. Because MGE's regulators are allowing these costs to be recovered in future rates, adoption of SFAS No. 143 in the first quarter of 2002 would have had no impact on net income and earnings per share of common stock. Accordingly, pro forma impacts are not presented.

FIN 45

In November 2002, the FASB issued FIN 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. This interpretation provides the disclosures to be made by a guarantor in interim and annual financial statements about obligations under certain guarantees. The interpretation also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation.

In connection with its "Shared Savings" program, 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 August 31, 2005. The liability for the fair value of the obligation associated with these loans is not material.

MGE would be required to perform under the guarantee if the customer defaulted on its loan. The energy-related equipment installed at the customer sites is used to secure the customer loans. The length of the MGE guarantee to the financial institution varies from one to ten years depending on the term of the customer loan. Principal payments for the next five years on the loans are \$0.8 million in 2005 and 2006, \$0.7 million in 2007, \$0.9 million in 2008, and \$1.3 million in 2009.

FIN 46(R)

In January 2003, the FASB issued FIN 46, *Consolidation of Variable Interest Entities - an Interpretation of ARB No. 51*. In December 2003, the FASB issued the updated and final interpretation FIN 46(R). FIN 46(R) requires that an equity investor in a VIE have significant equity at risk (generally a minimum of 10%, which is an increase from 3% required under the previous guidance) and hold a controlling interest, evidenced by voting rights, and absorb a majority of the entity's expected losses, receive a majority of the entity's expected returns, or both. If the equity investor is unable to evidence these characteristics, the entity that retains these ownership characteristics will be required to consolidate the VIE as the primary beneficiary. FIN 46 was applicable immediately to VIEs created or obtained after January 31, 2003. FIN 46(R) was effective on December 31, 2003, for interests in entities that were previously considered special-purpose entities under then existing authoritative guidance.

MGE Power West Campus is a VIE pursuant to FIN 46(R), as the equity investment at December 31, 2003, was not sufficient to permit the entity to finance its activities without additional support. MGE concluded a VIE relationship exists due to the long-term lease arrangement between MGE and MGE Power West Campus. MGE Power West Campus will lease a major portion of its assets, a power plant, to MGE, pursuant to this leasing arrangement, and MGE will absorb a majority of the expected losses, residual returns, or both. The VIE was consolidated into MGE as of December 31, 2003.

FIN 46(R) also requires MGE to assess whether the participants within its Shared Savings program constitute VIEs in which MGE might be considered to be the consolidating entity. MGE has reviewed 75% of the total Shared Savings program balance and has determined that the provisions of FIN 46(R) are not applicable via the "business scope exception." For the remaining 25% of the total Shared Savings program balance, MGE has not performed this assessment. These entities are not legally obligated to provide the financial information to MGE that is necessary to determine whether MGE must consolidate these entities. MGE will continue to attempt to obtain information from these customers in order to determine whether they should be consolidated by MGE.

FSP 106-2

On December 8, 2003, the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 was signed into law, authorizing Medicare to provide prescription drug benefits to retirees. FSP 106-2, *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003*, was issued on May 19, 2004. The FSP provides guidance on accounting for the effects of the new Medicare prescription drug legislation by employers whose prescription drug benefits are actuarially equivalent to the drug benefit under Medicare Part D.

During the third quarter of 2004, MGE adopted the provisions of FSP 106-2, resulting in a remeasurement of its postretirement plans' assets and APBO as of January 1, 2004. The effect of the subsidy on benefits attributable to past service was accounted for as an actuarial experience gain, resulting in a decrease in the APBO of \$4.3 million. The annualized reduction in the net periodic postretirement benefit cost is estimated to be \$0.7 million compared to the annual cost calculated without considering the effects of the Prescription Drug Act. Previously reported financial information for the three months ended March 31, 2004 and June 30, 2004 have also been adjusted to reflect a reduction in net periodic postretirement benefit cost as if FSP 106-2 was adopted as of January 1, 2004. Amounts for these periods, when presented in future periods for comparative purposes, will be presented as such.

FSP 109-1

In December 2004, the FASB issued FSP 109-1, "Application of FASB Statement No. 109, 'Application for Income Taxes,' to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004" (FSP FAS 109-1). The American Jobs Creation Act of 2004 (Act), signed into law on October 22, 2004, provided, generally, for a tax deduction, effective for taxable years beginning after December 31, 2004, for domestic manufacturing activities of up to nine percent (when fully phased-in) of the lesser of "qualified production activities income," as defined in the Act, or taxable income. FSP 109-1

clarified that the tax deduction for domestic manufacturing activities under the Act should be accounted for as a special deduction in accordance with SFAS No. 109, "Accounting for Income Taxes" (SFAS No. 109). This Act and these standards do not appear to have a significant impact on our consolidated financial statements.

EITF 03-01

In March 2004, the EITF reached consensus on and the FASB ratified EITF Issues No. 03-01, *The Meaning Other-Than-Temporary Impairment and its Application to Certain Investments* (EITF 03-01). EITF 03-01 provides guidance for evaluating whether an investment is other-than-temporarily impaired. MGE and MGE Energy adopted the disclosure requirements of EITF 03-01 for investments accounted for under SFAS No. 115 for the year ended December 31, 2004. On September 30, 2004, the FASB issued EITF 03-01-01, *Effective Date of Paragraphs 10-20 of EITF Issue No. 03-01, 'The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments,'* which delayed the effective date of the application guidance on impairment of securities included within EITF 03-01. The EITF and the FASB are reconsidering the conclusions reached within EITF 03-01.

Inflation

The current financial statements report operating results in terms of historical cost, but they do not evaluate the impact of inflation. Because utilities can depreciate only the historical cost of utility plant, there may not be adequate cash flows from existing plant to replace this investment. Under PSCW rate treatment, projected operating costs, including the impacts of inflation, are recovered in revenues.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk - MGE Energy and MGE.

MGE Energy and MGE are potentially exposed to market risk associated with interest rates, commodity prices, weather, and equity returns. MGE currently has no exposure to foreign currency risk. MGE manages some risk exposure through risk management policies and uses derivative instruments. MGE's market risk has not changed between 2003 and 2004. MGE does not enter into speculative trading transactions.

Weather Risk

MGE's sales forecasts, used to establish rates, are set by the PSCW based upon estimated temperatures, which approximate 20-year averages. MGE's electric revenues are sensitive to the summer cooling season and, to some extent, to the winter heating season. A significant portion of MGE's gas system demand is driven by heating. MGE's gas margin (revenues less gas purchased) is collected under a combination of fixed and volumetric rates set by the PSCW based on "normal weather." As a result of weather-sensitive demand and volumetric rates, a portion of MGE's gas margin is at risk for warmer-than-normal weather. MGE may use weather derivatives, pursuant to its risk management program, to reduce the impact of weather volatility on its gas margin.

In October 2004, MGE entered into a nonexchange-traded HDD Collar. Per the terms and conditions of this derivative agreement, MGE is subject to a floor and a ceiling based on forecasted heating degree days. If actual heating degree days exceed the ceiling, MGE is obligated to pay, and if heating degree days are below the floor, MGE will receive payment. The payment or receipt under this agreement is not permitted to exceed \$1.0 million (excluding premium). The term of this agreement extends from November 1, 2004, until March 31, 2005, and the premium for this weather hedge is \$0.1 million.

The Company is accounting for the HDD Collar using the intrinsic value method pursuant to the requirements of EITF No. 99-2, *Accounting for Weather Derivatives*. Through December 31, 2004, actual HDD were 1,954, resulting in a \$0.3 million gain for MGE.

A summary of actual weather information in the utility segment's service territory during 2004, 2003, and 2002, as measured by degree days, may be found in Results of Operations.

Interest Rate Risk

Both MGE and MGE Energy have short term borrowings at varying interest rates. MGE issues commercial paper for its short-term borrowings, while MGE Energy draws from its current credit facility to meet its short term borrowing needs (see Footnote 11 of the Notes to Consolidated Financial Statements). Borrowing levels vary from period to period depending upon capital investments and other factors. Future short-term interest expense and payments will reflect both future short-term interest rates and borrowing levels. MGE Energy and MGE manage interest rate risk by limiting its variable rate exposure and continually monitoring the effects of market changes on interest rates. MGE is not exposed to changes in interest rates on a substantial portion of its long-term debt until that debt matures and is refinanced at market rates. Assuming the current level of variable rate borrowings and assuming a 1% change in the 2004 average interest rate under these borrowings, it is estimated that our 2004 interest expense and net income would have changed by \$0.4 million for MGE and \$0.5 million for MGE Energy.

Equity Price Risk - Pension-Related Assets

MGE currently funds its liabilities related to employee benefits through trust funds. These funds, which include investments in debt and equity securities, are managed by various investment managers. Changes in market value of these investments can have an impact on the future expenses related to these liabilities. Holding other assumptions constant, for every 1% reduction in the expected rate of return on plan assets, annual pension expense would increase by approximately \$1.0 million, before taxes. MGE's risk of expense and annuity payments, as a result of changes in the market value of the trust funds, is mitigated in part

through future rate actions by the PSCW.

Commodity Price Risk

MGE has commodity price risk exposure with respect to the price of natural gas, electricity, coal, and oil. MGE employs established policies and procedures to reduce the market risks associated with changing commodity prices, including the use of commodity and financial instruments (see Footnote 15 of the Notes to Consolidated Financial Statements). MGE's commodity risks are somewhat mitigated by the current ratemaking process in place for recovering electric fuel, purchased energy, and the cost of natural gas purchased for resale. MGE's electric fuel costs are subject to fuel rules established by the PSCW, which further mitigate commodity risk. Under the fuel rules, if electric fuel costs exceed or fall below a 3.0% bandwidth set by the PSCW, MGE can apply for a fuel surcharge or may have a fuel credit to its customers. Under the PGA authorized by the PSCW, MGE passes through to customers the cost of gas, subject to certain limited incentives.

Under the fuel rules, MGE may include the costs and benefits of fuel price risk management tools implemented under a risk management plan approved by the PSCW. In 2004, the PSCW extended its conditional approval of MGE's Electric Procurement Risk Management Program through December 31, 2005.

MGE has a limited number of financial gas commodity contracts. These contracts are primarily comprised of exchange-traded option contracts to manage the cost of gas and over-the-counter financial floating-to-fixed price swaps and calls for the "Winter Set-Price Firm Gas Sales Service" pilot program. The derivative amounts recorded as a result of these gas contracts are offset with a corresponding regulatory asset or liability because these transactions are part of the PGA and not subject to incentive participation.

Regulatory Recovery Risk

MGE's electric operations burn natural gas in several of its peak power plants or as a supplemental fuel at several coal-fired plants and in many cases, the cost of purchased power is tied to the cost of natural gas. MGE bears significant regulatory risk for the recovery of such fuel and purchased power costs when they are higher than the base rate established in its current rate structure.

As noted above in Commodity Price Risk, the electric operations of MGE operate under a "fuel rules" adjustment clause for fuel and purchased power costs associated with the generation and delivery of electricity. This clause establishes a base rate for fuel and purchased power. MGE assumes the risks and benefits of variances that are within a 3.0% bandwidth. For 2004 and 2003, fuel and purchased power costs included in MGE's base fuel rates were \$95.0 million and \$81.0 million, respectively. In 2004 and 2003, the base fuel rates included a fuel credit in the amount of \$3.8 million and \$4.0 million, respectively. Of the \$3.8 million recorded in 2004, \$3.4 million related to the 2004 proceedings and \$0.4 million related to the 2003 proceedings.

Credit Risk - Counterparty

Credit risk is the loss that may result from counterparty nonperformance. MGE is exposed to credit risk primarily through its merchant energy business. MGE uses credit policies to manage its credit risk, which includes utilizing an established credit approval process, monitoring counterparty limits, employing credit mitigation measures such as collateral or prepayment arrangements, and using netting agreements.

Due to the possibility of extreme volatility in the prices of energy commodities and derivatives, the market value of contractual positions with individual counterparties could exceed established credit limits or collateral provided by those counterparties. If such a counterparty were then to fail to perform its obligations under its contract (for example, fail to deliver the electricity MGE originally contracted for), MGE could sustain a loss that could have a material impact on its financial results.

Additionally, if a counterparty were to default and MGE were to liquidate all contracts with that entity,

MGE's credit loss would include the loss in value of mark-to-market contracts; the amount owed for settled transactions; and additional payments, if any, to settle unrealized losses on accrual contracts.

MGE is obligated to provide service to all electric and gas customers within its respective franchised territories. As a result, MGE has a broad customer base. For the year ended December 31, 2004, MGE's ten largest electric customers represented approximately 18.3% of its retail electric revenues. MGE's ten largest gas customers represented approximately 5.6% of its gas revenues. Credit risk for electric and gas is managed by MGE's credit and collection policies, which are consistent with state regulatory requirements.

Item 8. Financial Statements and Supplementary Data.

Report of Independent Registered Public Accounting Firm

To the Board of Directors and
Shareholders of MGE Energy, Inc.:

We have completed an integrated audit of MGE Energy, Inc.'s 2004 consolidated financial statements and of its internal control over financial reporting as of December 31, 2004 and audits of its 2003 and 2002 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated financial statements and financial statement schedule

In our opinion, the consolidated financial statements listed in the index appearing under Item 15(a)(1) present fairly, in all material respects, the financial position of MGE Energy, Inc. and its subsidiaries at December 31, 2004 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2004 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15(a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Internal control over financial reporting

Also, in our opinion, management's assessment, included in Management's Report on Internal Control Over Financial Reporting appearing under Item 9A, that the Company maintained effective internal control over financial reporting as of December 31, 2004 based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2004, based on criteria established in Internal Control - Integrated Framework issued by the COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that,

in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP
Chicago, Illinois
March 11, 2005

Report of Independent Registered Public Accounting Firm

To the Board of Directors and
Shareholder of Madison Gas and Electric Company:

In our opinion, the consolidated financial statements listed in the index appearing under Item 15 (a)(1) present fairly, in all material respects, the financial position of Madison Gas and Electric Company and its subsidiaries at December 31, 2004 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2004 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15 (a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 2 to the consolidated financial statements, the Company adopted certain provisions of Financial Accounting Standards Board Interpretation No. 46, "Consolidation of Variable Interest Entities- an interpretation of ARB 51 (revised December 2003)," as of December 31, 2003.

/s/ PricewaterhouseCoopers LLP
Chicago, Illinois
March 11, 2005

MGE Energy, Inc.
Consolidated Statements of Income
(In thousands, except per-share amounts)

| | For the years ended December 31, | | |
|----------------------------------------------------------------|-----------------------------------------|------------------|------------------|
| | 2004 | 2003 | 2002 |
| Operating Revenues: | | | |
| Regulated | \$422,149 | \$401,547 | \$347,096 |
| Nonregulated | 2,732 | 1,023 | - |
| <i>Total Operating Revenues</i> | <u>424,881</u> | <u>402,570</u> | <u>347,096</u> |
| Operating Expenses: | | | |
| Fuel for electric generation | 43,553 | 41,557 | 38,210 |
| Purchased power | 52,052 | 49,521 | 44,607 |
| Natural gas purchased | 114,506 | 104,066 | 73,412 |
| Other operations and maintenance | 115,185 | 111,636 | 92,514 |
| Depreciation and amortization | 24,917 | 23,344 | 29,362 |
| Other general taxes | 12,715 | 11,592 | 10,861 |
| <i>Total Operating Expenses</i> | <u>362,928</u> | <u>341,716</u> | <u>288,966</u> |
| Operating Income | 61,953 | 60,854 | 58,130 |
| Other income, net | 3,977 | 1,500 | 2,476 |
| Interest expense | <u>(11,434)</u> | <u>(11,813)</u> | <u>(12,686)</u> |
| Income before income taxes | 54,496 | 50,541 | 47,920 |
| Income tax provision | <u>(20,656)</u> | <u>(19,901)</u> | <u>(18,727)</u> |
| Net Income | <u>\$ 33,840</u> | <u>\$ 30,640</u> | <u>\$ 29,193</u> |
| Earnings Per Share of Common Stock (basic and diluted): | <u>\$1.77</u> | <u>\$1.71</u> | <u>\$1.69</u> |
| Dividends paid per share of common stock | <u>\$1.36</u> | <u>\$1.35</u> | <u>\$1.34</u> |
| Average Shares Outstanding (basic and diluted) | 19,119 | 17,894 | 17,311 |

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

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

| | For the years ended December 31, | | |
|-----------------------------------------------------------|-----------------------------------------|------------------------|----------------------|
| | 2004 | 2003 | 2002 |
| Operating Activities: | | | |
| Net income | \$ 33,840 | \$ 30,640 | \$ 29,193 |
| Items not affecting cash: | | | |
| Depreciation and amortization | 24,917 | 23,344 | 29,362 |
| Deferred income taxes | 8,832 | 8,075 | 4,186 |
| Amortization of investment tax credits | (502) | (516) | (520) |
| Equity in earnings in ATC | (4,236) | (3,687) | (3,316) |
| Amortization of debt issuance costs and bond expense | 516 | 484 | 368 |
| Other items | 639 | (514) | (380) |
| Dividend income from ATC | 3,055 | 2,640 | 2,714 |
| Prepayments to ATC | - | 5,000 | (5,000) |
| Gain on the sale of property | (938) | - | - |
| Changes in working capital items: | | | |
| Trade and other Receivables, net | (16,760) | (1,438) | (11,214) |
| Inventories | (4,839) | (5,195) | 2,375 |
| Unbilled revenues | (3,236) | (3,105) | (2,053) |
| Prepayments | (1,660) | (3,674) | (2,278) |
| Accounts payable | 8,385 | 2,479 | 9,399 |
| Accrued interest and tax | (47) | (394) | (99) |
| Other current liabilities | (334) | 3,655 | 4,036 |
| Special billing projects - ATC | 10,657 | - | - |
| Other noncurrent items, net | 4,025 | 9,937 | (527) |
| <i>Cash Provided by Operating Activities</i> | <u>62,314</u> | <u>67,731</u> | <u>56,246</u> |
| Investing Activities: | | | |
| Capital expenditures | (95,747) | (82,970) | (77,001) |
| ATC- capital contribution | (3,475) | - | - |
| Advance to ATC related to WCCF | (2,308) | (9,223) | (1,281) |
| Increase in nuclear decommissioning fund | - | - | (7,804) |
| Proceeds from sale of property | 1,592 | - | - |
| Other | (277) | (410) | (623) |
| <i>Cash Used for Investing Activities</i> | <u>(100,215)</u> | <u>(92,603)</u> | <u>(86,709)</u> |
| Financing Activities: | | | |
| Issuance of common stock, net | 63,154 | 23,162 | 13,597 |
| Cash dividends paid on common stock | (25,943) | (24,137) | (23,170) |
| Repayment of long-term debt | (20,000) | (20,000) | (20,000) |
| Issuance of long-term debt, net | - | 50,000 | 35,000 |
| Increase (decrease) in short-term debt | 21,595 | (2,618) | 24,798 |
| Other | 636 | (200) | 484 |
| <i>Cash Provided by Financing Activities</i> | <u>39,442</u> | <u>26,207</u> | <u>30,709</u> |
| Change in Cash and Cash Equivalents: | 1,541 | 1,335 | 246 |
| Cash and cash equivalents at beginning of period | 2,020 | 685 | 439 |
| Cash and cash equivalents at end of period | <u><u>\$ 3,561</u></u> | <u><u>\$ 2,020</u></u> | <u><u>\$ 685</u></u> |
| Supplemental disclosures of cash flow information: | | | |
| Interest paid | \$11,518 | \$12,439 | \$12,408 |
| Income taxes paid | \$12,163 | \$18,279 | \$17,223 |
| Income taxes received | \$ - | \$ (3,159) | \$ (759) |

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

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

| | At December 31, | |
|-------------------------------------------------------------------------------|------------------------|-------------|
| | 2004 | 2003 |
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 3,561 | \$ 2,020 |
| Restricted cash | 876 | 764 |
| Accounts receivable, less reserves of \$2,755 and \$2,735, respectively | 34,130 | 30,236 |
| Other accounts receivable | 22,910 | 7,477 |
| Unbilled revenues | 24,880 | 21,644 |
| Materials and supplies, at lower of average cost or market | 9,107 | 7,851 |
| Fossil fuel, at lower of average cost or market | 5,523 | 5,054 |
| Stored natural gas, at lower of average cost or market | 21,712 | 18,598 |
| Prepaid taxes | 14,510 | 14,063 |
| Deferred income taxes | - | 1,206 |
| Other prepayments | 5,029 | 3,816 |
| <i>Total Current Assets</i> | 142,238 | 112,729 |
| Special billing projects | 3,121 | 14,574 |
| Regulatory assets | 21,101 | 11,446 |
| Deferred Charges | 16,077 | 17,605 |
| Property, Plant, and Equipment, Net | 480,154 | 449,022 |
| Construction work in progress | 127,244 | 88,489 |
| <i>Total Property, Plant, and Equipment</i> | 607,398 | 537,511 |
| Other property and investments | 37,436 | 31,293 |
| Total Assets | \$827,371 | \$725,158 |
| LIABILITIES AND CAPITALIZATION | | |
| Current Liabilities: | | |
| Long-term debt due within one year | \$ - | \$ 20,000 |
| Short-term debt - commercial paper | 53,275 | 31,680 |
| Accounts payable | 42,488 | 34,103 |
| Accrued interest and taxes | 3,101 | 3,028 |
| Deferred income taxes | 581 | - |
| Other current liabilities | 16,116 | 15,814 |
| <i>Total Current Liabilities</i> | 115,561 | 104,625 |
| Other Credits: | | |
| Deferred income taxes | 89,627 | 79,936 |
| Investment tax credit - deferred | 4,389 | 4,891 |
| Regulatory liabilities | 28,764 | 33,623 |
| Accrued pension and other postretirement benefits | 42,138 | 29,947 |
| Other deferred liabilities | 6,438 | 6,862 |
| <i>Total Other Credits</i> | 171,356 | 155,259 |
| Capitalization: | | |
| Common shareholders' equity | 338,197 | 263,070 |
| Long-term debt | 202,257 | 202,204 |
| <i>Total Capitalization</i> | 540,454 | 465,274 |
| Commitments and contingencies | - | - |
| Total Liabilities and Capitalization | \$827,371 | \$725,158 |

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

MGE Energy, Inc.
Consolidated Statements of Capitalization
(In thousands)

| | At December 31, | |
|------------------------------------------------------------|------------------------|------------------|
| | 2004 | 2003 |
| Common Shareholders' Equity: | | |
| Common stock - par value \$1 per share: | | |
| Authorized 50,000,000 shares | | |
| Outstanding 20,389,619 and 18,343,913 shares, respectively | \$ 20,390 | \$ 18,344 |
| Additional paid-in capital | 229,682 | 168,574 |
| Retained earnings | 87,439 | 79,542 |
| Accumulated other comprehensive income (loss) | 686 | (3,390) |
| <i>Total Common Shareholders' Equity</i> | 338,197 | 263,070 |
| First Mortgage Bonds: | | |
| 7.70%, 2028 Series | 1,200 | 1,200 |
| Other Long-Term Debt: | | |
| 7.49%, due 2007 | 15,000 | 15,000 |
| 6.02%, due 2008 | 30,000 | 30,000 |
| 4.875% 2012 Series, Industrial Development Revenue Bonds | 19,300 | 19,300 |
| 5.875% 2034 Series, Industrial Development Revenue Bonds | 28,000 | 28,000 |
| 6.58%, due 2012 | 15,000 | 15,000 |
| 5.26%, due 2017 | 20,000 | 20,000 |
| 7.12%, due 2032 | 25,000 | 25,000 |
| 6.12%, due 2028 | 20,000 | 20,000 |
| 5.68%, due 2033 | 30,000 | 30,000 |
| <i>Total Other Long-Term Debt</i> | 202,300 | 202,300 |
| Unamortized discount and premium on bonds, net | (1,243) | (1,296) |
| <i>Total Long-Term Debt</i> | 202,257 | 202,204 |
| Total Capitalization | \$540,454 | \$465,274 |

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

MGE Energy, Inc.
Consolidated Statements of Common Equity and Comprehensive Income
(In thousands, except per-share amounts)

| | <u>Common Stock</u> | | <u>Additional</u> | | <u>Accumulated</u> | |
|-------------------------------------------------------------------------------------|---------------------|-----------------|-------------------|-----------------|----------------------|----------------------|
| | <u>Shares</u> | <u>Value</u> | <u>Paid-in</u> | <u>Retained</u> | <u>Other</u> | <u>Comprehensive</u> |
| | | | <u>Capital</u> | <u>Earnings</u> | <u>(Loss)/Income</u> | <u>Income</u> |
| 2002 | | | | | | |
| Beginning balance – December 31, 2001 | 17,072 | \$17,072 | \$133,087 | \$67,016 | \$ (883) | |
| Net income | | | | 29,193 | | \$29,193 |
| Other comprehensive income/(loss): | | | | | | |
| Minimum pension liability adjustment, net of \$5,727 tax benefit | | | | | (8,542) | (8,542) |
| Total comprehensive income | | | | | | <u>\$20,651</u> |
| Common stock dividends declared (\$1.34 per share) | | | | (23,170) | | |
| Common stock issued, net | 503 | 503 | 13,094 | | | |
| Ending balance – December 31, 2002 | <u>17,575</u> | <u>\$17,575</u> | <u>\$146,181</u> | <u>\$73,039</u> | <u>\$(9,425)</u> | |
| 2003 | | | | | | |
| Net income | | | | \$30,640 | | \$30,640 |
| Other comprehensive income/(loss): | | | | | | |
| Minimum pension liability adjustment, net of \$4,046 tax expense | | | | | \$ 6,035 | 6,035 |
| Total comprehensive income | | | | | | <u>\$36,675</u> |
| Common stock dividends declared (\$1.35 per share) | | | | (24,137) | | |
| Common stock issued, net | 769 | 769 | 22,393 | | | |
| Ending balance - December 31, 2003 | <u>18,344</u> | <u>\$18,344</u> | <u>\$168,574</u> | <u>\$79,542</u> | <u>\$(3,390)</u> | |
| 2004 | | | | | | |
| Net income | | | | \$33,840 | | \$33,840 |
| Other comprehensive income/(loss): | | | | | | |
| Minimum pension liability reclassification, net of \$2,273 tax expense | | | | | \$ 3,390 | 3,390 |
| Net unrealized gain on investments, net of \$460 tax expense | | | | | 686 | 686 |
| Total comprehensive income | | | | | | <u>\$37,916</u> |
| Common stock dividends declared (\$1.36 per share) | | | | (25,943) | | |
| Common stock issued, net | 2,046 | 2,046 | 61,108 | | | |
| Ending balance - December 31, 2004 | <u>20,390</u> | <u>\$20,390</u> | <u>\$229,682</u> | <u>\$87,439</u> | <u>\$ 686</u> | |

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

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

| | For years ended December 31, | | |
|------------------------------------------------|-------------------------------------|------------------|------------------|
| | 2004 | 2003 | 2002 |
| Operating Revenues: | | | |
| Regulated electric revenues | \$250,386 | \$241,745 | \$224,987 |
| Regulated gas revenues | 171,763 | 159,802 | 122,109 |
| <i>Total Operating Revenues</i> | 422,149 | 401,547 | 347,096 |
| Operating Expenses: | | | |
| Fuel for electric generation | 43,553 | 41,557 | 38,210 |
| Purchased power | 52,052 | 49,521 | 44,607 |
| Natural gas purchased | 114,506 | 104,066 | 73,412 |
| Other operations and maintenance | 114,741 | 111,254 | 92,499 |
| Depreciation and amortization | 24,917 | 23,344 | 29,362 |
| Other general taxes | 12,713 | 11,589 | 10,861 |
| Income tax provision | 18,655 | 19,094 | 17,573 |
| <i>Total Operating Expenses</i> | 381,137 | 360,425 | 306,524 |
| Net Operating Income | 41,012 | 41,122 | 40,572 |
| Other Income and Deductions: | | | |
| AFUDC - equity funds | 548 | 514 | 380 |
| Equity in earnings in ATC | 4,236 | 3,687 | 3,316 |
| Income tax provision | (866) | (463) | (889) |
| Other deductions | (1,394) | (2,703) | (1,067) |
| <i>Total Other Income and Deductions</i> | 2,524 | 1,035 | 1,740 |
| Interest Expense: | | | |
| Interest on long-term debt | 11,062 | 11,857 | 12,386 |
| Other interest | 507 | 201 | 508 |
| AFUDC – borrowed funds | (217) | (230) | (213) |
| <i>Net Interest Expense</i> | 11,352 | 11,828 | 12,681 |
| Net Income | \$ 32,184 | \$ 30,329 | \$ 29,631 |

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

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

| | For the years ended December 31, | | |
|--------------------------------------------------------------------------|----------------------------------|-----------------|-----------------|
| | 2004 | 2003 | 2002 |
| Operating Activities: | | | |
| Net income | \$ 32,184 | \$ 30,329 | \$ 29,631 |
| Items not affecting cash: | | | |
| Depreciation and amortization | 24,917 | 23,344 | 29,362 |
| Deferred income taxes | 8,831 | 8,135 | 4,186 |
| Amortization of investment tax credits | (502) | (516) | (520) |
| Amortization of debt issuance costs and bond discount | 516 | 484 | 368 |
| AFUDC - equity funds | (548) | (514) | (380) |
| Equity in earnings in ATC | (4,236) | (3,687) | (3,316) |
| Gain on the sale of property | (359) | - | - |
| Other items | 1,181 | - | - |
| Dividend income from ATC | 3,055 | 2,640 | 2,714 |
| Prepayments to ATC | - | 5,000 | (5,000) |
| Changes in working capital items: | | | |
| Trade and other receivables, net | (14,148) | 1,838 | (11,230) |
| Inventories | (4,839) | (5,195) | 2,375 |
| Unbilled revenues | (3,236) | (3,105) | (2,053) |
| Prepayments | (2,291) | (4,119) | (2,047) |
| Accounts payable | 5,868 | 3,110 | 6,511 |
| Accrued taxes and interest | (45) | (367) | (103) |
| Other current liabilities | (417) | 3,592 | 3,923 |
| Special billing projects - ATC | 10,657 | - | - |
| Other noncurrent items, net | 3,895 | 11,322 | (921) |
| <i>Cash Provided by Operating Activities</i> | <u>60,483</u> | <u>72,291</u> | <u>53,500</u> |
| Investing Activities: | | | |
| Capital expenditures | (95,775) | (43,755) | (58,149) |
| Advance to ATC related to WCCF | (2,308) | (9,223) | (1,281) |
| ATC-capital contribution | (3,475) | - | - |
| AFUDC - borrowed funds | (217) | (230) | (213) |
| Proceeds from sale of property, plant, and equipment | 980 | - | - |
| Increase in nuclear decommissioning fund | - | - | (7,804) |
| Other | (86) | (180) | (410) |
| <i>Cash Used for Investing Activities</i> | <u>(100,881)</u> | <u>(53,388)</u> | <u>(67,857)</u> |
| Financing Activities: | | | |
| Equity contributions from parent | 20,532 | 19,606 | 4,497 |
| Issuance of common stock | - | - | 7,471 |
| Cash dividends paid to parent | (25,158) | (29,685) | (17,316) |
| Affiliate financing of WCCF | 432 | (10,542) | - |
| Equity contribution received by MGE Power West Campus | 40,377 | - | - |
| Long-term debt maturities/redemptions | (20,000) | (20,000) | (20,000) |
| Issuance of long-term debt | - | 20,000 | 35,000 |
| Increase in short-term debt | 24,775 | 2,000 | 4,000 |
| Other | (40) | (300) | 484 |
| <i>Cash Provided by (used for) Financing Activities</i> | <u>40,918</u> | <u>(18,921)</u> | <u>14,136</u> |
| Change in Cash and Cash Equivalents | 520 | (18) | (221) |
| Cash and cash equivalents at beginning of period | 450 | 468 | 439 |
| Cash and cash equivalents at end of period | <u>\$ 970</u> | <u>\$ 450</u> | <u>\$ 218</u> |
| Supplemental disclosures of cash flow information: | | | |
| Interest paid | \$11,028 | \$12,439 | \$12,408 |
| Income taxes paid | \$11,906 | \$18,279 | \$17,223 |
| Income taxes received | - | \$(3,159) | \$(759) |
| Non cash operating, investing, and financing activities: | | | |
| Dividend received for transfer of net assets related to two subsidiaries | - | - | \$1,499 |
| Assignment of liabilities from MGE Power to MGE Power West Campus | - | \$46,618 | - |
| Assignment of assets from MGE Power to MGE Power West Campus | - | \$(46,618) | - |

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

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

| | At December 31, | |
|-------------------------------------------------------------------------------|------------------------|-------------------|
| | 2004 | 2003 |
| ASSETS | | |
| Utility Plant (At Original Cost, In Service): | | |
| Electric | \$ 612,684 | \$ 573,326 |
| Gas | 242,074 | 232,401 |
| Gross plant in service | 854,758 | 805,727 |
| Less accumulated provision for depreciation | (374,604) | (356,705) |
| Net plant in service | 480,154 | 449,022 |
| Construction work in progress | 127,272 | 88,489 |
| <i>Total Utility Plant</i> | 607,426 | 537,511 |
| Other property and investments | 3,202 | 2,679 |
| Investment in ATC | 32,542 | 27,886 |
| <i>Total Other Property and Investments</i> | 35,744 | 30,565 |
| Current Assets: | | |
| Cash and cash equivalents | 970 | 450 |
| Restricted cash | 876 | 764 |
| Accounts receivable, less reserves of \$2,755 and \$2,735, respectively | 34,122 | 30,161 |
| Affiliate receivables | 636 | - |
| Other accounts receivable | 16,410 | 4,292 |
| Unbilled revenues | 24,880 | 21,644 |
| Materials and supplies, at lower of average cost or market | 9,107 | 7,851 |
| Fossil fuel, at lower of average cost or market | 5,523 | 5,054 |
| Stored natural gas, at lower of average cost or market | 21,712 | 18,598 |
| Prepaid taxes | 15,383 | 14,305 |
| Deferred income taxes | - | 1,125 |
| Other prepayments | 5,001 | 3,788 |
| <i>Total Current Assets</i> | 134,620 | 108,032 |
| Special billing projects | 3,121 | 14,574 |
| Regulatory assets | 21,101 | 11,446 |
| Other deferred charges | 16,064 | 17,334 |
| Total Assets | \$ 818,076 | \$ 719,462 |
| CAPITALIZATION AND LIABILITIES | | |
| Common stockholder equity | \$ 287,830 | \$ 256,819 |
| Minority interest | 40,377 | - |
| Long-term debt | 202,257 | 202,204 |
| <i>Total Capitalization</i> | 530,464 | 459,023 |
| Current Liabilities: | | |
| Long-term debt - due within one year | - | 20,000 |
| Short-term debt - commercial paper | 40,275 | 15,500 |
| Accounts payable | 37,754 | 31,886 |
| Affiliate payables | 19,350 | 18,918 |
| Accrued interest and taxes | 3,099 | 3,024 |
| Accrued payroll - related items | 7,439 | 6,786 |
| Deferred income taxes | 285 | - |
| Other current liabilities | 7,804 | 8,815 |
| <i>Total Current Liabilities</i> | 116,006 | 104,929 |
| Other Credits: | | |
| Deferred income taxes | 89,627 | 79,936 |
| Investment tax credit - deferred | 4,389 | 4,891 |
| Regulatory liabilities | 28,764 | 33,623 |
| Accrued pension and other postretirement benefits | 42,138 | 29,947 |
| Other deferred liabilities | 6,688 | 7,113 |
| <i>Total Other Credits</i> | 171,606 | 155,510 |
| Commitments and Contingencies | - | - |
| Total Capitalization and Liabilities | \$ 818,076 | \$ 719,462 |

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

Madison Gas and Electric Company
Consolidated Capitalization Statement
(In thousands)

| | At December 31, | |
|----------------------------------------------------------------------|------------------------|------------------|
| | 2004 | 2003 |
| Common Shareholder's Equity: | | |
| Common stock - par value \$1 per share: | | |
| Authorized 50,000,000 shares | | |
| Outstanding 17,347,889 and 17,347,889 shares, respectively | \$ 17,348 | \$ 17,348 |
| Additional paid-in capital | 184,917 | 164,385 |
| Retained earnings | 85,502 | 78,476 |
| Accumulated other comprehensive income (loss) | 63 | (3,390) |
| <i>Total Common Shareholders' Equity</i> | <u>287,830</u> | <u>256,819</u> |
| Minority Interest | <u>40,377</u> | <u>-</u> |
| Redeemable Preferred Stock, | | |
| Cumulative, \$25 par value, 1,175,000 authorized, but unissued | <u>-</u> | <u>-</u> |
| First Mortgage Bonds: | | |
| 7.70%, 2028 Series | <u>1,200</u> | <u>1,200</u> |
| Other Long-Term Debt: | | |
| 7.49%, due 2007 | 15,000 | 15,000 |
| 6.02%, due 2008 | 30,000 | 30,000 |
| 4.875% 2012 Series, Industrial Development Revenue Bonds | 19,300 | 19,300 |
| 5.875% 2034 Series, Industrial Development Revenue Bonds | 28,000 | 28,000 |
| 6.58%, due 2012 | 15,000 | 15,000 |
| 5.26%, due 2017 | 20,000 | 20,000 |
| 7.12%, due 2032 | 25,000 | 25,000 |
| 6.12%, due 2028 | 20,000 | 20,000 |
| 5.68%, due 2033 | 30,000 | 30,000 |
| <i>Other Long-Term Debt</i> | <u>202,300</u> | <u>202,300</u> |
| Unamortized discount and premium on bonds, net | <u>(1,243)</u> | <u>(1,296)</u> |
| <i>Total Long-Term Debt</i> | <u>202,257</u> | <u>202,204</u> |
| Total Capitalization | <u>\$530,464</u> | <u>\$459,023</u> |

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

Madison Gas and Electric Company
Consolidated Statements of Common Equity and Comprehensive Income
(In thousands, except per-share amounts)

| | <u>Common Stock</u> | | <u>Additional</u> | | <u>Accumulated</u> | |
|-------------------------------------------------------------------------------------|---------------------|-----------------|-------------------|-----------------|----------------------|----------------------|
| | <u>Shares</u> | <u>Value</u> | <u>Paid-in</u> | <u>Retained</u> | <u>Other</u> | <u>Comprehensive</u> |
| | | | <u>Capital</u> | <u>Earnings</u> | <u>(Loss)/Income</u> | <u>Income</u> |
| 2002 | | | | | | |
| Beginning balance - December 31, 2001 | 17,072 | \$17,072 | \$133,087 | \$67,016 | \$ (883) | |
| Net income | | | | 29,631 | | \$29,631 |
| Other comprehensive income/(loss): | | | | | | |
| Minimum pension liability adjustment, net of \$5,727 tax benefit | | | | | (8,542) | <u>(8,542)</u> |
| Total comprehensive income | | | | | | <u>\$21,089</u> |
| Common stock dividends declared | | | | (17,316) | | |
| Transfer of subsidiary equity to parent | | | | (1,499) | | |
| Common stock issued | 276 | 276 | 11,692 | | | |
| Ending balance - December 31, 2002 | <u>17,348</u> | <u>\$17,348</u> | <u>\$144,779</u> | <u>\$77,832</u> | <u>\$(9,425)</u> | |
| 2003 | | | | | | |
| Net income | | | | \$30,329 | | \$30,329 |
| Other comprehensive income/(loss): | | | | | | |
| Minimum pension liability adjustment, net of \$4,046 tax expense | | | | | \$6,035 | <u>6,035</u> |
| Total comprehensive income | | | | | | <u>\$36,364</u> |
| Common stock dividends declared | | | | (29,685) | | |
| Capital distribution from parent | | | 19,606 | | | |
| Ending balance - December 31, 2003 | <u>17,348</u> | <u>\$17,348</u> | <u>\$164,385</u> | <u>\$78,476</u> | <u>\$(3,390)</u> | |
| 2004 | | | | | | |
| Net income | | | | \$32,184 | | \$32,184 |
| Other comprehensive income/(loss): | | | | | | |
| Minimum pension liability reclassification, net of \$2,273 tax expense | | | | | \$3,390 | 3,390 |
| Net unrealized gain on investments, net of \$42 tax expense | | | | | 63 | <u>63</u> |
| Total comprehensive income | | | | | | <u>\$35,637</u> |
| Common stock dividends declared | | | | (25,158) | | |
| Capital distribution from parent | | | 20,532 | | | |
| Ending balance - December 31, 2004 | <u>17,348</u> | <u>\$17,348</u> | <u>\$184,917</u> | <u>\$85,502</u> | <u>\$ 63</u> | |

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

Notes to Consolidated Financial Statements

December 31, 2004, 2003, and 2002

This report is a combined report of MGE Energy and MGE. The notes to the consolidated financial statements that follow include consolidated MGE Energy footnotes and certain footnotes related to MGE.

1. Summary of Significant Accounting Policies.

a. General - MGE Energy and MGE.

On August 12, 2002, MGE Energy became the holding company for MGE as the result of completing an exchange of shares of MGE Energy common stock for shares of MGE common stock. The MGE Energy financial statements reflect this transaction for all periods presented. Consequently, MGE constitutes a substantial portion of all of the assets, liabilities, and results of operations of MGE Energy and is expected to continue to do so for the foreseeable future.

MGE, a wholly owned subsidiary of MGE Energy, is a regulated electric and gas utility headquartered in Madison, Wisconsin. Other wholly owned subsidiaries of MGE Energy include CWDC, MAGAEL, MGE Construct, and MGE Power. MGE Power owns 100% of MGE Power West Campus. These subsidiaries are part of our nonregulated energy operations, which were formed to construct and own new electric generation projects.

Accounting policies for regulated operations are in accordance with those prescribed by the regulatory authorities having jurisdiction, principally the PSCW, FERC, and SEC under the Public Utility Holding Company Act of 1935.

b. Principles of Consolidation - MGE Energy and MGE.

The consolidated financial statements reflect the application of certain accounting policies described in this note. All significant intercompany accounts and transactions have been eliminated in consolidation.

c. Use of Estimates - MGE Energy and MGE.

In order to prepare consolidated financial statements in conformity with generally accepted accounting principles, management must make estimates and assumptions. These estimates could affect reported amounts of assets, liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from management's estimates.

d. Cash Equivalents - MGE Energy and MGE.

MGE Energy and MGE consider all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

e. Restricted Cash - MGE Energy and MGE.

MGE has some cash accounts that are restricted to uses other than current operations and designated for a specific purpose. MGE's restricted cash accounts relate to cash held by trustee for certain employee benefits.

f. Trade Receivables, Allowance for Doubtful Accounts, and Concentration Risk - MGE Energy and MGE.

Trade accounts receivable are recorded at the invoiced amount and do not bear interest. However, a 1% late payment charge is recorded on all receivables unpaid after the due date. The allowance for doubtful accounts associated with these receivables represents our best estimate of the amount of probable credit losses in our existing accounts receivable. We determine our allowance for doubtful accounts based on historical write-off experience, regional economic data, and review of the accounts receivable aging.

MGE is obligated to provide service to all electric and gas customers within its respective franchised territories. MGE's franchised electric territory includes a 250-square-mile area in Dane County, Wisconsin, and MGE's franchised gas territory includes a service area covering 1,375 square miles in Wisconsin. MGE manages this concentration and the related credit risk through its credit and collection policies, which are consistent with state regulatory requirements.

g. Other Receivables - MGE Energy and MGE.

Other receivables represent receivables generated from nonregulated operations or from activities that are outside of the core business. MGE Energy's other receivables at December 31, 2004, are primarily comprised of the receivable and retainage receivable from the state and the advance made to ATC, including interest.

At December 31, 2004, MGE Construct had a \$1.6 million receivable from the State which represents actual costs incurred on behalf of the State for the construction of WCCF. These costs are billed to the State on a monthly basis pursuant to the EPC Agreement.

At December 31, 2004, MGE Construct also had a \$4.9 million retainage receivable from the State associated with WCCF. Ten percent of all nonmajor equipment and service costs (up to \$5 million) billed to the State will be retained until commercial operation of the facility pursuant to the EPC Agreement.

MGE has advanced funds for construction of transmission equipment and work done by ATC related to WCCF. At December 31, 2004, MGE had a \$13.0 million receivable from ATC which represents the advanced funds (\$12.8 million), plus interest charged on the advanced funds (\$0.2 million). MGE expects repayment of these amounts in the second quarter of 2005.

h. Inventories - MGE Energy and MGE.

Inventories consist of natural gas in storage, fossil fuels, and materials and supplies. MGE values all natural gas in storage, fossil fuels, and materials and supplies using average cost.

i. Regulatory Assets and Liabilities - MGE Energy and MGE.

Pursuant to SFAS No. 71, *Accounting for the Effects of Certain Types of Regulation*, MGE capitalizes as regulatory assets incurred costs that are expected to be recovered in future electric and natural gas rates. MGE also records as regulatory liabilities obligations to customers to refund previously collected revenue or to spend revenue collected from customers on future costs.

Electric industry restructuring could affect MGE's ability to continue establishing certain regulatory asset and liability amounts now allowed under SFAS No. 71. MGE is unable to predict whether any adjustments to regulatory assets and liabilities will occur in the future. However, the PSCW has recognized the need to allow recovery for commitments made under prior regulation. See Footnote 6 for further discussion of regulatory assets and liabilities.

j. Debt Issuance Costs - MGE Energy and MGE.

Premiums, discounts, and expenses incurred with the issuance of outstanding long-term debt are amortized over the life of the debt issue. Any call premiums or unamortized expenses associated with refinancing higher-cost debt obligations used to finance utility-regulated assets and operations are amortized consistent with regulatory treatment of those items.

k. Property, Plant, and Equipment - MGE Energy and MGE.

Utility property, plant, and equipment is recorded at cost. Cost includes indirect costs consisting of payroll taxes, pensions, postretirement benefits, other fringe benefits, administrative and general costs, and AFUDC. Additions for significant replacements of property are charged to property, plant, and equipment at cost; minor items are charged to maintenance expense. The cost of depreciable utility property less salvage value is charged to accumulated depreciation when property is retired. Depreciation rates are approved by the PSCW and are based on the estimated economic lives of property.

Provisions at composite straight-line depreciation rates, excluding decommissioning costs, approximate the following percentages for the cost of depreciable property:

| | 2004 | 2003 | 2002 |
|----------------|------|------|------|
| Electric | 3.0% | 3.0% | 2.8% |
| Gas | 3.4% | 3.3% | 3.3% |

l. Capitalized Interest - MGE Energy and MGE.

Interest costs of \$2.1 million in 2004, associated with the construction of WCCF, have been capitalized as part of the cost of the asset in accordance with the provisions set forth in SFAS No. 34, *Capitalization of Interest Cost*. These costs will be amortized over the asset's estimated useful life.

m. Allowance for Funds Used During Construction - MGE Energy and MGE.

Allowance for funds used during construction is included in utility plant accounts and represents the cost of borrowed funds used during plant construction and a return on stockholders' capital used for construction purposes. In the Consolidated Income Statements, the cost of borrowed funds (AFUDC-debt) is presented as an offset to interest expense and the return on stockholders' capital (AFUDC-capital) is shown as an Item within other income. As approved by the PSCW, MGE capitalized AFUDC-debt and equity on 50% of applicable average construction work in progress during 2004 at 9.73%. Although the allowance does not represent current cash income, it is recovered under the ratemaking process over the service lives of the related properties.

n. Investments - MGE Energy and MGE.

Investments in the common stock of affiliated companies in which MGE Energy's ownership interest is 50% or less and in which MGE Energy exercises significant influence over operating and financial policies are accounted for using the equity method, after eliminating the effects of any material intercompany transactions. All other investments are carried at fair value or at cost, as appropriate.

o. Capitalized Software Costs- MGE Energy and MGE.

Property, plant and equipment includes the capitalized costs of internal use software totaling \$6.1 million at December 31, 2004. There were no capitalized software costs at December 31, 2003. During 2004 MGE recorded \$0.2 million of amortization expense related to these costs.

These software costs include internal and external costs incurred during the application development stage of software projects. These costs are amortized on a straight-line basis over the estimated useful lives of the assets. For internal use software, the useful lives range from five to ten years.

p. Income Taxes and Excise Taxes - MGE Energy and MGE.

Income Taxes

Under the liability method prescribed by SFAS No. 109, income taxes are deferred for all temporary differences between pretax financial and taxable income and between the book and tax basis of assets and liabilities using the tax rates scheduled by law to be in effect when the temporary differences reverse. Future tax benefits are recognized to the extent that realization of such benefits is more likely than not. A valuation allowance is recorded for those benefits that do not meet this criterion.

Regulation and SFAS No. 109 have resulted in a regulatory liability related to income taxes. Excess deferred income taxes result from past taxes provided at rates higher than current rates. The SFAS No. 109 regulatory liability and deferred investment tax credit reflects the revenue requirement associated with the return of these tax benefits to customers.

Investment tax credits from regulated operations are amortized over related property service lives.

Tax credits for the generation of electricity from wind are based on kWh produced and sold during the year at the current statutory tax credit rate of 1.8 cents per kWh.

Excise Taxes

MGE Energy, through its utility operations, pays a state license fee tax in lieu of property taxes on property used in utility operations. License fee tax is calculated as a percent of adjusted operating revenues of the prior year. The electric tax rate is 3.19%, and the gas tax rate is 0.97%. The tax is required to be estimated and prepaid in the year prior to its computation and expensing. License fee tax expense, included in other general taxes, was \$9.3 million, \$8.4 million, and \$7.8 million for the years ended December 31, 2004, 2003, and 2002, respectively.

Operating income taxes, including tax credits, and license fee tax are included in rates.

q. Comprehensive Income - MGE Energy and MGE.

Comprehensive income includes all changes in equity during a period except those resulting from investments by and distributions to shareholders. Comprehensive income is reflected in the Consolidated Statements of Common Equity and Comprehensive Income.

r. Revenues - MGE Energy and MGE.

Revenues from the sale of electricity and gas to customers are recorded when electricity/gas is delivered to those customers. The quantity of those sales is measured by customers' meters. Due to the large volume of those meters, it is impractical to read all of them at month-end. Meters are read on a systematic basis throughout the month based on established meter-reading schedules. Consequently, at the end of any month, there exists a quantity of electricity and gas service that has been delivered but not billed. As a result, management must estimate revenue related to electricity and gas delivered to customers between their meter-read date and the end of the period.

In order to estimate unbilled revenues as of the end of a particular period, MGE performs a series of calculations based upon actual and estimated numbers and assumptions. MGE begins by calculating the amount of electricity and gas available for sale within its system during that period based upon known inputs (i.e., electricity and gas purchases from third parties, gas from storage, and MGE-generated electricity). These amounts are then adjusted to deduct the amounts actually

included in customers' bills for that period.

In the case of electricity, the amount is further reduced by estimating the quantity of electricity lost in the process of transmitting and distributing it to customers. The resulting available-for-sale quantities are then allocated to various customer classes based upon historical utilization patterns for those customers. MGE applies published tariffs to determine the associated revenues. Utilization patterns are based upon assumptions regarding weather, economic conditions, and consistency of use over the period in question. Actual use can be affected by variations in those items. The resulting estimate is then compared to other available statistics, including accounts receivable and billed sales for the particular period, in order to confirm its reasonableness.

During 2003, many of MGE's largest customers were shifted to a calendar-month bill. As a result of this shift, the majority of these customers' electricity usage is now accounted for in the unbilled calculation. The unbilled amounts are based on actual usage billed the following month and are therefore very reliable. Due to this billing shift, MGE has seen the ratio of unbilled receivables to total electric sales climb. The ratio has settled into a range of 45% to 65%, and MGE will continue to monitor and track this range.

Gas revenues are subject to an adjustment clause related to periodic changes in the cost of gas.

s. Risk Management Activities - MGE Energy and MGE.

As part of regular operations, MGE enters into contracts including options, swaps, futures, forwards, and other contractual commitments to manage its exposure to interest rates, commodity prices, and gas margin. MGE manages its interest rate risk by limiting its variable rate exposure through interest rate swap agreements. MGE evaluates its derivative contracts in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended and interpreted. SFAS No. 133 requires the Company to recognize all derivatives in the consolidated balance sheets at fair value, with changes in the fair value of derivative instruments to be recorded in current earnings or deferred in accumulated other comprehensive income (loss), depending on whether a derivative is designated as, and is effective as, a hedge and on the type of hedge transaction.

If the derivative qualifies for regulatory deferral subject to the provisions of SFAS No. 71, *Accounting for the Effects of Certain Types of Regulation*, the derivatives are marked to fair value pursuant to SFAS No. 133 and are offset with a corresponding regulatory asset or liability.

t. Impairment of Long-Lived Assets - MGE Energy and MGE.

MGE reviews plant and equipment and other property for impairment when events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. MGE's policy for determining when long-lived assets are impaired is to recognize an impairment loss if the sum of the expected future cash flows (undiscounted and without interest charges) from an asset are less than the carrying amount of that asset. If an impairment loss is recognized, the amount that will be recorded will be measured as the amount by which the carrying amount of the asset exceeds the fair value of the asset. MGE believes there is no impairment of long-lived assets in accordance with SFAS No. 144 at December 31, 2004.

u. Recently Issued Accounting Pronouncements - MGE Energy and MGE.

SFAS No. 143

Effective January 1, 2003, MGE adopted SFAS No. 143, *Accounting for Asset Retirement Obligations*. Under the new accounting standard, MGE recognizes, at fair value, legal obligations associated with the retirement of tangible long-lived assets that result from the acquisition, construction or development, and/or normal operation of the asset. This liability is estimated at \$1.5 million at December 31, 2004, and is included in other deferred liabilities. The liability is

accreted to its present value each period. MGE defers this accretion as a regulatory asset based on its determination that these costs can be collected from customers. The associated retirement costs are capitalized as part of the related long-lived asset and depreciated over the useful life of the asset. SFAS No. 71 is applied to the regulated operations and regulatory assets or liabilities are recognized for the timing differences between when legal asset retirement obligations are recovered in rates and when recognition of these costs is required under SFAS No. 143.

FIN 45

In November 2002, the FASB issued FIN 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. This interpretation provides the disclosures to be made by a guarantor in interim and annual financial statements about obligations under certain guarantees. The interpretation also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation.

In connection with its "Shared Savings" program, 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 August 31, 2005. The liability for the fair value of the obligation associated with these loans is not material.

MGE would be required to perform under the guarantee if the customer defaulted on its loan. The energy-related equipment installed at the customer sites is used to secure the customer loans. The length of the MGE guarantee to the financial institution varies from one to ten years depending on the term of the customer loan. Principal payments for the next five years on the loans are \$0.8 million in 2005 and 2006, \$0.7 million in 2007, \$0.9 million in 2008, and \$1.3 million in 2009.

FIN 46

In January 2003, the FASB issued FIN 46, *Consolidation of Variable Interest Entities - An Interpretation of ARB No. 51*. In December 2003, the FASB issued the updated and final interpretation FIN 46(R). FIN 46(R) requires that an equity investor in a VIE have significant equity at risk (generally a minimum of 10%, which is an increase from 3% required under the previous guidance) and hold a controlling interest, evidenced by voting rights, and absorb a majority of the entity's expected losses, receive a majority of the entity's expected returns, or both. If the equity investor is unable to evidence these characteristics, the entity that retains these ownership characteristics will be required to consolidate the VIE as the primary beneficiary. FIN 46 was applicable immediately to VIEs created or obtained after January 31, 2003. FIN 46(R) was effective on December 31, 2003, for interests in entities that were previously considered special-purpose entities under then existing authoritative guidance.

MGE Power West Campus is a VIE pursuant to FIN 46(R), as the equity investment at December 31, 2003, was not sufficient to permit the entity to finance its activities without additional support. MGE concluded a VIE relationship exists due to the long-term lease arrangement between MGE and MGE Power West Campus. MGE Power West Campus will lease a major portion of its assets, a power plant, to MGE, pursuant to this leasing arrangement and MGE will absorb a majority of the expected losses, residual, or both. The VIE was consolidated into MGE as of December 31, 2003.

FIN 46(R) also requires MGE to assess whether the participants within its Shared Savings program constitute VIEs in which MGE might be considered to be the consolidating entity. MGE has reviewed 75% of the total current Shared Savings program balance and has determined that the provisions of FIN 46(R) are not applicable via the "business scope exception." For the remaining 25% of the total current Shared Savings program balance, MGE has not performed this assessment. These entities are not legally obligated to provide the financial information to MGE that is necessary to determine whether MGE must consolidate these entities. MGE will continue to attempt to obtain information from these customers in order to determine whether they should be

consolidated by MGE.

FSP 106-2

On December 8, 2003, the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 was signed into law authorizing Medicare to provide prescription drug benefits to retirees. FSP 106-2, *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003*, was issued on May 19, 2004. The FSP provides guidance on accounting for the effects of the new Medicare prescription drug legislation by employers whose prescription drug benefits are actuarially equivalent to the drug benefit under Medicare Part D. MGE applied the provisions of this guidance in the third quarter of 2004. At this time, previously reported financial information for the three months ended March 31, 2004 and June 30, 2004 were adjusted to reflect a reduction in net periodic postretirement benefit cost as if FSP 106-2 was adopted as of January 1, 2004. Amounts for these periods, when presented in future periods for comparative purposes, will be presented as such.

FSP 109-1

In December 2004, the FASB issued FSP 109-1, *Application of FASB Statement No. 109, 'Application for Income Taxes,' to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004* (FSP FAS 109-1). The American Jobs Creation Act of 2004 (Act), signed into law on October 22, 2004, provided, generally, for a tax deduction, effective for taxable years beginning after December 31, 2004, for domestic manufacturing activities of up to nine percent (when fully phased-in) of the lesser of "qualified production activities income," as defined in the Act, or taxable income. FSP 109-1 clarified that the tax deduction for domestic manufacturing activities under the Act should be accounted for as a special deduction in accordance with SFAS No. 109, "Accounting for Income Taxes" (SFAS No. 109). This Act and these standards do not appear to have a significant impact on our consolidated financial statements.

EITF 03-01

In March 2004, the EITF reached consensus on and the FASB ratified EITF Issues No. 03-01, *The Meaning Other-Than-Temporary Impairment and its Application to Certain Investments* (EITF 03-01). EITF 03-01 provides guidance for evaluating whether an investment is other-than-temporarily impaired. MGE and MGE Energy adopted the disclosure requirements of EITF 03-01 for investments accounted for under SFAS No. 115 for the year ended December 31, 2004. On September 30, 2004, the FASB issued EITF 03-01-01, *Effective Date of Paragraphs 10-20 of EITF Issue No. 03-01, 'The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments*, which delayed the effective date of the application guidance on impairment of securities included within EITF 03-01. The EITF and the FASB are reconsidering the conclusions reached within EITF 03-01.

v. Reclassification - MGE Energy and MGE.

Certain prior-year amounts have been reclassified for comparative purposes. These reclassifications did not affect consolidated net income or shareholders' equity for the years presented.

2. Basis of Consolidation - MGE Energy and MGE.

MGE Power West Campus is not a subsidiary of MGE; however, it has been consolidated in the financial statements of MGE as of December 31, 2003, and subsequent periods due to the adoption of FIN 46(R) (see Footnote 1). MGE Power West Campus was created for the purpose of owning new generating assets including WCCF. These new generating assets are for the primary benefit of MGE's customers. The long-term lease arrangement between MGE and MGE Power West Campus creates a VIE relationship under FIN 46(R). MGE is considered the primary beneficiary of this VIE because it will absorb a majority of the entity's expected losses, residual returns, or both.

The consolidation of MGE Power West Campus resulted in a significant increase to certain balance sheet accounts such as construction work in progress of \$95.7 million, long-term debt of \$30.0 million, minority interest of \$40.4 million, and affiliate payables of \$19.4 million as of December 31, 2004. In 2003, the inclusion of MGE Power West campus resulted in an increase to construction work in progress of \$48.6 million, an increase in long-term debt of \$30.0 million, and affiliate payables of \$18.9 million at December 31, 2003. As MGE Power West Campus had no significant operations, the consolidation of this entity by MGE did not have a material impact on MGE's consolidated statements of income for 2004. However, the construction of WCCF resulted in the inclusion of \$2.7 million and \$1.0 million in other nonregulated revenues at MGE Construct in 2004 and 2003, respectively. The aforementioned amounts are included in the consolidated income statement of MGE Energy at December 31, 2004, and 2003. These revenues were for services provided to the State by MGE Construct in its role as EPC contractor for the WCCF.

3. Property, Plant, and Equipment - MGE.

Property, plant, and equipment consisted of the following at December 31:

| <i>(In thousands)</i> | <u>2004</u> | <u>2003</u> |
|----------------------------------------------------|------------------|------------------|
| Production | \$251,361 | \$239,872 |
| Distribution | 521,346 | 491,423 |
| General | <u>82,051</u> | <u>74,432</u> |
| Total utility plant | 854,758 | 805,727 |
| Less: Accumulated depreciation and amortization .. | <u>374,604</u> | <u>356,705</u> |
| In-service plant, net | 480,154 | 449,022 |
| Construction work in progress | <u>127,272</u> | <u>88,489</u> |
| Total property, plant, and equipment | <u>\$607,426</u> | <u>\$537,511</u> |

MGE's utility plant is subject to the lien of its First Mortgage Bonds up to \$1.2 million, the balance of First Mortgage Bonds outstanding at December 31, 2004. See Footnote 10 for further discussion of this facility.

4. Asset Sales and Divestitures.

a. ATC - MGE Energy and MGE.

On January 1, 2001, MGE transferred substantially all of its electric transmission facilities to ATC in exchange for approximately a 5% interest in this joint venture. ATC is comprised of Wisconsin investor-owned utilities and some Wisconsin municipal utilities, cooperatives, and power supply agencies.

MGE has a seat on the Board of Directors of ATC and has a 20% ownership interest in ATC Management, Inc. Due to MGE's ability to exercise significant control over management activities, MGE has accounted for this investment under the equity method of accounting. MGE records as equity in earnings of the investee its share of ATC's earnings, amortization of the SFAS No. 109 regulatory liability, and deferred investment tax credits related to the transmission assets transferred to ATC. MGE recorded equity earnings from its investment in ATC of \$4.2 million (pretax) in 2004, \$3.7 million (pretax) in 2003, and \$3.3 million (pretax) in 2002. In 2004, MGE made \$3.5 million in additional capital contributions. Dividend income received from ATC was \$3.1 million in 2004, \$2.6 million in 2003, and \$2.7 million in 2002.

MGE recorded transmission expenses from ATC of \$12.7 million in 2004, \$13.9 million in 2003, and \$7.9 million in 2002.

The PSCW authorized an electric rate surcharge of \$4.5 million, or 2.0%, over a twelve-month

period ended October 23, 2003, for MGE to recover deferred costs associated with the ATC formation and ongoing incremental transmission costs during 2001 and 2002.

b. Kewaunee sale - MGE Energy and MGE.

MGE sold to WPSC its 17.8% ownership interest in Kewaunee in September 2001. On the closing date, MGE also transferred its qualified decommissioning fund (\$65.0 million, fair market value) and nonqualified decommissioning fund (\$28.1 million, fair market value), which decreased accumulated depreciation by an equal amount.

MGE made monthly contributions of approximately \$0.7 million (the level authorized by the PSCW) to the MGE nonqualified decommissioning fund from September 23, 2001, through December 31, 2002. These costs were recovered from customers in rates. MGE's decommissioning liability is limited to the fund balances at the closing date plus all decommissioning collections through 2002. Under the Kewaunee sale agreement, MGE was obligated to continue collecting decommissioning costs from its customers during 2002, and to remit those amounts, net of trust investment expenses and taxes on investment income, to the WPSC nonqualified decommissioning fund, which it did on January 3, 2003. MGE has no further obligation to the decommissioning of Kewaunee except as described in the next paragraph with respect to spent nuclear fuel.

The federal government is responsible for the disposition and storage of spent nuclear fuel. Federal legislation is being considered to establish an interim storage facility. Spent nuclear fuel is currently stored at Kewaunee. Minor plant modifications to the spent fuel pools in 2001 should ensure Kewaunee has sufficient fuel-storage capacity until the end of its licensed life in 2013. MGE retained spent fuel obligations for all fuel burned at Kewaunee for its share of the generation from the opening of the plant to the transaction closing date with WPSC. WPSC took title to such fuel at the closing date.

A surcharge imposed by the National Energy Policy Act of 1992 requires nuclear power companies to fund the decontamination and decommissioning of U.S. Department of Energy facilities that process nuclear fuel. As a result, the Kewaunee co-owners are required to pay a surcharge on uranium enrichment services purchased from the federal government prior to October 23, 1992. On an inflation-adjusted basis, MGE's portion of the obligation related to Kewaunee is approximately \$0.6 million at December 31, 2004. MGE is required to continue paying its portion of this annual assessment.

As allowed under the Kewaunee sale agreement, MGE exercised an option to purchase 90 MW of electric capacity and energy at a fixed price from September 24, 2001, through September 23, 2003, to help meet customers' electric needs.

5. Joint Plant Ownership - MGE Energy and MGE.

MGE and two other utilities jointly own Columbia, a coal-fired generating facility, which accounts for 35.0% (225 MW) of MGE's net generating capability. Power from this facility is shared in proportion to each company's ownership interest. MGE has a 22.0% ownership interest in Columbia. The other owners are Alliant, which operates Columbia, and WPSC. MGE's share of fuel, operating, and maintenance expenses for Columbia was \$27.9 million, \$27.4 million, and \$26.2 million for the years ended December 31, 2004, 2003, and 2002, respectively.

Each owner provides its own financing and reflects its respective portion of facilities and operating costs in its financial statements. MGE's interest in Columbia, included in its gross utility plant in service, and the related accumulated depreciation reserves at December 31 were as follows:

| <i>(In thousands)</i> | <u>2004</u> | <u>2003</u> |
|--------------------------------|------------------|------------------|
| Utility plant | \$ 98,069 | \$ 95,594 |
| Accumulated depreciation | <u>(62,992)</u> | <u>(60,723)</u> |
| Net plant | <u>\$ 35,077</u> | <u>\$ 34,871</u> |

6. Regulatory Assets and Liabilities - MGE Energy and MGE.

The following regulatory assets and liabilities are reflected in MGE's consolidated balance sheet as of December 31:

Regulatory Assets

| <i>(In thousands)</i> | <u>2004</u> | <u>2003</u> |
|-----------------------------------------------------------|-----------------|-----------------|
| Decommissioning and decontamination | \$ 579 | \$ 846 |
| Environmental costs | 2,064 | 1,825 |
| Deferred charges related to ATC | 787 | 340 |
| Deferred changes related to interest - 2027A Series | 775 | 810 |
| Regulatory asset - SFAS No. 133 | 1,073 | 277 |
| Tax recovery related to AFUDC equity | 2,869 | 2,740 |
| Asset retirement obligation - SFAS No. 143 | 966 | 850 |
| Minimum pension liability | 9,782 | - |
| Tax recovery for prior flow through | 1,879 | 3,205 |
| Other | 327 | 553 |
| <i>Total regulatory assets</i> | <u>\$21,101</u> | <u>\$11,446</u> |

Regulatory Liabilities

| <i>(In thousands)</i> | <u>2004</u> | <u>2003</u> |
|---------------------------------------------------|-----------------|-----------------|
| Regulatory liability - SFAS No. 109 | \$ 8,604 | \$ 9,877 |
| Regulatory liability - SFAS No. 133 | - | 732 |
| Non-SFAS No. 143 removal cost | 17,683 | 18,247 |
| Regulatory liability - customer fuel credit | 1,656 | 2,762 |
| Other | 821 | 2,005 |
| <i>Total regulatory liabilities</i> | <u>\$28,764</u> | <u>\$33,623</u> |

MGE expects to recover their regulatory assets and return their regulatory liabilities through rates charged to customers based on PSCW decisions made during the ratemaking process based on PSCW long-standing policies and guidelines. The adjustments to rates for these regulatory assets and liabilities will occur over the periods either specified by the PSCW or over the corresponding period related to the asset or liability. We believe it is probable that MGE will continue to recover from customers the regulatory assets described above based on prior and current ratemaking treatment for such costs. MGE is earning a return on all regulatory assets, except for amounts expended for environmental costs.

Decommissioning and Decontamination

Costs related to decommissioning and decontamination will be recovered in rates through September 2007. The 1992 National Energy Policy Act requires all utilities that have used federal enrichment facilities to pay a special assessment for decontaminating and decommissioning these facilities. This special assessment is based on past enrichment. MGE has deferred in deferred charges an estimated \$0.6 million and \$0.8 million for its portion of the special assessment at December 31, 2004, and 2003, respectively. MGE believes any additional costs will be recovered in future rates.

Environmental Costs

MGE has received regulatory treatment on environmental costs including clean up of two landfill sites and a substation site. The regulators have not allowed MGE to recover carrying costs on these environmental expenditures. As of December 31, 2004, MGE has recorded \$2.1 million in regulatory assets for environmental costs, including \$0.1 million for accrual for estimated future site remediation and \$2.0 million of deferrals for actual remediation costs incurred. These costs are being recovered over a four year period.

Deferred Charges Related to ATC

Deferred charges in connection with the start-up of ATC and ongoing incremental transmission costs during 2001 and 2002, associated with ATC were deferred under SFAS No. 71. MGE recovered these costs from October 2002 through October 2003. The PSCW has also allowed MGE to continue to use escrow accounting for the incremental transmission costs. The escrow accounting allows the utility to true-up its actual costs incurred and reflect the amount of the true-up in its next rate case filing and amortize the amount over that rate case period. A carrying cost component is calculated on the escrow balance.

Deferred Charges Related to Interest - 2027A Series

Deferred charges on the interest expense of the 2027A Series relates to the incremental difference in the interest that MGE earned on its construction bond fund and the actual interest that MGE paid out. That incremental difference between interest earned and interest expensed is currently being amortized over the remaining life of the bonds as part of the rate recovery allowed by the PSCW.

Regulatory Asset (Liability) - SFAS No. 133

MGE has a limited number of physical and financial gas commodity contracts that are defined as derivatives under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The derivative amounts recorded as a result of these gas contracts is offset with a corresponding regulatory asset or liability because these transactions are part of the PGA clause authorized by the PSCW and not subject to the gas cost incentive sharing mechanism.

As of December 31, 2004, MGE has recorded a regulatory asset of \$1.1 million for the cumulative mark-to-market value of its gas supply contracts and the Columbia coal contract. As of December 31, 2003, MGE had recorded a regulatory asset of \$0.3 million related to the commercial paper swap agreement and a regulatory liability of \$0.7 million for the cumulative mark-to-market value of its gas supply derivatives.

Tax Recovery Related to AFUDC Equity

AFUDC equity represents the after-tax equity cost associated with utility plant construction and results in a temporary difference between the book and tax basis of such plant. Deferred income taxes are provided on this temporary difference in accordance with SFAS No. 109, *Accounting for Income Taxes*. It is probable under PSCW regulation that MGE will recover in future rates the future increase in taxes payable represented by the deferred income tax liability. The amounts will be recovered in rates over the depreciable life of the asset for which AFUDC was applied. Tax recovery related to AFUDC equity represents the revenue requirement related to recovery of these future taxes payable, calculated at current statutory tax rates.

Asset Retirement Obligation - SFAS No. 143

See Footnote 18 for further discussion.

Minimum Pension Liability

On December 21, 2004, the PSCW issued a final order which concluded that minimum pension liabilities related to regulated operations should be classified as regulatory assets within the consolidated balance sheet. As such, the minimum pension liability required for MGE's pension plan has been recorded as a regulatory asset at December 31, 2004, rather than within other comprehensive income as prescribed by SFAS No. 87.

Tax Recovery For Prior Flow Through

The PSCW has allowed rate recovery of deferred taxes on all temporary differences since June 1991 when the FERC Uniform System of Accounts was adopted. Unrecovered deferred taxes in existence at the time of adoption were authorized for rate recovery over 15 years through 2006.

Tax recovery for prior flow through represents the revenue requirement, calculated at current tax rates, related to the remaining recovery period.

Regulatory Liability - SFAS No. 109

Regulation and SFAS No. 109 have resulted in a regulatory liability related to income taxes. Excess deferred income taxes result from past taxes provided at rates higher than current rates. The SFAS No. 109 regulatory liability and deferred investment tax credit reflects the revenue requirement associated with the return of these tax benefits to customers.

Non-SFAS No. 143 Removal Costs

In connection with the adoption of SFAS No. 143, companies are required to reclassify cumulative collections for non-ARO removal costs as a regulatory liability, with an offsetting entry to accumulated depreciation. Under the current rate structure, these removal costs are being recovered as a component of depreciation expense.

Regulatory Liability - Customer Fuel Credit

See Footnote 16 for further discussion.

7. Decommissioning Trusts - MGE Energy and MGE.

MGE transferred the assets of its external decommissioning trusts to external trusts of WPSC in September 2001, as part of the Kewaunee sale agreement (see Footnote 4). The agreement required MGE to continue funding its external decommissioning trust through the end of 2002, at the PSCW-authorized level of approximately \$0.7 million per month. These costs were recovered from customers in rates. At the beginning of 2003, the remaining assets of the MGE external trust were transferred to the external trust of WPSC.

As required by SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, MGE's debt and equity security investments in the trusts were classified as available for sale. Gains and losses on the trusts were determined based on specific identification. Net unrealized holding gains and losses on the trusts were recorded as part of accumulated provision for depreciation.

8. Common Equity.

a. Common Stock - MGE Energy.

On September 15, 2004, MGE Energy completed the sale of 1,265,000 shares of common stock at a net sale price of \$30.815 per share. The Company's proceeds, net of underwriters' fees and other expenses, were approximately \$39.0 million. These funds were utilized to repay short-term borrowings incurred to finance the construction of WCCF and for general corporate purposes.

On August 15, 2003, MGE Energy entered into a Distribution Agreement (Agreement) with BOCM Under the terms of this Agreement, MGE Energy may offer and sell up to 1,600,000 shares of its common stock from time to time through BOCM as its sales agent or to BOCM as principal. The sales are made pursuant to a shelf registration statement MGE Energy filed with the SEC in March 2003, and which has been declared effective.

Under the Agreement, MGE Energy sold 124,000 and 165,000 shares of its common stock during 2004 and 2003, respectively. These sales resulted in net proceeds of \$3.8 million and \$5.1 million for 2004 and 2003, respectively. The proceeds from the issuance of common stock were used to pay for capital expenditures related to WCCF and for other general corporate purposes.

MGE Energy also issues new shares of its common stock through its Dividend Reinvestment and Direct Stock Purchase Plan (the Plan). During 2004, MGE Energy issued 657,000 new shares of common stock under the Plan for net proceeds of \$20.7 million. During 2003, MGE Energy issued 604,000 new shares of common stock under the Plan for net proceeds of \$18.1 million. The proceeds from the issuance of common stock for the Plan were contributed to MGE for its capital expenditures and to strengthen its capital structure.

b. Preferred Stock - MGE Energy and MGE.

MGE has 1,175,000 shares of \$25 par value redeemable preferred stock (cumulative) that is authorized but unissued at December 31, 2004.

c. Dilutive Shares Calculation - MGE Energy.

MGE Energy does not hold any dilutive securities.

9. Minority Interest - MGE.

MGE Power West Campus is not a subsidiary of MGE; however, it has been consolidated in the consolidated financial statements of MGE as of December 31, 2003 and 2004, due to the adoption of FIN 46(R) (see Footnote 1).

MGE Power West Campus is owned indirectly by MGE Energy. MGE Energy's proportionate share of the equity (through its wholly owned subsidiary MGE Power) of MGE Power West Campus is classified within the MGE financial statements as minority interest. As of December 31, 2004, MGE Energy (through its wholly owned subsidiary MGE Power) had invested \$40.4 million in MGE Power West Campus.

10. Long-Term Debt.

a. 5.68% Senior Secured Notes - MGE and MGE Energy.

On September 30, 2003, MGE Energy, through MGE Power West Campus, issued \$30.0 million of 5.68% senior secured notes maturing September 25, 2033, in a private placement offering. Interest only will be paid monthly for the first ten years and then principal and interest payments will be paid monthly for the remaining life of the debt. The proceeds from these notes were used to pay off a portion of MGE Energy's bank loans, which provided temporary financing of capital expenditures for the WCCF.

The debt is subject to a collateral assignment of lease payments that MGE will be making to MGE Power West Campus for use of the cogeneration facility. Until the facility is operational, MGE Energy will guarantee the debt.

b. First Mortgage Bonds and Other Long-Term Debt - MGE Energy and MGE.

MGE's utility plant is subject to the lien of its First Mortgage Bonds.

MGE's outstanding First Mortgage Bonds contain certain debt covenant restrictions with respect to dividends. The covenant restricts the payment of dividends or any other distribution or purchase of shares to the existing earned surplus (retained earnings) on MGE common stock. As of December 31, 2004, MGE's earned surplus exceeded all such payments for all years covered under this report.

On September 9, 2003, MGE issued \$20 million in unsecured 6.12% Medium-Term Notes maturing on September 1, 2028. Interest on these notes is paid semiannually on March 1 and September 1 of each year. The proceeds from this issue were used to redeem \$20 million, 7.70%, 2028 Series, First Mortgage Bonds, on September 30, 2003. The call premium for the redeemed bonds was \$0.9 million and is recoverable through rates.

On November 27, 2002, MGE issued \$15.0 million in unsecured variable-rate Medium-Term Notes, which matured on November 26, 2004. Interest on the notes was paid quarterly on the third Wednesday of March, June, September, and December. The variable rate was based on the three-month London Interbank Offered Rate (LIBOR) plus 12.5 basis points.

The indenture under which the Medium-Term Notes were issued provides that they will be entitled to be equally and ratably secured in the event that MGE issues any additional First Mortgage Bonds.

Below is MGE's aggregate maturities for all long-term debt for years following the December 31, 2004, balance sheet.

| | <i>(In thousands)</i> | <u>Amount</u> |
|--------------------|-----------------------|------------------|
| 2005 | | \$ - |
| 2006 | | - |
| 2007 | | 15,000 |
| 2008 | | 30,000 |
| 2009 | | - |
| Future years | | <u>158,500</u> |
| Total* | | <u>\$203,500</u> |

**Includes \$30 million maturity for MGE Power West Campus, which is consolidated with MGE's debt in accordance with FIN 46(R) (see Footnote 1).*

11. Notes Payable to Banks, Commercial Paper, and Lines of Credit - MGE Energy and MGE.

For short-term borrowings, MGE generally issues commercial paper (issued at the prevailing discount rate at the time of issuance), which is supported by unused bank lines of credit. During 2004, MGE entered into a \$45 million bank line of credit with a group of banks. MGE also added an additional \$10.0 million credit facility which matures on March 29, 2005. These agreements will be used principally to support MGE's commercial paper program. MGE also has a letter of credit with a commercial bank (established as collateral for equipment purchases) that ATC will use to provide necessary upgrades for the WCCF.

During 2004, MGE Energy renewed its \$60 million line of credit note. The term of the line of credit note extends until September 30, 2005. The maximum principal amount available under this note from September 29, 2004, through December 31, 2004, was \$30 million. The maximum principal amount available under this note is \$45 million on January 1, 2005, through March 31, 2005, and \$60 million on April 1, 2005, through September 30, 2005. At any time, MGE Energy may amend the note and increase the "Commitment Amount" then available to an amount not to exceed \$60 million. The line of credit will be used for temporary financing of the capital commitments for the WCCF and general corporate purposes.

Information concerning short-term borrowings for the past three years is shown below:

| <i>(In thousands)</i> | As of December 31, | | |
|------------------------------------------|--------------------|-----------|----------|
| | 2004 | 2003 | 2002 |
| MGE Energy | | | |
| Available lines of credit | \$115,000 | \$100,000 | \$85,000 |
| Short-term debt outstanding | \$ 53,275 | \$ 31,680 | \$34,298 |
| Weighted-average interest rate | 2.53% | 1.73% | 2.09% |
| <i>During the year:</i> | | | |
| Maximum short-term borrowings | \$ 80,405 | \$ 54,605 | \$34,298 |
| Average short-term borrowings | \$ 29,182 | \$ 36,681 | \$14,613 |
| Weighted-average interest rate | 2.06% | 1.99% | 1.83% |
| MGE | | | |
| Available lines of credit | \$ 55,000 | \$ 40,000 | \$40,000 |
| Commercial paper outstanding | \$ 40,275 | \$ 15,500 | \$13,500 |
| Weighted-average interest rate | 2.41% | 1.21% | 1.40% |
| <i>During the year:</i> | | | |
| Maximum short-term borrowings | \$ 40,275 | \$ 15,500 | \$33,500 |
| Average short-term borrowings | \$ 6,526 | \$ 2,162 | \$14,359 |
| Weighted-average interest rate | 1.79% | 1.29% | 1.82% |

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

At December 31, 2004, and 2003, 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's long-term debt and interest-rate swap agreements are based on quoted market prices at December 31. The estimated fair market value of MGE's financial instruments are as follows:

| <i>(In thousands)</i> | 2004 | | 2003 | |
|--------------------------------------------|--------------------|---------------|--------------------|---------------|
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| MGE Energy | | | | |
| <i>Assets:</i> | | | | |
| Cash and cash equivalents | \$ 3,561 | \$ 3,561 | \$ 2,020 | \$ 2,020 |
| Restricted cash | 876 | 876 | 764 | 764 |
| <i>Liabilities:</i> | | | | |
| Short-term debt - bank loans | 13,000 | 13,000 | 16,180 | 16,180 |
| Short-term debt - commercial paper | 40,275 | 40,275 | 15,500 | 15,500 |
| Long-term debt | 203,500 | 218,292 | 218,500 | 231,712 |
| Other long-term debt swap agreements | - | - | (148) | (148) |
| MGE | | | | |
| <i>Assets:</i> | | | | |
| Cash and cash equivalents | 970 | 970 | 450 | 450 |
| Restricted cash | 876 | 876 | 764 | 764 |
| <i>Liabilities:</i> | | | | |
| Short-term debt - commercial paper | 40,275 | 40,275 | 15,500 | 15,500 |
| Long-term debt | 203,500 | 218,292 | 218,500 | 231,712 |
| Other long-term debt swap agreements | - | - | (148) | (148) |

13. Income Taxes.

a. MGE Energy Income Taxes.

MGE Energy files a consolidated federal income tax return that includes the operations of all subsidiary companies. The consolidated income tax provision consists of the following provision (benefit) components for the years ended December 31:

| <i>(In thousands)</i> | 2004 | 2003 | 2002 |
|----------------------------------------|-----------------|-----------------|-----------------|
| <i>Current payable:</i> | | | |
| Federal | \$ 8,946 | \$ 8,976 | \$10,677 |
| State | 3,380 | 3,366 | 4,384 |
| <i>Net-deferred:</i> | | | |
| Federal | 7,486 | 6,874 | 4,073 |
| State | 1,346 | 1,201 | 113 |
| Amortized investment tax credits | (502) | (516) | (520) |
| Total income tax provision | <u>\$20,656</u> | <u>\$19,901</u> | <u>\$18,727</u> |

MGE Energy's consolidated income tax provision differs from the amount computed by applying the statutory federal income tax rate to income before income taxes, as follows:

| | <u>2004</u> | <u>2003</u> | <u>2002</u> |
|--------------------------------------------------|--------------|--------------|--------------|
| Statutory federal income tax rate | 35.0% | 35.0% | 35.0% |
| Amortized investment tax credits | (0.9)% | (1.0)% | (1.1)% |
| State income taxes, net of federal benefit | 5.1% | 5.4% | 5.5% |
| Credit for electricity from wind energy | (0.7)% | (0.8)% | (0.9)% |
| Medicare subsidy | (0.4)% | - | - |
| Other, individually insignificant | (0.2)% | 0.8% | 0.6% |
| Effective income tax rate | <u>37.9%</u> | <u>39.4%</u> | <u>39.1%</u> |

The significant components of deferred tax liabilities (assets) that appear on MGE Energy's consolidated balance sheets as of December 31 are as follows:

| <i>(In thousands)</i> | <u>2004</u> | <u>2003</u> |
|-----------------------------------------------|------------------|------------------|
| Property-related | \$ 79,944 | \$ 75,314 |
| Investment in ATC | 14,479 | 10,862 |
| Bond transactions | 2,699 | 2,841 |
| Pension expense | 1,846 | 1,742 |
| Additional minimum pension obligation | 5,809 | 2,150 |
| Tax deductible prepayments | 4,818 | 4,275 |
| Other | 5,794 | 4,562 |
| Gross deferred income tax liabilities | <u>115,389</u> | <u>101,746</u> |
| Accrued expenses | (7,676) | (7,502) |
| Retirement benefits, other than pension | (4,880) | (3,909) |
| Deferred tax regulatory account | (5,215) | (5,927) |
| Additional minimum pension obligation | (5,809) | (4,423) |
| Other | <u>(1,969)</u> | <u>(1,623)</u> |
| Gross deferred income tax assets | (25,549) | (23,384) |
| Less valuation allowance | 368 | 368 |
| Net deferred income tax assets | <u>(25,181)</u> | <u>(23,016)</u> |
| Deferred income taxes | <u>\$ 90,208</u> | <u>\$ 78,730</u> |

The valuation allowance reduces MGE Energy's deferred tax assets for state carryforward losses to estimated realizable value due to the uncertainty of future income estimates in various state tax jurisdictions.

For tax purposes, as of December 31, 2004, MGE Energy had approximately \$7.6 million of state tax net operating loss deductions that expire between 2011 to 2019 if unused.

b. MGE Income Taxes.

On a separate company basis, the components of MGE's income tax provision are as follows for the years ended December 31:

| <i>(In thousands)</i> | <u>2004</u> | <u>2003</u> | <u>2002</u> |
|----------------------------------------|-----------------|-----------------|-----------------|
| Current payable: | | | |
| Federal | \$ 8,046 | \$ 8,747 | \$10,877 |
| State | 3,146 | 3,191 | 3,919 |
| Net-deferred: | | | |
| Federal | 7,484 | 6,922 | 4,073 |
| State | 1,347 | 1,213 | 113 |
| Amortized investment tax credits | (502) | (516) | (520) |
| Total income tax provision | <u>\$19,521</u> | <u>\$19,557</u> | <u>\$18,462</u> |

MGE's income tax provision on a separate company basis differs from the amount computed by applying the statutory federal income tax rate to income before income tax provision as follows:

| | <u>2004</u> | <u>2003</u> | <u>2002</u> |
|--------------------------------------------------|--------------|--------------|--------------|
| Statutory federal income tax rate | 35.0% | 35.0% | 35.0% |
| Amortized investment tax credits | (1.0)% | (1.0)% | (1.1)% |
| State income taxes, net of federal benefit | 5.1% | 5.2% | 4.9% |
| Credit for electricity from wind energy | (0.8)% | (0.8)% | (0.9)% |
| Medicare subsidy | (0.4)% | - | - |
| Other, individually insignificant | (0.1)% | 0.8% | 0.5% |
| Effective income tax rate | <u>37.8%</u> | <u>39.2%</u> | <u>38.4%</u> |

The significant components of deferred tax liabilities (assets) that appear on MGE's consolidated balance sheets as of December 31 are as follows:

| <i>(In thousands)</i> | <u>2004</u> | <u>2003</u> |
|-----------------------------------------------|------------------|------------------|
| Property-related | \$ 79,944 | \$ 75,314 |
| Investment in ATC | 14,479 | 10,862 |
| Bond transactions | 2,699 | 2,841 |
| Pension expense | 1,846 | 1,742 |
| Additional minimum pension obligation | 5,809 | 2,150 |
| Tax deductible prepayments | 4,818 | 4,275 |
| Other | 5,377 | 4,562 |
| Gross deferred income tax liabilities | <u>114,972</u> | <u>101,746</u> |
| Accrued expenses | (7,555) | (7,502) |
| Retirement benefits, other than pension | (4,880) | (3,909) |
| Deferred tax regulatory account | (5,215) | (5,927) |
| Additional minimum pension obligation | (5,809) | (4,423) |
| Other | (1,969) | (1,542) |
| Gross deferred income tax assets | <u>(25,428)</u> | <u>(23,303)</u> |
| Less valuation allowance | 368 | 368 |
| Net deferred income tax assets | <u>(25,060)</u> | <u>(22,935)</u> |
| Deferred income taxes | <u>\$ 89,912</u> | <u>\$ 78,811</u> |

The valuation allowance reduces MGE's deferred tax assets for state carryforward losses to estimated realizable value due to the uncertainty of future income estimates in various state tax jurisdictions.

For tax purposes, as of December 31, 2004, MGE had approximately \$7.6 million of state tax net operating loss deductions that expire between 2011 to 2019 if unused.

14. Pension Plans - MGE Energy and MGE.

MGE maintains qualified and nonqualified pension plans. MGE also provides health care and life insurance benefits for its retired employees. MGE uses a measurement date of December 31 for all of its pension and postretirement benefit plans.

MGE maintains two defined contribution 401(k) benefit plans for its employees. MGE's costs of the 401(k) plans were \$0.8 million in 2004, \$0.7 million in 2003, and \$0.6 million in 2002.

a. Benefit Obligations.

| <i>(In thousands)</i> | Pension Benefits | | Postretirement Benefits | |
|-----------------------------------------------------|------------------|------------------|-------------------------|-----------------|
| | 2004 | 2003 | 2004 | 2003 |
| Change in benefit obligation: | | | | |
| Net benefit obligation at beginning of year | \$133,461 | \$117,410 | \$54,813 | \$45,639 |
| Service cost | 4,171 | 3,418 | 1,852 | 1,806 |
| Interest cost | 8,578 | 8,023 | 3,076 | 3,248 |
| Plan participants' contributions | - | - | 322 | 304 |
| Plan amendments | - | 557 | 446 | - |
| Actuarial loss | 12,882 | 7,743 | (7,331) | 5,051 |
| Special termination benefits | - | 280 | - | - |
| Gross benefits paid | <u>(4,496)</u> | <u>(3,970)</u> | <u>(1,278)</u> | <u>(1,235)</u> |
| Net benefit obligation at end of year | <u>\$154,596</u> | <u>\$133,461</u> | <u>\$51,900</u> | <u>\$54,813</u> |

The accumulated benefit obligation for the defined benefit pension plan at the end of 2004 and 2003 was \$129.7 million and \$113.8 million, respectively. The accumulated benefit obligation for the other postretirement benefits at the end of 2004 and 2003, was \$51.9 million and \$54.8 million, respectively.

| Weighted-average assumptions used to determine end of year benefit obligations: | Pension Benefits | | Postretirement Benefits | |
|---------------------------------------------------------------------------------|------------------|-------|-------------------------|-------|
| | 2004 | 2003 | 2004 | 2003 |
| Discount rate | 5.85% | 6.25% | 5.85% | 6.25% |
| Rate of compensation increase | 4.55% | 4.50% | NA | NA |

The following table shows assumed health care cost trend rates at December 31:

| | 2004 | 2003 |
|---------------------------------------------------------------------------------------------|------|------|
| Health care cost trend rate assumed for next year | 10% | 13% |
| Rate to which the cost trend rate is assumed to decline (the ultimate trend rate) | 5% | 5% |
| Year that the rate reaches the ultimate trend rate | 2012 | 2012 |

The assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. For 2004, the health trend was reset to 10% with the ultimate trend of 5% reached in 2012. The health trend assumption for 2005 was reset from 12% to 10% as a result of an expanded relationship with a managed care health provider with a greater emphasis on preventive care, provider discounts, and better utilization management.

The following table shows how an assumed 1% increase or 1% decrease in health care cost trends could impact postretirement benefits in 2004 dollars:

| <i>(In thousands)</i> | <u>1% Increase</u> | <u>1% Decrease</u> |
|-------------------------------------------------------|--------------------|--------------------|
| Effect on postretirement benefit obligation | \$8,214 | (\$7,070) |

On December 8, 2003, the "Medicare Prescription Drug, Improvement and Modernization Act of 2003" (the Act) was signed into law authorizing Medicare to provide prescription drug benefits to retirees. The Prescription Drug Act introduced a prescription drug benefit under Medicare as well as a Federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to the Medicare prescription drug benefit. Management believes the prescription drug benefit provided under MGE's postretirement benefit plans is at least actuarially equivalent to the Medicare prescription drug benefit. In response to the enactment of the Prescription Drug Act, on May 19, 2003 FSP 106-2, *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003*, was issued.

During the third quarter of 2004, MGE adopted the provisions of FSP 106-2, resulting in a remeasurement of its postretirement benefits and a remeasurement of its postretirement plans' assets and APBO as of January 1, 2004. The effect of the subsidy on benefits attributable to past service was accounted for as an actuarial experience gain, resulting in a decrease in the APBO of \$4.3 million. The annualized reduction in the net periodic postretirement benefit cost is estimated to be \$0.7 million compared to the annual cost calculated without considering the effects of the Prescription Drug Act. Previously reported financial information for the three months ended March 31, 2004 and June 30, 2004 have also been adjusted to reflect a reduction in net periodic postretirement benefit cost as if FSP 106-2 was adopted as of January 1, 2004. Amounts for these periods, when presented in future periods for comparative purposes, will be presented as such.

b. Plan Assets.

| <i>(In thousands)</i> | <u>Pension Benefits</u> | | <u>Postretirement Benefits</u> | |
|------------------------------------------------------|-------------------------|------------------|--------------------------------|-----------------|
| | 2004 | 2003 | 2004 | 2003 |
| Change in plan assets: | | | | |
| Fair value of plan assets at beginning of year . . . | \$100,228 | \$ 79,821 | \$ 9,941 | \$ 7,292 |
| Actual return on plan assets | 11,416 | 20,883 | 898 | 1,429 |
| Employer contributions | 1,512 | 3,494 | 816 | 2,152 |
| Plan participants' contributions | - | - | 322 | 304 |
| Gross benefits paid | <u>(4,496)</u> | <u>(3,970)</u> | <u>(1,278)</u> | <u>(1,236)</u> |
| Fair value of plan assets at end of year | <u>\$108,660</u> | <u>\$100,228</u> | <u>\$10,699</u> | <u>\$ 9,941</u> |

The fair value of plan assets for these plans is \$108.7 million and \$100.2 million at the end of 2004 and 2003, respectively. The expected long-term rate of return on these plan assets was 9.0% in 2004 and 2003.

c. Explanation of Long-Term Rate of Return.

MGE employs a building-block approach in determining the expected long-term rate of return for asset classes. Historical markets are studied and long-term historical relationships among asset classes are analyzed, consistent with the widely accepted capital market principle that assets with higher volatility generate a greater return over the long run. Current market factors such as interest rates and dividend yields are evaluated before long-term capital market assumptions are determined.

The expected long-term nominal rate of return for plan assets is primarily a function of expected long-term real rates of return for component asset classes and the plan's target asset allocation in conjunction with an inflation assumption. Consideration is also given to diversification, rebalancing, and active portfolio management. Peer data and historical returns are reviewed to check for reasonability and appropriateness.

The asset allocation for MGE's pension plans at the end of 2004 and 2003, and the target allocation for 2005, by asset category, follows:

| | Target Allocation | Percentage of Plan Assets at Year End | |
|-------------------------|----------------------|------------------------------------------|--------|
| | | 2004 | 2003 |
| Equity securities | 75.0% | 75.6% | 75.8% |
| Debt securities* | 15.0% | 13.8% | 19.4% |
| Real estate* | 10.0% | 10.6% | 4.8% |
| Total | 100.0% | 100.0% | 100.0% |

* The target allocation related to debt securities changed during 2004 from 20% in 2003 to 15% in 2004. The target allocation related to real estate securities also changed in 2004 from 5% in 2003 to 10% in 2004.

d. Investment Strategy.

MGE employs a total return investment approach whereby a mix of equities, fixed income, and real estate investments are used to maximize the expected long return of plan assets for a prudent level of risk. Risk tolerance is established through careful consideration of plan liabilities, plan-funded status, and corporate financial condition. The investment portfolio contains a diversified blend of equity, fixed income, and real estate investments. Target asset allocations are as follows: 55% United States equity, 20% non-United States equity, 15% fixed income, and 10% real estate. Investment risk is measured and monitored on an ongoing basis through periodic investment portfolio reviews and liability measurements.

e. Postretirement Benefits.

The fair value of plan assets for these postretirement benefit plans is \$10.7 million and \$9.9 million at the end of 2004 and 2003, respectively. The expected long-term rate of return on these plan assets was 9.0% in 2004 and 2003.

Of the above amounts, \$8.1 million and \$7.3 million at the end of 2004 and 2003, respectively, were held in the master pension trust and are allocable to postretirement health expenses. The target asset allocation and investment strategy for the portion of assets held in the master pension trust are the same as that explained for MGE's pension plans.

The remainder of postretirement benefit assets are held either in an insurance continuance fund for the payment of retiree life benefits or a health benefit trust for payment of retiree health claims. There is no formal target asset allocation for these assets, but the intent is to seek interest income and maintain stability of principal.

f. Funded Status.

The funded status of the plans, reconciled to the amount reported on the statement of financial position, follows:

| <i>(In thousands)</i> | Pension Benefits | | Postretirement Benefits | |
|-----------------------------------------------------|-------------------|-------------------|-------------------------|--------------------|
| | 2004 | 2003 | 2004 | 2003 |
| Fair value of plan assets at end of year | \$108,660 | \$100,228 | \$ 10,699 | \$ 9,941 |
| Benefit obligations | 154,596 | 133,461 | 51,900 | 54,813 |
| Funded status at end of year | (45,936) | (33,233) | (41,201) | (44,872) |
| Unrecognized net actuarial (gain)/loss | 34,721 | 25,364 | 16,710 | 24,904 |
| Unrecognized prior service cost | 3,767 | 4,170 | 1,193 | 971 |
| Unrecognized net transition obligation | 925 | 1,167 | 3,471 | 3,908 |
| Net amount recognized at end of year | <u>\$ (6,523)</u> | <u>\$ (2,532)</u> | <u>\$ (19,827)</u> | <u>\$ (15,089)</u> |
| Amounts recognized in the balance sheet consist of: | | | | |
| Prepaid benefit cost | \$ - | \$ - | \$ 62 | \$ 67 |
| Accrued benefit liability | (20,998) | (13,551) | (19,889) | (15,156) |
| Intangible asset | 4,693 | 5,357 | - | - |
| Regulatory Asset | 9,782 | - | - | - |
| Accumulated other comprehensive income | - | 5,662 | - | - |
| Net amount recognized at end of year | <u>\$ (6,523)</u> | <u>\$ (2,532)</u> | <u>\$ (19,827)</u> | <u>\$ (15,089)</u> |

On December 21, 2004, the PSCW issued a final order which concluded that minimum pension liabilities related to regulated operations should be classified as regulatory assets within the consolidated balance sheet. As such, the minimum pension liability required for MGE's pension plan has been recorded as a regulatory asset as of December 31, 2004, rather than within other comprehensive income as prescribed by SFAS No. 87.

Prior to the issue of the order mentioned above, MGE's minimum pension liability was included in other comprehensive income. For the year ended December 31, 2003, MGE included a minimum pension liability of \$5.7 million (pretax) in the other comprehensive income balance.

The projected benefit obligation, accumulated benefit obligation, and fair value of assets for pension plans with a projected benefit obligation in excess of plan assets and pension plans and postretirement plans with an accumulated benefit obligation in excess of the fair value of assets are as follows:

(In thousands)

| As of December 31, | Pension Benefits | | Postretirement Benefits | |
|-----------------------------------------------------|------------------|-----------|-------------------------|----------|
| | 2004 | 2003 | 2004 | 2003 |
| Projected benefit obligation exceeds plan assets: | | | | |
| Projected benefit obligation | \$154,596 | \$133,461 | NA | NA |
| Accumulated benefit obligation | 129,657 | 113,779 | NA | NA |
| Fair value of assets | 108,660 | 100,228 | NA | NA |
| Accumulated benefit obligation exceeds plan assets: | | | | |
| Projected benefit obligation | 154,596 | 133,461 | NA | NA |
| Accumulated benefit obligation | 129,657 | 113,779 | \$51,900 | \$54,813 |
| Fair value of assets | 108,660 | 100,228 | 10,699 | 9,941 |

g. Expected Cash Flows.

There are no required contributions, but MGE may elect discretionary deductible contributions depending upon its valuation results and cash flow from operations. MGE made a \$4 million contribution in 2005 related to the 2004 plan year. This payment is strictly at MGE's discretion as there are no contributions required for 2004 or 2005.

h. Benefit Payments.

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid as follows:

| | Pension | Post-Retirement | | |
|--------------|------------------|--------------------------------|----------------------------------|------------------------------|
| | Pension Benefits | Gross Post-Retirement Benefits | Expected Medicare Part D Subsidy | Net Post-Retirement Benefits |
| 2005 | \$ 4,734 | \$ 1,307 | \$ - | \$ 1,307 |
| 2006 | 5,146 | 1,517 | (96) | 1,421 |
| 2007 | 5,773 | 1,790 | (108) | 1,682 |
| 2008 | 6,370 | 2,099 | (122) | 1,977 |
| 2009 | 7,189 | 2,434 | (140) | 2,294 |
| 2010-2014 | 46,585 | 16,792 | (1,003) | 15,789 |

i. Net Periodic Cost.

MGE has elected to recognize the cost of its transition obligation (the accumulated postretirement benefit obligation as of January 1, 1993) by amortizing it on a straight-line basis over 20 years.

| <i>(In thousands)</i> | <u>Pension Benefits</u> | | | <u>Postretirement Benefits</u> | | |
|------------------------------------------|-------------------------|-----------------|-----------------|--------------------------------|-----------------|-----------------|
| Components of net periodic benefit cost: | <u>2004</u> | <u>2003</u> | <u>2002</u> | <u>2004</u> | <u>2003</u> | <u>2002</u> |
| Service cost | \$ 4,171 | \$ 3,418 | \$ 2,603 | \$ 1,852 | \$ 1,806 | \$ 1,062 |
| Interest cost | 8,579 | 8,023 | 7,514 | 3,076 | 3,248 | 2,190 |
| Expected return on assets | (8,848) | (7,023) | (8,556) | (849) | (627) | (687) |
| Amortization of: | | | | | | |
| Transition obligation | 239 | 104 | 104 | 434 | 434 | 434 |
| Prior service cost | 404 | 480 | 457 | 224 | 190 | 190 |
| Actuarial gain/(loss) | 958 | 1,444 | 147 | 815 | 1,155 | 285 |
| Net periodic benefit cost | <u>\$ 5,503</u> | <u>\$ 6,446</u> | <u>\$ 2,269</u> | <u>\$ 5,552</u> | <u>\$ 6,206</u> | <u>\$ 3,474</u> |

Weighted-average assumptions used to determine net periodic cost:

| | | | | | | |
|--------------------------------------|-------|-------|-------|-------|-------|-------|
| Discount rate | 6.25% | 6.75% | 7.25% | 6.25% | 6.75% | 7.25% |
| Expected return on plan assets . . . | 9.00% | 9.00% | 9.50% | 9.00% | 9.00% | 9.50% |
| Rate of compensation increase . . . | 4.50% | 4.50% | 4.50% | NA | NA | NA |

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A 1% change in the assumed health care cost trend rates would have had the following effect:

| <i>(In thousands)</i> | <u>1% Increase</u> | <u>1% Decrease</u> |
|----------------------------------------------------------------|--------------------|--------------------|
| Effect on total service and interest cost components | \$887 | \$(767) |

15. Risk Management Activities - MGE Energy and MGE.

Cash, cash equivalents, and customer accounts receivable are the financial instruments that potentially subject MGE Energy and MGE to concentrations of credit risk. MGE Energy and MGE place their cash and cash equivalents with high credit-quality financial institutions. MGE has limited concentrations of credit risk from customer accounts receivable because of the large number of customers and strong economy in its service territory.

In October 2004, MGE entered into a nonexchange-traded HDD Collar. Per the terms and conditions of this derivative agreement, MGE is subject to a floor and a ceiling based on forecasted heating degree days. If actual heating degree days exceed the ceiling, MGE is obligated to pay and if heating degree days are below the floor, MGE will receive payment. The payment or receipt under this agreement is not permitted to exceed \$1.0 million (excluding premium). The term of this agreement extends from November 1, 2004, until March 31, 2005, and the premium for this weather hedge is \$0.1 million. MGE is accounting for the HDD Collar using the intrinsic value method pursuant to the requirements of EITF No. 99-2, *Accounting for Weather Derivatives*. Through December 31, 2004, actual HDD were 1,954, resulting in a \$0.3 million gain for MGE.

MGE had an interest-rate swap agreement with a commercial bank totaling \$5.0 million for a portion of 2004, and all of 2003 and 2002. This agreement, which terminated on June 10, 2004, had a fixed rate and was backed by MGE's commercial paper. MGE recorded the changes in the fair market value currently in the income statement as required by SFAS No. 133 each quarter, which was offset by a corresponding regulatory asset or liability.

MGE purchased and sold exchange-traded option contracts to manage the cost of gas and purchased over-the-counter financial floating-to-fixed price swaps and calls to fix the price of gas for the “Winter Set-Price Firm Gas Sales Service” pilot program. These contracts have terms of January, February, and March 2005. Under MGE’s natural gas risk management program, approved by the PSCW, the cost of the financial option and swap contracts (as well as the gains or losses realized) will be recovered under the PGA and will not affect net income. The fair value of these financial contracts was a liability of \$1.0 million at December 31, 2004, and an asset of \$0.7 million at December 31, 2003.

Nonperformance of counterparties to the nonexchange-traded derivatives could expose MGE to credit loss. However, MGE enters into transactions only with companies that meet or exceed strict credit guidelines.

MGE has a 22.0% ownership interest in Columbia, which is operated by Alliant. Alliant has entered into a long-term coal supply agreement with Dynegy Marketing and Trade. The contract contains certain put options, and consequently, in accordance with the terms of SFAS No. 133, the contract is recorded at fair value on the balance sheet. Gains and losses are recorded in other income with an offsetting entry to a corresponding regulatory asset or liability.

16. Rate Matters - MGE Energy and MGE.

a. Rate proceedings.

On December 21, 2004, the PSCW authorized MGE to increase 2005 electric revenues by \$27.4 million and to decrease 2005 gas revenues by \$4.2 million. The increase to electric revenues will cover rising fuel costs, commercial operation of WCCF, and increased transmission expenses.

On January 14, 2004, the PSCW authorized MGE to increase revenues by \$12.8 million. The increase covers rising fuel costs for electric generation and addresses increased system demands for both gas and electric.

Effective March 1, 2003, the PSCW authorized MGE to increase revenues by \$27.1 million. The increase covered rising fuel costs and addressed increased system demands and costs to complete a new AMR project.

Effective January 1, 2002, the PSCW authorized MGE to increase revenues by \$12.0 million. The increase was associated with a limited reopener to address specific issues affecting 2002. These issues included the full-year impact of selling its ownership interest in Kewaunee, rising fuel costs, and installing an AMR system.

b. Fuel rules.

Actual electric fuel costs are subject to reconciliation to the amount approved by the PSCW in MGE’s rate order covering the applicable period. Known as “fuel rules,” the process can produce a fuel surcharge for MGE or require MGE to make a refund in the form of a credit, to the extent that the actual fuel costs are outside a 3.0% range higher or lower than the level authorized by the PSCW.

On August 10, 2004, the PSCW reopened MGE’s current rate docket for the limited purpose of determining whether a fuel credit was due for 2004 under the fuel rules. On September 30, 2004, MGE filed an application to decrease electric rates for 2004 by \$0.0025 per kWh, reflecting its view of the credit due customers under the fuel rules. This amount was subsequently revised to \$0.00275 per kWh. Based upon these filings, MGE recorded a reduction to electric revenues to reflect the fuel credit refund in the amount of \$3.4 million for 2004. \$1.8 million of this amount was credited on customers’ bills during 2004, and \$1.6 million of this amount will be refunded in January 2005.

During 2003, MGE submitted an application for a fuel cost credit. On August 14, 2003, the PSCW approved an interim fuel credit of \$0.00099 per kWh and also required a full review of the actual and forecasted costs for 2003, with MGE's fuel rates subject to refund. The fuel credit began on August 14, 2003, and ended on January 13, 2004. The fuel credit totaled \$4.4 million, of which \$1.2 million represents the interim fuel credit and \$3.2 million is the additional fuel credit, that resulted from PSCW review and was credited to customers in the first quarter of 2004. Of the \$3.2 million in additional fuel credit, \$0.4 million was from January 1 through January 13, 2004.

Effective October 24, 2002, the PSCW authorized an electric rate surcharge of \$4.5 million to recover deferred costs associated with forming ATC and ongoing incremental transmission costs during 2001 and 2002. The surcharge was in effect for a twelve-month period ending October 23, 2003 (see Footnotes 4 and 22 for additional information on ATC).

In July 2002, MGE notified the PSCW that its electric fuel costs were below the 3.0% range established in its most recent order, thus triggering a fuel credit to its customers. The fuel credit was \$1.2 million through December 31, 2002. The fuel credit continued through February 28, 2003.

17. Commitments.

a. Coal Contracts - MGE Energy and MGE.

MGE has coal contracts related to the Blount plant. None of these contracts contain demand obligations. Fuel procurement for MGE's jointly owned Columbia plant is handled by Alliant, the operating company. If any minimum purchase obligations must be paid under these contracts, management believes these obligations would be considered costs of service and recoverable in rates.

b. Purchased Power Contracts - MGE Energy and MGE.

MGE has several purchased power contracts to help meet future electric supply requirements. As of December 31, 2004, MGE's total commitments for energy and purchased power contracts for capacity are estimated to be \$16.7 million in 2005, \$13.5 million in 2006, \$10.5 million in 2007, and \$9.1 million in 2008 and 2009. Management expects to recover these costs in future customer rates.

Related to the purchased power contracts, MGE has negotiated several firm transmission contracts. As of December 31, 2004, MGE's total commitments for transmission are estimated to be \$1.1 million in 2005 and 2006, \$0.8 million in 2007, and \$0.6 million in 2008 and 2009. Beginning in 2007, transmission commitments may be reduced if transmission capacity is not available. Management also expects to recover these costs in future customer rates.

On July 16, 2004, MGE signed a 20-year power purchase agreement for 40 MW of wind energy to be located near Waupun, Wisconsin. This agreement is not reflected in the purchased power commitments figures above as MGE is not currently able to estimate the related commitment as the site has not yet been constructed.

c. Natural Gas Transportation and Storage Contracts - MGE Energy and MGE.

MGE's natural gas supply, transportation, and storage contracts require fixed monthly payments for firm supply pipeline transportation and storage capacity. The pricing components of the fixed monthly payments for the transportation and storage contracts are established by FERC but may be subject to change. As of December 31, 2004, these payments are estimated to be \$14.1 million in 2005, \$14.4 million in 2006, \$14.3 million in 2007, \$14.1 million in 2008, and \$13.7 million in 2009. Management expects to recover these costs in future customer rates.

d. Environmental - MGE Energy and MGE.

As a result of the Blount 69-kV transmission substation expansion, coal tar-contaminated soil and debris within the excavation zone are being removed and disposed of in accordance with a DNR approved "Removal Action Work Plan." MGE has paid \$1.5 million in expenses to complete this cleanup and expects to recover cleanup costs in future electric rates. Carrying costs associated with the cleanup expenditures will not be recoverable.

MGE is listed as a potentially responsible party for a site the EPA has placed on the national priorities Superfund list. The Lenz Oil site in Lemont, Illinois, was used for storing and processing waste oil for several years. This site requires clean up under the Comprehensive Environmental Response, Compensation and Liability Act. A group of companies, including MGE, is currently working on cleaning up the site.

Management believes that its share of the final cleanup costs will not result in any materially adverse effects on MGE's operations, cash flows, or financial position. Insurance may cover a portion of the cleanup costs. Management believes that the cleanup costs not covered by insurance will be recovered in current and future rates. At December 31, 2004, MGE accrued a \$0.1 million liability for this matter.

e. 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 August 31, 2005. At December 31, 2004, 2003, and 2002, respectively, MGE had sold a \$6.0 million, \$6.1 million, and \$6.8 million interest in these receivables, which MGE accounted for as a sale under SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities - a Replacement of FASB Statement No. 125*. MGE retains the servicing responsibility for these receivables.

MGE maintains responsibility for collecting and remitting loan payments from customers to the financial institution and does not retain any interest in the assets sold to the financial institution. As of December 31, 2004, 2003, and 2002, MGE has recorded a servicing asset of \$0.2 million, \$0.3 million, and \$0.2 million, respectively. In 2004, 2003, and 2002, gains of \$0.1 million, \$0.1 million, and \$0.2 million, respectively, were recognized in connection with the sale of loan assets. The servicing asset recognized and the amount amortized in 2004 was \$0.0 million. The loan assets are sold to the financial institution at cost, which approximates fair value in view of their market rates of interest. During 2004, 2003, and 2002, MGE received approximately \$1.2 million, \$1.3 million, and \$3.3 million, respectively, from the financial institution for the sale of loan assets. During those same years, payments of \$1.9 million, \$1.6 million, and \$2.4 million, respectively, were made by MGE to the financial institution.

MGE would be required to perform under the guarantee if the customer defaulted on their loan. The energy-related equipment installed at the customer sites is used to secure the customer loans. The length of the MGE guarantee to the financial institution varies from one to ten years depending on the term of the customer loan. Principal payments for the next five years on the loans are \$0.8 million in 2005 and 2006, \$0.7 million in 2007, \$0.9 million in 2008, and \$1.3 million in 2009.

MGE Energy has guaranteed debt service payments on a development project.

f. WCCF Purchase Commitments - MGE Energy.

MGE has entered into various contracts for the purchase of gas and steam turbines and

miscellaneous equipment for the WCCF. Most of these contracts have been assigned or are in the process of being assigned to MGE Construct. MGE Construct has entered into a contract for the purchase of chiller equipment, the purchase of miscellaneous equipment, project contractor services, and project management services. These contracts are summarized in the following table.

| <i>(In thousands)</i> | Contract Total | Payments through December 31, 2004 | Remaining Contract Amounts |
|--------------------------------------|------------------|---------------------------------------|-------------------------------|
| Gas turbines | \$ 30,296 | \$ 30,072 | \$ 224 |
| Steam turbine | 7,805 | 7,796 | 9 |
| Heat-recovery steam generators | 12,008 | 11,993 | 15 |
| Chiller equipment | 6,689 | 6,020 | 669 |
| Prime Contractors | 50,108 | 41,000 | 9,108 |
| Project management | 8,400 | 7,848 | 552 |
| Miscellaneous equipment | 39,444 | 34,079 | 5,365 |
| Total | <u>\$154,750</u> | <u>\$138,808</u> | <u>\$15,942</u> |

g. Leases - MGE Energy and MGE.

MGE has noncancelable operating leases, primarily for combustion turbines, trains, and computer equipment. The operating leases generally contain renewal options for periods ranging from one to ten years and require MGE to pay all executory costs such as maintenance and insurance.

Future minimum rental payments at December 31, 2004, under agreements classified as operating leases with noncancellable terms in excess of one year are as follows:

| <i>(In thousands)</i> | |
|-------------------------------------------|-----------------|
| 2005 | \$ 2,159 |
| 2006 | 1,915 |
| 2007 | 1,472 |
| 2008 | 1,269 |
| 2009 | 1,268 |
| Thereafter | <u>7,660</u> |
| Total minimum future lease payments . . . | <u>\$15,743</u> |

Rental expense under operating leases totaled \$2.4 million for 2004, \$2.1 million for 2003, and \$2.1 million for 2002.

18. Asset Retirement Obligations - MGE Energy and MGE.

Effective January 1, 2003, MGE recorded an obligation for the fair value of its legal liability for asset retirement obligations associated with removing an electric substation, a combustion turbine generating unit, wind generating facilities, and photovoltaic generating facilities, all of which are located on property not owned by MGE and would be removed upon the ultimate end of the lease. At December 31, 2004, this liability is estimated at \$1.5 million and is included in other deferred liabilities.

MGE also may have asset retirement obligations relating to various assets, such as combustion turbine generating units, small distributed generating units, aboveground and underground storage tanks, facilities located at Columbia (co-owned with Alliant and WPSC), and certain electric and gas distribution facilities. These facilities are generally located on property owned by third parties, on which MGE is permitted to operate by lease, permit, easement, license, or service agreement, but also include some facilities located on property owned by MGE. The asset retirement obligations associated with these facilities cannot be reasonably determined due to the indeterminate life of the related assets.

The pro forma asset retirement obligation MGE would have recognized as of January 1, 2002, had MGE implemented SFAS No. 143 as of that date, was approximately \$1.2 million based on the information, assumptions, and interest rates as of January 1, 2003, used to determine the \$1.4 million liability recognized upon initial adoption of SFAS No. 143. Because MGE's regulators are allowing these costs to be recovered in future rates, adoption of SFAS No. 143 in the first quarter of 2002 would have had no impact on net income and earnings per share of common stock. Accordingly, pro forma impacts are not presented.

The following table shows costs as of December 31, 2003, and changes to the asset retirement obligation and accumulated depreciation through December 31, 2004.

| <i>(In thousands)</i> | (a) | (b) | (c) (a + b) | (d) |
|-------------------------------------|--------------------------------------------|--------------------------|-----------------------------------|-----------------------------------------------|
| | Original Asset Retirement Obligation | Accumulated Accretion | Asset Retirement Obligation | Accumulated Depreciation- Related Asset |
| Balance, Dec. 31, 2003 | \$686 | \$675 | \$1,361 | \$175 |
| Changes through Dec. 31, 2004 | 27 | 86 | 113 | 29 |
| Balance, Dec. 31, 2004 | <u>\$713</u> | <u>\$761</u> | <u>\$1,474</u> | <u>\$204</u> |

MGE has a regulatory asset for the total accumulated accretion and total accumulated depreciation related to its asset retirement obligation.

Accumulated costs of removal that are non-SFAS No. 143 obligations are classified within the financial statements as regulatory liabilities. At December 31, 2004 and 2003, there were \$17.7 million and \$18.2 million of these costs recorded as regulatory liabilities within the financial statements, respectively.

19. WCCF - MGE Energy and MGE.

MGE Energy, through MGE Power, MGE Power West Campus, and MGE Construct, is building a natural gas-fired cogeneration facility on the UW-Madison campus. As planned, the facility will have capacity to produce 20,000 tons of chilled water, 500,000 pounds per hour of steam, and approximately 150 MW of electricity. The facility will be jointly owned by the UW and MGE Power West Campus. The UW will own a controlling interest in the chilled-water and steam plants, which will be used to meet the growing needs for air-conditioning and steam-heat capacity for the UW-Madison campus. MGE Power West Campus will own a controlling interest in the electric generation plant, which will be used to provide electricity to MGE's customers. MGE entered into a lease with MGE Power West Campus to lease the assets owned by MGE Power West Campus and will operate the entire facility. MGE Construct will be responsible for the construction of the facility. A PSCW order approving the issuance of a CPCN for the WCCF was received on October 9, 2003. Construction on the project commenced in October of 2003, and it is estimated that the project will be completed by 2nd quarter 2005. In 2004 and 2003, MGE Construct received service fees of \$2.7 million and \$1.0 million (pretax), respectively, from the State in relation to its role as EPC contractor for WCCF. The total fee of \$5.0 million is being recognized as services are rendered and will be collected over a 22-month period.

In accordance with the WCCF lease between MGE Power West Campus and MGE, MGE Power West Campus began billing MGE for carrying costs on WCCF. The carrying costs billed to MGE started on January 29, 2004, the date MGE received approval from the PSCW to defer these costs, and will continue through construction of the project. Carrying costs totaled \$8.3 million for the year ended December 31, 2004.

MGE Energy, MGE Power West Campus, and MGE Construct have assumed certain risks related to some of the executed agreements. In the EPC Agreement, MGE Power West Campus is responsible for cost overruns and MGE Construct is responsible for the construction process of the entire facility, including paying liquidated damages relating to failure to achieve the Mechanical Completion Date Guarantee and/or the Acceptance Test Capacity Guarantee. MGE Energy is the guarantor of MGE Construct's obligations under the EPC Agreement.

The expected cost to construct WCCF is approximately \$185 million in total, of which \$105 million is MGE Power West Campus' estimated portion. As of December 31, 2004, MGE Power West Campus had incurred \$95.7 million of costs on the project, which is reflected in construction work in progress on MGE Energy's and MGE's consolidated balance sheets. These costs represent amounts paid for equipment as well as other costs associated with construction of the facility.

20. Segment Information - MGE Energy and MGE.

Prior to 2003, MGE Energy operated in two business segments: electric utility operations and gas utility operations. In 2003, MGE Energy added a third segment for nonregulated energy operations as discussed below. The electric utility business generates and distributes electricity and contracts for transmission service. The gas utility business purchases and distributes natural gas and contracts for the transportation of natural gas. Both the electric and gas segments operate through MGE Energy's principal subsidiary MGE.

The nonregulated energy operations are conducted through MGE Energy's other subsidiaries: MGE Power, MGE Power West Campus, and MGE Construct. These subsidiaries have been formed to own and construct new electric generating capacity and are currently undertaking the construction of WCCF, a 150 MW cogeneration plant on the UW-Madison campus. Construction on this facility started in the fall of 2003. The table below shows key information about all three of these segments, including the distribution of net assets, for the years ended December 31.

General corporate expenses include the cost of executive management, corporate accounting and finance, information technology, risk management, human resources and legal functions, and employee benefits that are allocated to electric and gas based on formulas prescribed by the PSCW. Identifiable assets are those used in MGE's operations in each segment. Assets not allocated consist primarily of cash and cash equivalents, restricted cash, accounts receivable, and prepaid assets.

The following table shows segment information for MGE Energy's and MGE's operations:

(In thousands)

MGE Energy

| <i>Year ended December 31, 2004</i> | <u>Electric</u> | <u>Gas</u> | <u>Nonregulated</u> | <u>Consolidated</u> |
|-------------------------------------|------------------|------------------|---------------------|---------------------|
| Gross operating revenues | \$ 250,834 | \$ 179,343 | \$2,732 | \$432,909 |
| Interdepartmental revenues | (448) | (7,580) | - | (8,028) |
| Depreciation and amortization | (17,526) | (7,391) | - | (24,917) |
| Other operating expenses | (188,912) | (148,454) | (645) | (338,011) |
| Operating income | <u>\$ 43,948</u> | <u>\$ 15,918</u> | <u>\$2,087</u> | <u>\$ 61,953</u> |
| <i>Year ended December 31, 2003</i> | | | | |
| Gross operating revenues | \$ 242,264 | \$ 167,550 | \$1,023 | \$ 410,837 |
| Interdepartmental revenues | (519) | (7,748) | - | (8,267) |
| Depreciation and amortization | (16,437) | (6,907) | - | (23,344) |
| Other operating expenses | (183,622) | (134,346) | (404) | (318,372) |
| Operating income | <u>\$ 41,686</u> | <u>\$ 18,549</u> | <u>\$ 619</u> | <u>\$ 60,854</u> |
| <i>Year ended December 31, 2002</i> | | | | |
| Gross operating revenues | \$ 225,453 | \$ 126,639 | \$ - | \$ 352,092 |
| Interdepartmental revenues | (466) | (4,530) | - | (4,996) |
| Depreciation and amortization | (23,072) | (6,290) | - | (29,362) |
| Other operating expenses | (158,428) | (101,160) | (16) | (259,604) |
| Operating income | <u>\$ 43,487</u> | <u>\$ 14,659</u> | <u>\$ (16)</u> | <u>\$ 58,130</u> |

MGE

| | | | | |
|-------------------------------------|------------------|------------------|----------------|------------------|
| <i>Year ended December 31, 2004</i> | | | | |
| Gross operating revenues | \$ 250,834 | \$ 179,343 | \$ - | \$ 430,177 |
| Interdepartmental revenues | (448) | (7,580) | - | (8,028) |
| Depreciation and amortization | (17,526) | (7,391) | - | (24,917) |
| Other operating expenses | (205,723) | (153,677) | 3,180 | (356,220) |
| Operating income | <u>\$ 27,137</u> | <u>\$ 10,695</u> | <u>\$3,180</u> | <u>\$ 41,012</u> |
| <i>Year ended December 31, 2003</i> | | | | |
| Gross operating revenues | \$ 242,264 | \$ 167,550 | \$ - | \$ 409,814 |
| Interdepartmental revenues | (519) | (7,748) | - | (8,267) |
| Depreciation and amortization | (16,437) | (6,907) | - | (23,344) |
| Other operating expenses | (196,267) | (140,795) | (19) | (337,081) |
| Operating income | <u>\$ 29,041</u> | <u>\$ 12,100</u> | <u>\$ (19)</u> | <u>\$ 41,122</u> |
| <i>Year ended December 31, 2002</i> | | | | |
| Gross operating revenues | \$ 225,453 | \$ 126,639 | \$ - | \$ 352,092 |
| Interdepartmental revenues | (466) | (4,530) | - | (4,996) |
| Depreciation and amortization | (23,072) | (6,290) | - | (29,362) |
| Other operating expenses | (170,870) | (106,292) | - | (277,162) |
| Operating income | <u>\$ 31,045</u> | <u>\$ 9,527</u> | <u>\$ -</u> | <u>\$ 40,572</u> |

The following table shows the reconciliation of operating income by segment to net income:

(In thousands)

| | 2004 | 2003 | 2002 |
|--------------------------------------|------------------|------------------|------------------|
| MGE Energy | | | |
| Electric operating income | \$ 43,948 | \$ 41,686 | \$ 43,487 |
| Gas operating income | 15,918 | 18,549 | 14,659 |
| Nonregulated operating income/(loss) | 2,087 | 619 | (16) |
| Consolidated | <u>61,953</u> | <u>60,854</u> | <u>58,130</u> |
| Other income | 3,977 | 1,500 | 2,476 |
| Interest expense | (11,434) | (11,813) | (12,686) |
| Income tax provision | (20,656) | (19,901) | (18,727) |
| Net income | <u>\$ 33,840</u> | <u>\$ 30,640</u> | <u>\$ 29,193</u> |
| MGE | | | |
| Electric operating income | \$ 27,137 | \$ 29,041 | \$ 31,045 |
| Gas operating income | 10,695 | 12,100 | 9,527 |
| Nonregulated operating loss | 3,180 | (19) | - |
| Net operating income | 41,012 | 41,122 | 40,572 |
| Equity in earnings in ATC | 4,236 | 3,687 | 3,316 |
| Other income and deductions | (1,712) | (2,652) | (1,576) |
| Interest expense, net | (11,352) | (11,828) | (12,681) |
| Net income | <u>\$ 32,184</u> | <u>\$ 30,329</u> | <u>\$ 29,631</u> |

The following table shows segment information for MGE Energy's and MGE's assets and capital expenditures:

(In thousands)

| | Utility | | | Consolidated | | |
|------------------------------|-----------|-----------|----------------------|--------------|--------------|-----------|
| | Electric | Gas | Assets not Allocated | Nonregulated | Eliminations | Total |
| MGE Energy | | | | | | |
| <i>Assets:</i> | | | | | | |
| December 31, 2004 | \$478,436 | \$176,573 | \$74,663 | \$111,759 | \$(14,060) | \$827,371 |
| December 31, 2003 | 448,904 | 166,731 | 55,200 | 54,624 | (301) | 725,158 |
| December 31, 2002 | 421,771 | 154,806 | 52,819 | 20,798 | (179) | 650,015 |
| <i>Capital Expenditures:</i> | | | | | | |
| Year ended December 31, 2004 | 36,418 | 12,315 | - | 47,042 | (28) | 95,747 |
| Year ended December 31, 2003 | 40,833 | 13,875 | - | 28,262 | - | 82,970 |
| Year ended December 31, 2002 | 42,940 | 15,209 | - | 18,852 | - | 77,001 |
| MGE | | | | | | |
| <i>Assets:</i> | | | | | | |
| December 31, 2004 | 478,436 | 176,573 | 74,663 | 101,800 | (13,396) | 818,076 |
| December 31, 2003 | 448,923 | 166,731 | 54,899 | 48,928 | (19) | 719,462 |
| December 31, 2002 | 421,771 | 154,806 | 52,799 | - | - | 629,376 |
| <i>Capital Expenditures:</i> | | | | | | |
| Year ended December 31, 2004 | 36,418 | 12,315 | - | 47,042 | - | 95,775 |
| Year ended December 31, 2003 | 40,833 | 13,875 | - | 28,262 | - | 82,970 |
| Year ended December 31, 2002 | 42,940 | 15,209 | - | - | - | 58,149 |

21. Quarterly Summary of Operations - MGE Energy (unaudited).

(In thousands, except per-share amounts)

| | Quarters Ended | | | |
|-----------------------------|------------------|-----------------|------------------|-----------------|
| | March 31 | June 30 | Sept. 30 | Dec. 31 |
| 2004 | | | | |
| Operating revenues: | | | | |
| Regulated electric revenues | \$ 59,911 | \$ 61,426 | \$ 69,771 | \$ 59,278 |
| Regulated gas revenues | 74,688 | 23,306 | 16,388 | 57,381 |
| Nonregulated revenues | 682 | 682 | 681 | 687 |
| Total | <u>135,281</u> | <u>85,414</u> | <u>86,840</u> | <u>117,346</u> |
| Operating expenses | <u>111,309</u> | <u>74,572</u> | <u>70,534</u> | <u>106,513</u> |
| Operating income | 23,972 | 10,842 | 16,306 | 10,833 |
| Interest and other income | (1,272) | (1,534) | (2,067) | (2,584) |
| Income tax provision | <u>(8,909)</u> | <u>(3,481)</u> | <u>(5,131)</u> | <u>(3,135)</u> |
| Earnings on common stock | <u>\$ 13,791</u> | <u>\$ 5,827</u> | <u>\$ 9,108</u> | <u>\$ 5,114</u> |
| Earnings per common share | <u>\$0.75</u> | <u>\$0.31</u> | <u>\$0.48</u> | <u>\$0.25</u> |
| Dividends per share | \$0.338 | \$0.338 | \$0.342 | \$0.342 |
| 2003 | | | | |
| Operating revenues: | | | | |
| Regulated electric revenues | \$ 56,099 | \$ 58,607 | \$ 72,811 | \$ 54,228 |
| Regulated gas revenues | 72,395 | 24,041 | 15,120 | 48,246 |
| Nonregulated revenues | - | - | - | 1,023 |
| Total | <u>128,494</u> | <u>82,648</u> | <u>87,931</u> | <u>103,497</u> |
| Operating expenses | <u>111,043</u> | <u>71,015</u> | <u>68,238</u> | <u>91,420</u> |
| Operating income | 17,451 | 11,633 | 19,693 | 12,077 |
| Interest and other income | (2,035) | (1,991) | (2,797) | (3,490) |
| Income tax provision | <u>(6,041)</u> | <u>(3,809)</u> | <u>(6,788)</u> | <u>(3,263)</u> |
| Earnings on common stock | <u>\$ 9,375</u> | <u>\$ 5,833</u> | <u>\$ 10,108</u> | <u>\$ 5,324</u> |
| Earnings per common share | <u>\$0.53</u> | <u>\$0.33</u> | <u>\$0.56</u> | <u>\$0.29</u> |
| Dividends per share | \$0.336 | \$0.336 | \$0.338 | \$0.338 |

Notes:

- Operating income and earnings on common stock for the three months ended March 31, 2004 and June 30, 2004 have been adjusted to reflect a reduction in net periodic postretirement benefit cost of \$0.1 million for each period due to the adoption of FSP FAS 106-2. See Footnote 14 for additional information.
- Operating income for the three months ended December 31, 2003 has been adjusted to reflect a reclassification from other income to nonregulated operating revenues, for comparison purposes related to the service fee received from the State by MGE Construct.
- The quarterly results of operations within a year may not be comparable because of seasonal and other factors.
- The sum of earnings per share of common stock for any four quarters may vary slightly from the earnings per share of common stock for the equivalent twelve-month period due to rounding and seasonality.
- MGE Energy's operations are based primarily on its utility subsidiary MGE.

22. Related Party Transactions - MGE Energy and MGE.*ATC*

On November 21, 2002, MGE and ATC entered into an interconnection agreement related to transmission system upgrades for WCCF. MGE issued to ATC a “Notice to Proceed for the Procurement of the Equipment” for the system upgrades. MGE has advanced funds for construction of transmission equipment and work done by ATC related to WCCF in the amounts of \$2.3 million and \$9.2 million in 2004 and 2003, respectively. Total funds advanced to ATC for this project are \$12.8 million. MGE does not expect to make any additional advances to ATC in 2005 related to WCCF. MGE will be reimbursed by ATC for all previously advanced funds plus interest, upon completion of the project.

During 2004, 2003, and 2002, MGE paid ATC \$12.7 million, \$9.1 million, and \$7.7 million, respectively for transmission services. MGE also provides a variety of operational, maintenance, and project management work for ATC, which is reimbursed by ATC. At December 31, 2004 and 2003, MGE had a payable balance to ATC of \$18.5 million and \$20.2 million, respectively. At December 31, 2004 and 2003, MGE had a receivable due from ATC of \$10.6 million and \$14.0 million, respectively (including funds advanced to ATC related to WCCF). For additional discussion on MGE’s relationship with ATC see Footnotes 4 and 22.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

MGE Energy and MGE

None.

Item 9A. Controls and Procedures.

MGE Energy

Management's Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15f. Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an assessment of the effectiveness of our internal control over financial reporting based on the framework in Internal Control- Integrated Framework issued by the Committee Sponsoring Organizations of the Treadway Commission. Based on our assessment under the framework in Internal Control- Integrated Framework, our management concluded that our internal control over financial reporting was effective as of December 31, 2004.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Our management's assessment of the effectiveness of our internal control over financial reporting as of December 31, 2004, has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which is included herein.

MGE Energy and MGE

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

Each registrant's management, including the principal executive officer and principal financial officer, evaluated its disclosure controls and procedures related to the recording, processing, summarization, and reporting of information in its periodic reports that it files with the SEC. These disclosure controls and procedures have been designed to ensure that material information relating to that registrant, including its subsidiaries, is accumulated and made known to that registrant's management, including its principal executive officer and its principal executive financial officer, by other employees of that registrant and its subsidiaries as appropriate to allow timely decisions regarding required disclosure, and that this information is recorded, processed, summarized, evaluated, and reported, as applicable, within the time periods specified in the SEC's rules and forms. Due to the inherent limitations of control systems, not all misstatements may be detected. These inherent limitations include the realities that judgments in decision making can be faulty and breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. Also, the registrants do not control or manage certain of their unconsolidated entities, and thus, their access and ability to apply their procedures to those entities is more limited than is the case for their consolidated subsidiaries.

As of December 31, 2004, the principal executive officer and principal financial officer of each registrant concluded that such registrant's disclosure controls and procedures were effective to accomplish their objectives (as defined in the SEC Act of 1934 Rules 13a-15(e) and 15d-15(e)). Each registrant intends to continually strive to improve its disclosure controls and procedures to enhance the quality of its financial reporting.

Item 9B. Other Information.

MGE Energy

On October 15, 2004, MGE Energy's Board of Directors approved a change to compensation for directors who are not employees of MGE Energy or its subsidiaries. As approved, directors who are not employees of MGE receive an annual retainer of \$16,000, plus \$1,200 for each Board meeting attended and \$750 for each Audit, Compensation, Executive, or Personnel Committee meeting attended. Mr. Wolter receives no additional compensation for serving as a director. The chairperson of the Audit Committee receives an additional \$10,000 retainer. The chairperson of the Compensation Committee receives an additional \$5,000 retainer.

PART III.

Item 10. Directors and Executive Officers of the Registrants.

MGE Energy

The information required by Item 10 relating to directors and nominees for election as directors at MGE Energy's annual meeting of shareholders is incorporated herein by reference to the information under the heading "ELECTION OF DIRECTORS" (not including the information under the subheading "Audit Committee Report," which is not incorporated herein) in MGE Energy's definitive proxy statement (2005 Proxy Statement) to be filed with the SEC prior to April 29, 2005.

The information required by Item 10 relating to executive officers is set forth above in Item 1. Business - Executive Officers of the Registrants.

Code of Ethics

MGE Energy has adopted a Code of Ethics applicable to its directors and all of its employees, including its chief executive officer, chief financial officer, and principal accounting officer. The Code of Ethics is available on MGE Energy's Web site at www.mgeenergy.com.

Item 11. Executive Compensation.

See Item 12.

Item 12. Security Ownership of Certain Beneficial Owners and Management.

MGE Energy

The required information for Items 11 and 12 is included in MGE Energy's 2005 Proxy Statement under the section "Executive Compensation," not including "Report on Executive Compensation" and "Company Performance," and under the section "Beneficial Ownership of Common Stock," which is incorporated herein by reference.

Item 13. Certain Relationships and Related Transactions.

MGE Energy

None.

Item 14. Principal Accountant Fees and Services.

MGE Energy

The information required by Item 14 is incorporated herein by reference to the information under the heading "OTHER INFORMATION - Independent Accountants" in MGE Energy's 2005 Proxy Statement.

MGE

Independent Accountant Fees Disclosure

| | <u>2004</u> | <u>2003</u> |
|---------------------------------------------------------------------|------------------|------------------|
| Audit Fees: | | |
| Audit of financial statements and Internal Controls (1) | \$815,988 | \$190,220 |
| Review of SEC filings and comfort letters | <u>12,000</u> | <u>10,200</u> |
| Total Audit Fees | <u>\$827,988</u> | <u>\$200,420</u> |
| Audit-Related Fees: | | |
| Financial accounting and reporting standards consultation | \$ 40,000 | \$ 14,000 |
| Fee to access online accounting standards library (2) | <u>1,500</u> | <u>1,400</u> |
| Total Audit-Related Fees | <u>\$ 41,500</u> | <u>\$ 15,400</u> |
| Tax Fees: | | |
| Review of federal and state income tax returns | \$ 16,000 | \$ 14,900 |
| Tax advice on financial accounting issues | <u>0</u> | <u>6,400</u> |
| Total Tax Fees | <u>\$ 16,000</u> | <u>\$ 21,300</u> |
| All Other Fees: | | |
| Financial analysis for generation projects | <u>\$ 87,500</u> | <u>\$198,400</u> |
| Total All Other Fees | <u>\$ 87,500</u> | <u>\$198,400</u> |

- (1) The increase in 2004 reflects the increased work that was required in connection with the independent registered public accounting firms' attestation report on MGE Energy's assessment of its internal control over financial reporting.
- (2) Annual license fee to access online library of professional financial reporting and assurance literature maintained by PricewaterhouseCoopers LLP, which library we consult in the preparation of our financial statements.

MGE is a wholly owned subsidiary of MGE Energy and does not have a separate audit committee. Instead, that function is fulfilled for MGE by the MGE Energy Audit Committee. The Audit Committee approves each engagement of the independent registered public accounting firm to render any audit or non-audit services before the firm is engaged to render those services. The Chair of the Audit Committee or other designated Audit Committee member may represent the entire Audit Committee for purposes of this approval. Any services approved by the Chair or other designated Audit Committee member are reported to the full Audit Committee at the next scheduled Audit Committee meeting. No de minimis exceptions to this approval process are allowed under the Audit Committee Charter; and thus, none of the services described in the preceding table were approved pursuant to Rule 2-01(c)(7)(i)(C) of Regulation S-X.

PART IV.

Item 15. Exhibits and Financial Statement Schedules.

(a) 1. Financial Statements.

MGE Energy

| | |
|--------------------------------------------------------------------------------------------------------------------|----|
| Report of Independent Registered Public Accounting Firm | 43 |
| Consolidated Statements of Income for the years ended December 31, 2004, 2003, and 2002 | 46 |
| Consolidated Statements of Cash Flows for the years ended December 31, 2004, 2003, and 2002 | 47 |
| Consolidated Balance Sheets as of December 31, 2004 and 2003 | 48 |
| Consolidated Statements of Capitalization as of December 31, 2004 and 2003 | 49 |
| Consolidated Statements of Common Equity and Comprehensive Income as of December 31, 2004, 2003, and 2002 | 50 |
| Notes to Consolidated Financial Statements | 56 |

MGE

| | |
|--------------------------------------------------------------------------------------------------------------------|----|
| Report of Independent Registered Public Accounting Firm | 45 |
| Consolidated Statements of Income for the years ended December 31, 2004, 2003, and 2002 | 51 |
| Consolidated Statements of Cash Flows for the years ended December 31, 2004, 2003, and 2002 | 52 |
| Consolidated Balance Sheets as of December 31, 2004 and 2003 | 53 |
| Consolidated Capitalization Statement as of December 31, 2004 and 2003 | 54 |
| Consolidated Statements of Common Equity and Comprehensive Income as of December 31, 2004, 2003, and 2002 | 55 |
| Notes to Consolidated Financial Statements | 56 |

2. Financial Statement Schedule.

Schedule II - Valuation and Qualifying Accounts for MGE Energy, Inc. and Madison Gas and Electric Company.

All other schedules have been omitted because they are not applicable or not required, or because the required information is shown in the consolidated financial statements or notes thereto.

3. All Exhibits Including Those Incorporated by Reference.

Exhibits. Certain of the following exhibits are incorporated herein by reference under Rule 12b-32 of the Securities and Exchange Act of 1934, as amended, as indicated by the parenthetical reference. Certain other instruments which would otherwise be required to be listed below have not been so listed because such instruments do not authorize securities in an amount which exceeds 10% of the total assets of the applicable registrant and its subsidiaries on a consolidated basis and the relevant registrant agrees to furnish a copy of any such instrument to the Commission upon request. An asterisk (*) indicates a management contract or compensatory plan or arrangement.

3.1 Amended and Restated Articles of Incorporation of MGE Energy. (Exhibit 3.1 to MGE Energy's Registration Statement on Form S-4, Registration No. 333-72694.)

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- 3.2 Amended and Restated Bylaws of MGE Energy. (Exhibit 3.2 to MGE Energy's Registration Statement on Form S-4, Registration No. 333-72694.)
 - 3.3 Articles of Incorporation of MGE as in effect at May 6, 1996. (Exhibit 3.(i) to Form 10-K for year ended December 31, 1996, File No. 0-1125.)
 - 3.4 Amended Bylaws of MGE as in effect at August 16, 2002. (Exhibit 3.4 to Form 10-K for year ended December 31, 2002, File No. 0-1125.)
 - 4.1 Indenture of Mortgage and Deed of Trust between MGE and Firststar Trust Company, as Trustee, dated as of January 1, 1946. (Exhibit 7-D to SEC File No. 0-1125.)
 - 4.2 Supplemental Indenture to aforementioned Mortgage and Deed of Trust.

| <u>Supplemental Indenture</u> | <u>Dated as of</u> | <u>Exhibit No.</u> | <u>SEC File No.</u> |
|-------------------------------|--------------------|--------------------|-------------------------------------------------------------|
| Seventeenth | February 1, 1993 | 4F | Form 10-K for year ended December 31, 1992, File No. 0-1125 |

- 4.3 Indenture between MGE and Bank One, N.A., as Trustee, dated as of September 1, 1998. (Exhibit 4B to Form 10-K for year ended December 31, 1999, File No. 0-1125.)
- 10.1 Copy of Joint Power Supply Agreement with Wisconsin Power and Light Company and Wisconsin Public Service Corporation dated February 2, 1967. (Exhibit 4.09 to Registration Statement, Registration No. 2-27308.)
- 10.2 Copy of Joint Power Supply Agreement (Exclusive of Exhibits) with Wisconsin Power and Light Company and Wisconsin Public Service Corporation dated July 26, 1973, amending Exhibit 5.04. (Exhibit 5.04A to Registration Statement, Registration No. 2-48781.)
- 10.3 Copy of revised Agreement for Construction and Operation of Columbia Generating Plant with Wisconsin Power and Light Company and Wisconsin Public Service Corporation dated July 26, 1973. (Exhibit 5.07 to Registration Statement, Registration No. 2-48781.)
- 10.4* Form of Severance Agreement. (Exhibit 10F to Form 10-K for the year ended December 31, 1994, File No. 0-1125.)
- 10.5 Line of Credit Note dated September 29, 2004, from MGE Energy, Inc. to Bank One, NA (Exhibit 10.1 to Form 10-Q for the quarter ended September 30, 2004, File No. 0-49965)
- 10.6 Credit Agreement dated as of July 14, 2004, among Madison Gas and Electric Company, the Lenders party thereto, and Bank One, NA, as Administrative Agent (Exhibit 10.1 to Form 10-Q for the quarter ended June 30, 2004, File No. 0-1125)
- 10.7 Line of Credit Note dated December 29, 2004, from Madison Gas and Electric Company to JPMorgan Chase Bank, N.A. (Exhibit 10.1 to Form 8-K dated December 30, 2004, File No. 0-1125)

Statements regarding computation of ratio of earnings to fixed charges:

- 12.1 MGE Energy, Inc.
- 12.2 Madison Gas and Electric Company
- 21.1 Subsidiaries of MGE Energy, Inc.

23.1 Consent of Independent Registered Public Accounting Firm - MGE Energy, Inc.

Certifications Pursuant to Rule 13a-14(a) and 15d-14(a) of the Securities and Exchange Act of 1934 as to the Annual Report on Form 10-K for the year ended December 31, 2004, filed by the following officers for the following companies:

- 31.1 Filed by Gary J. Wolter for MGE Energy, Inc.
- 31.2 Filed by Terry A. Hanson for MGE Energy, Inc.
- 31.3 Filed by Gary J. Wolter for Madison Gas and Electric Company
- 31.4 Filed by Terry A. Hanson for Madison Gas and Electric Company

Certifications Pursuant to Section 1350 of Chapter 63 of Title 18 United States Code (Sarbanes-Oxley Act of 2002) as to the Annual Report on Form 10-K for the year ended December 31, 2004, filed by the following officers for the following companies:

- 32.1 Filed by Gary J. Wolter for MGE Energy, Inc.
- 32.2 Filed by Terry A. Hanson for MGE Energy, Inc.
- 32.3 Filed by Gary J. Wolter for Madison Gas and Electric Company
- 32.4 Filed by Terry A. Hanson for Madison Gas and Electric Company

Schedule II

MGE Energy, Inc. and Madison Gas and Electric Company

Valuation and Qualifying Accounts

| | | Additions | | | |
|-------------------------------------------------------|--------------------------------------|--------------------------------------------|----------------------------------------|--------------------------------|-----------------------------|
| | Balance at beginning of period | (1) Charged to costs and expenses | (2) Charged to other accounts | Net Accounts written off | Balance at end of period |
| Fiscal Year 2002: | | | | | |
| Accumulated provision for uncollectibles | (3,764,327) | (1,149,000) | - | 2,254,073 | (2,659,254) |
| Fiscal Year 2003: | | | | | |
| Accumulated provision for uncollectibles | (2,659,254) | (1,765,463) | - | 1,689,269 | (2,735,448) |
| Fiscal Year 2004: | | | | | |
| Accumulated provision for uncollectibles | (2,735,448) | (2,106,711) | - | 2,087,311 | (2,754,848) |

Signatures - MGE Energy, Inc.

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, hereunto duly authorized.

MGE Energy, Inc.
(Registrant)

Date: March 11, 2005

/s/ Gary J. Wolter

Chairman, President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on March 11, 2005.

/s/ Gary J. Wolter

Gary J. Wolter
Chairman, President and Chief Executive Officer and Director
(Principal Executive Officer)

/s/ Terry A. Hanson

Terry A. Hanson
Vice President, Chief Financial Officer and Secretary
(Principal Financial Officer and Principal Accounting Officer)

/s/ Richard E. Blaney

Richard E. Blaney, Director

/s/ F. Curtis Hastings

F. Curtis Hastings, Director

/s/ Regina M. Millner

Regina M. Millner, Director

/s/ Frederic E. Mohs

Frederic E. Mohs, Director

/s/ John R. Nevin

John R. Nevin, Director

/s/ Donna K. Sollenberger

Donna K. Sollenberger, Director

/s/ H. Lee Swanson

H. Lee Swanson, Director

Signatures - Madison Gas and Electric Company

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, hereunto duly authorized.

Madison Gas and Electric Company
(Registrant)

Date: March 11, 2005

/s/ Gary J. Wolter

Chairman, President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on March 11, 2005.

/s/ Gary J. Wolter

Gary J. Wolter
Chairman, President and Chief Executive Officer and Director
(Principal Executive Officer)

/s/ Terry A. Hanson

Terry A. Hanson
Vice President, Chief Financial Officer and Secretary
(Principal Financial Officer and Principal Accounting Officer)

/s/ Richard E. Blaney

Richard E. Blaney, Director

/s/ F. Curtis Hastings

F. Curtis Hastings, Director

/s/ Regina M. Millner

Regina M. Millner, Director

/s/ Frederic E. Mohs

Frederic E. Mohs, Director

/s/ John R. Nevin

John R. Nevin, Director

/s/ Donna K. Sollenberger

Donna K. Sollenberger, Director

/s/ H. Lee Swanson

H. Lee Swanson, Director