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

**FORM 10-Q**

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

For the quarterly period ended:

**June 30, 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	<b>MGE Energy, Inc.</b> <i>(a Wisconsin Corporation)</i> 133 South Blair Street Madison, Wisconsin 53703 (608) 252-7000	39-2040501
000-1125	<b>Madison Gas and Electric Company</b> <i>(a Wisconsin Corporation)</i> 133 South Blair Street Madison, Wisconsin 53703 (608) 252-7000  <b>www.mge.com and/or</b> <b>www.mgeenergy.com</b> <i>(Web sites)</i>	39-0444025

Indicate by check mark whether the registrants (1) have filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months and (2) have been subject to such filing requirements for the past 90 days: Yes ☒ No ☐

Indicate by check mark whether the registrants are an accelerated filer (as defined in Rule 12b-2 of the Exchange Act):  
MGE Energy, Inc. Yes ☒ No ☐ Madison Gas and Electric Company Yes ☐ No ☒

**Number of shares outstanding of each class of common stock as of August 9, 2004**

MGE Energy, Inc.	Common stock, \$1.00 par value, 18,831,249 shares outstanding.
Madison Gas and Electric Company	Common stock, \$1.00 par value, 17,347,889 shares outstanding (all of which are owned beneficially and of record by MGE Energy, Inc.).

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

### **Filing Format**

This combined Form 10-Q is being filed separately by MGE Energy, Inc. (MGE Energy) and Madison Gas and Electric Company (MGE). MGE is a wholly owned subsidiary of MGE Energy and represents a 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.

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## 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 that may be 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
AMR	automated meter reading
APBO	Accumulated Postretirement Benefit Obligation
ATC	American Transmission Company LLC
Alliant	Alliant Energy Corporation
Blount	Blount Station
BOCM	Banc One Capital Markets, Inc.
CPCN	Certificate of Public Convenience and Necessity
CO <sub>2</sub>	carbon dioxide
Columbia	Columbia Energy Center
ComEd	Commonwealth Edison, a unit of Chicago-based Exelon Corporation
CWDC	Central Wisconsin Development Corporation
DNR	Wisconsin Department of Natural Resources
DOA	Wisconsin Department of Administration
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	Financial Interpretation No.
FTR	Financial Transmission Rights
GCIM	gas cost incentive mechanism
interconnection agreement	Generation-Transmission Interconnection Agreement
heating degree days	Measure of the extent to which the average daily temperature is below 65 degrees Fahrenheit, increasing demand for heating
Kewaunee	Kewaunee Nuclear Power Plant
kV	kilovolt
kWh	kilowatt-hour
LMP	Locational Marginal Pricing
MACT	Maximum available control technology
MAGAEL	MAGAEL, LLC
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

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Midwest ISO	Midwest Independent System Operator (a regional transmission organization)
Moody's	Moody's Investors Service, Inc.
MW	megawatt
Nasdaq	The Nasdaq National Stock Market
NO <sub>x</sub>	nitrogen oxide
NO <sub>x</sub> SIP Call	Nitrogen oxide State Implementation Plan (federal rule 40 CFR Part 96, commonly referred to as the NO <sub>x</sub> SIP Call)
PGA clause	Purchased Gas Adjustment clause
PJM	PJM Interconnection, LLC (a regional transmission organization)
PSCW	Public Service Commission of Wisconsin
RTO	Regional Transmission Organization
S&P	Standard & Poor's Ratings Group, a division of The McGraw-Hill Companies, Inc.
SEC	Securities and Exchange Commission
SFAS	Statement of Financial Accounting Standards (issued by the FASB)
SO <sub>2</sub>	sulfur dioxide
the State	State of Wisconsin
UW	University of Wisconsin-Madison
VIE	Variable Interest Entity
WCCF	West Campus Cogeneration Facility
WDOJ	Wisconsin Department of Justice
WELA	Wisconsin Environmental Law Advocates
Working capital	current assets less current liabilities
WPL	Wisconsin Power and Light Company
WPSC	Wisconsin Public Service Corporation

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**Item 1. Financial Statements.**

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
<b>Revenues:</b>				
Regulated utility operations . . . . .	\$84,732	\$82,648	\$219,331	\$211,142
Nonregulated operations . . . . .	682	-	1,364	-
<b>Total Revenues</b> . . . . .	<u>85,414</u>	<u>82,648</u>	<u>220,695</u>	<u>211,142</u>
<b>Expenses:</b>				
Fuel for electric generation . . . . .	11,870	9,540	23,109	20,121
Purchased power . . . . .	11,919	11,616	23,915	25,982
Natural gas purchased . . . . .	13,671	14,140	65,386	64,953
Other operations and maintenance . . . . .	28,005	26,817	55,140	53,347
Depreciation and amortization . . . . .	6,150	6,049	12,211	11,761
Other general taxes . . . . .	3,104	2,853	6,414	5,894
<i>Total Operating Expenses</i> . . . . .	<u>74,719</u>	<u>71,015</u>	<u>186,175</u>	<u>182,058</u>
<b>Operating Income</b> . . . . .	<u>10,695</u>	<u>11,633</u>	<u>34,520</u>	<u>29,084</u>
Other income . . . . .	1,190	885	2,769	1,726
Interest expense, net . . . . .	(2,724)	(2,876)	(5,575)	(5,752)
Income before income taxes . . . . .	9,161	9,642	31,714	25,058
Income tax provision . . . . .	(3,481)	(3,809)	(12,390)	(9,850)
<b>Net Income</b> . . . . .	<u>\$ 5,680</u>	<u>5,833</u>	<u>\$ 19,324</u>	<u>\$ 15,208</u>
Other Comprehensive Income (net of tax) . . . . .	248	-	248	-
<b>Total Comprehensive Income</b> . . . . .	<u>\$ 5,928</u>	<u>\$ 5,833</u>	<u>\$ 19,572</u>	<u>\$ 15,208</u>
<b>Earnings per Share of Common Stock</b>				
(basic and diluted) . . . . .	<u>\$0.30</u>	<u>\$0.33</u>	<u>\$1.04</u>	<u>\$0.86</u>
Dividends paid per share of common stock . . . . .	<u>\$0.338</u>	<u>\$0.336</u>	<u>\$0.676</u>	<u>\$0.672</u>
<b>Weighted Average Shares Outstanding</b> (basic and diluted) . . . . .	<u>18,657</u>	<u>17,787</u>	<u>18,541</u>	<u>17,711</u>

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

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

	Six Months Ended June 30,	
	2004	2003
<b>Operating Activities:</b>		
Net income	\$19,324	\$15,208
Items not affecting cash:		
Depreciation and amortization	12,211	11,761
Deferred income taxes	4,058	1,121
Amortization of investment tax credits	(251)	(258)
Amortization of debt issuance costs and bond discount	260	239
Other	(439)	(217)
Equity in earnings of ATC	(2,038)	(1,821)
Dividend income from ATC	1,473	1,280
Prepayment to ATC	-	5,000
Gain on the sale of property	(579)	-
Changes in working capital, excluding cash equivalents, current long-term debt maturities, and short-term debt:		
Decrease in current assets	21,288	19,161
Increase (decrease) in current liabilities	791	(3,496)
Other noncurrent items, net	(808)	7,288
<i>Cash provided by operating activities</i>	<u>55,290</u>	<u>55,266</u>
<b>Investing Activities:</b>		
Capital expenditures	(50,035)	(53,729)
Advance to ATC related to WCCF	(2,001)	(2,636)
ATC - capital call	(1,757)	-
Proceeds from sale of property	612	-
Other	556	(102)
<i>Cash used for investing activities</i>	<u>(52,625)</u>	<u>(56,467)</u>
<b>Financing Activities:</b>		
Issuance of common stock	13,562	8,486
Cash dividends on common stock	(12,557)	(11,900)
Repayments of debt	(20,000)	(13,500)
Borrowings of debt	17,200	25,436
<i>Cash (used for) provided by financing activities</i>	<u>(1,795)</u>	<u>8,522</u>
<b>Change in Cash and Cash Equivalents</b>	870	7,321
Cash and cash equivalents at beginning of period	2,020	2,998
Cash and cash equivalents at end of period	<u>\$ 2,890</u>	<u>\$10,319</u>

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

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

	June 30, 2004	Dec. 31, 2003
<b>ASSETS</b>		
<b>Current Assets:</b>		
Cash and cash equivalents .....	\$ 2,890	\$ 2,020
Restricted cash .....	2,938	3,364
Accounts receivable, less allowance for doubtful accounts of \$2,672 and \$2,735, respectively .....	32,749	37,713
Unbilled revenues .....	13,727	21,644
Materials and supplies, at lower of average cost or market .....	8,974	7,851
Fossil fuel, at lower of average cost or market .....	5,153	5,054
Stored natural gas, at lower of average cost or market .....	13,559	18,598
Prepaid taxes .....	9,804	14,063
Other prepayments .....	1,825	2,156
<i>Total Current Assets</i> .....	<u>91,619</u>	<u>112,463</u>
Special billing projects .....	17,824	14,574
Regulatory assets .....	11,555	8,241
Deferred charges .....	16,332	17,605
<b>Property, Plant, and Equipment, Net</b> .....	457,212	449,022
Construction work in progress .....	117,849	88,489
<i>Total Property, Plant, and Equipment</i> .....	<u>575,061</u>	<u>537,511</u>
<b>Other Property and Investments</b> .....	34,236	31,293
<b>Total Assets</b> .....	<u><u>\$746,627</u></u>	<u><u>\$721,687</u></u>
<b>LIABILITIES AND CAPITALIZATION</b>		
<b>Current Liabilities:</b>		
Long-term debt - due within one year .....	\$ 15,000	\$ 20,000
Short-term debt .....	33,880	31,680
Accounts payable .....	38,403	35,043
Accrued taxes .....	878	-
Accrued interest .....	3,095	2,968
Other current liabilities .....	12,300	15,874
<i>Total Current Liabilities</i> .....	<u>103,556</u>	<u>105,565</u>
<b>Other Credits:</b>		
Deferred income taxes .....	79,583	75,525
Investment tax credit - deferred .....	4,640	4,891
Regulatory liabilities .....	29,599	34,469
Other deferred liabilities .....	43,338	35,963
<i>Total Other Credits</i> .....	<u>157,160</u>	<u>150,848</u>
<b>Capitalization:</b>		
Common stockholders' equity .....	283,681	263,070
Long-term debt .....	202,230	202,204
<i>Total Capitalization</i> .....	<u>485,911</u>	<u>465,274</u>
Commitments and contingencies .....	-	-
<b>Total Liabilities and Capitalization</b> .....	<u><u>\$746,627</u></u>	<u><u>\$721,687</u></u>

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



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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
<b>Operating Revenues:</b>				
Regulated electric revenues .....	\$61,426	\$58,607	\$121,337	\$114,706
Regulated gas revenues .....	23,306	24,041	97,994	96,436
<i>Total Operating Revenues</i> .....	<u>84,732</u>	<u>82,648</u>	<u>219,331</u>	<u>211,142</u>
<b>Operating Expenses:</b>				
Fuel for electric generation .....	11,870	9,540	23,109	20,121
Purchased power .....	11,919	11,616	23,915	25,982
Natural gas purchased .....	13,671	14,140	65,386	64,953
Other operations and maintenance .....	27,923	26,768	54,987	53,283
Depreciation and amortization .....	6,150	6,049	12,211	11,761
Other general taxes .....	3,098	2,846	6,401	5,886
Income tax provision .....	2,721	3,490	10,829	9,212
<i>Total Operating Expenses</i> .....	<u>77,352</u>	<u>74,449</u>	<u>196,838</u>	<u>191,198</u>
<b>Net Operating Income</b> .....	<u>7,380</u>	<u>8,199</u>	<u>22,493</u>	<u>19,944</u>
<b>Other Income and Deductions:</b>				
AFUDC - equity funds .....	150	113	291	217
Equity earnings in ATC .....	942	933	2,038	1,821
Income tax provision .....	(516)	(336)	(841)	(660)
Other income (deductions) .....	149	(168)	(144)	(327)
<i>Total Other Income and Deductions</i> .....	<u>725</u>	<u>542</u>	<u>1,344</u>	<u>1,051</u>
Income before interest expense .....	<u>8,105</u>	<u>8,741</u>	<u>23,837</u>	<u>20,995</u>
<b>Interest Expense:</b>				
Interest on long-term debt .....	2,808	2,891	5,623	5,784
Other interest .....	33	33	71	65
AFUDC - borrowed funds .....	(59)	(48)	(115)	(102)
<i>Net Interest Expense</i> .....	<u>2,782</u>	<u>2,876</u>	<u>5,579</u>	<u>5,747</u>
<b>Net Income</b> .....	<u>\$ 5,323</u>	<u>\$ 5,865</u>	<u>\$ 18,258</u>	<u>\$ 15,248</u>
<b>Total Comprehensive Income</b> .....	<u>\$ 5,323</u>	<u>\$ 5,865</u>	<u>\$ 18,258</u>	<u>\$ 15,248</u>

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

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

	Six Months Ended June 30,	
	2004	2003
<b>Operating Activities:</b>		
Net income	\$18,258	\$15,248
Items not affecting cash:		
Depreciation and amortization	12,211	11,761
Deferred income taxes	3,867	1,121
Amortization of investment tax credits	(251)	(258)
Amortization of debt issuance costs and bond discount	260	239
Other	(148)	-
AFUDC - equity funds	(291)	(217)
Equity in earnings of ATC	(2,038)	(1,821)
Dividend income from ATC	1,473	1,280
Prepayment to ATC	-	5,000
Changes in working capital, excluding cash equivalents, current long-term debt maturities, and short-term debt:		
Decrease in current assets	24,282	18,867
(Decrease) in current liabilities	(7,826)	(2,629)
Other noncurrent items, net	(775)	7,476
<i>Cash provided by operating activities</i>	<u>49,022</u>	<u>56,067</u>
<b>Investing Activities:</b>		
Capital expenditures	(50,035)	(24,073)
Advance to ATC related to WCCF	(2,001)	(2,636)
AFUDC - borrowed funds	(115)	(102)
ATC - capital call	(1,757)	-
Other	671	-
<i>Cash used for investing activities</i>	<u>(53,237)</u>	<u>(26,811)</u>
<b>Financing Activities:</b>		
Equity contributions from parent	9,970	9,176
Cash dividends to parent	(12,402)	(17,781)
Affiliate financing of WCCF	329	-
Short-term debt repayments	(20,000)	(13,500)
Equity contribution received by MGE Power West Campus	26,796	-
Other	(86)	-
<i>Cash provided by (used for) financing activities</i>	<u>4,607</u>	<u>(22,105)</u>
<b>Change in Cash and Cash Equivalents</b>	392	7,151
Cash and cash equivalents at beginning of period	450	2,531
Cash and cash equivalents at end of period	<u>\$ 842</u>	<u>\$ 9,682</u>

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

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

	June 30, 2004	Dec. 31, 2003
<b>ASSETS</b>		
<b>Utility Plant</b> (At Original Cost, in Service):		
Electric .....	\$ 586,655	\$ 573,326
Gas .....	236,973	232,401
Gross plant in service .....	823,628	805,727
Less accumulated provision for depreciation .....	(366,416)	(356,705)
Net plant in service .....	457,212	449,022
Construction work in progress .....	117,849	88,489
<i>Total Utility Plant</i> .....	<u>575,061</u>	<u>537,511</u>
Other property and investments .....	2,873	2,679
Investment in ATC .....	30,208	27,886
<i>Total Other Property and Investments</i> .....	<u>33,081</u>	<u>30,565</u>
<b>Current Assets:</b>		
Cash and cash equivalents .....	842	450
Restricted cash .....	2,938	3,364
Accounts receivable, less allowance for doubtful accounts of \$2,672 and \$2,735, respectively .....	26,669	34,453
Unbilled revenues .....	13,727	21,644
Materials and supplies, at lower of average cost or market .....	8,974	7,851
Fossil fuel, at lower of average cost or market .....	5,153	5,054
Stored natural gas, at lower of average cost or market .....	13,559	18,598
Prepaid taxes .....	9,859	14,305
Other prepayments .....	1,810	2,128
<i>Total Current Assets</i> .....	<u>83,531</u>	<u>107,847</u>
Special billing projects .....	17,824	14,574
Regulatory assets .....	11,555	8,241
Other deferred charges .....	16,290	17,334
<b>Total Assets</b> .....	<u><u>\$ 737,342</u></u>	<u><u>\$ 716,072</u></u>
<b>CAPITALIZATION AND LIABILITIES</b>		
Common stockholder equity .....	\$ 272,645	\$ 256,819
Minority interest .....	26,796	-
Long-term debt .....	202,230	202,204
<i>Total Capitalization</i> .....	<u>501,671</u>	<u>459,023</u>
<b>Current Liabilities:</b>		
Long-term debt - due within one year .....	15,000	20,000
Short-term debt - commercial paper .....	500	15,500
Accounts payable .....	28,490	32,826
Affiliate payables .....	19,247	18,918
Accrued taxes .....	122	-
Accrued interest .....	3,093	2,967
Other current liabilities .....	11,920	15,658
<i>Total Current Liabilities</i> .....	<u>78,372</u>	<u>105,869</u>
<b>Other Credits:</b>		
Deferred income taxes .....	79,473	75,606
Investment tax credit - deferred .....	4,640	4,891
Regulatory liabilities .....	29,599	34,469
Pension liability .....	35,491	29,947
Other deferred liabilities .....	8,096	6,267
<i>Total Other Credits</i> .....	<u>157,299</u>	<u>151,180</u>
Commitments and contingencies .....	-	-
<b>Total Capitalization and Liabilities</b> .....	<u><u>\$ 737,342</u></u>	<u><u>\$ 716,072</u></u>

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

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**MGE Energy, Inc. and Madison Gas and Electric Company**  
**Notes to Condensed Consolidated Financial Statements (unaudited)**  
**June 30, 2004**

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

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

MGE Energy is a holding company. MGE, a wholly owned subsidiary of MGE Energy, is a regulated electric and gas utility headquartered in Madison, Wisconsin. MGE generates and distributes electricity to nearly 132,000 customers in a 250-square-mile area of Dane County. MGE also purchases and distributes natural gas to more than 129,000 customers in a 1,375-square-mile service territory in seven south-central Wisconsin Counties. Other wholly owned subsidiaries of MGE Energy include CWDC, MAGAEL, MGE Construct, and MGE Power. MGE Power owns 100% of MGE Power West Campus and MGE Power Elm Road, which have been formed to construct and own new electric generation projects.

The accompanying condensed consolidated financial statements as of June 30, 2004, and for the three and six months then ended are unaudited but include all adjustments that MGE Energy and MGE management consider necessary for a fair presentation of their respective financial statements. All adjustments are of a normal, recurring nature except as otherwise disclosed. The year-end consolidated balance sheet information was derived from the audited balance sheet appearing in MGE Energy's and MGE's annual reports on Form 10-K for the year ended December 31, 2003, but does not include all disclosures required by generally accepted accounting principles. These notes should be read in conjunction with the financial statements and the notes on pages 55 through 84 of the 2003 Form 10-K. Certain amounts in prior periods' financial statements and related notes have been reclassified to conform to the 2004 presentation.

**2. Basis of Consolidation - MGE.**

MGE Power West Campus is not a subsidiary of MGE; however, it has been included in the consolidated financial statements of MGE as of December 31, 2003, due to the adoption of FIN No. 46R (see Footnote 9.c.). 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 No. 46R. 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 balances such as construction work in progress of \$77.9 million, an increase in long-term debt of \$30.0 million, minority interest of \$26.8 million, and affiliate payables of \$19.2 million for the six months ended June 30, 2004. 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 the three or six months ended June 30, 2004.

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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 financial statements of MGE as minority interest. As of June 30, 2004, MGE Energy (through its wholly owned subsidiary MGE Power) had invested \$26.8 million in MGE Power West Campus. This investment has no impact on the MGE consolidated statements of income. MGE has reflected \$29.3 million of capital expenditures and \$26.8 million in equity contributions received by MGE Power West Campus in the MGE consolidated statement of cash flows.

### **3. Per-Share Amounts - MGE Energy.**

Earnings per share of MGE Energy common stock are computed on the basis of the weighted average of the daily number of shares outstanding in accordance with SFAS No. 128, *Earnings Per Share*. For the three months ended June 30, 2004 and 2003, respectively, there were 18,656,887 and 17,787,360 weighted average shares outstanding. Dividends declared and paid per share of common stock for the same three-month periods were \$0.338 and \$0.336, respectively.

For the six months ended June 30, 2004 and 2003, there were 18,541,476 and 17,710,835 weighted average shares outstanding. Dividends declared and paid per share of common stock for the same six-month periods were \$0.676 and \$0.672, respectively.

MGE Energy does not hold any dilutive securities.

### **4. Rate Matters - MGE.**

On May 5, 2004, MGE filed with the PSCW a request to increase electric rates by 8.5% and decrease gas rates by 1.0%. The electric rate request includes costs of commercial operation of WCCF and increased transmission expenses. The PSCW is conducting its audit, which will be completed in August 2004. An order is expected in the beginning of 2005.

Under the fuel rules, if electric fuel costs are outside a 3.0% range higher or lower than the level set by the PSCW, MGE can apply for a fuel surcharge or may be required to return a fuel credit to its customers. During 2003, MGE submitted an application for a fuel cost credit. On August 14, 2003, the PSCW approved an interim fuel cost credit of \$.00099 per kWh. The PSCW 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 from January 1 through January 13, 2004, totaled \$0.4 million. The fuel credit totaled \$4.4 million, of which \$1.3 million represents the interim fuel credit and \$3.1 million is the estimate for the additional fuel credit, as a result of PSCW review, to be refunded to customers. The additional fuel credit of \$3.1 million was credited to customers in the first quarter of 2004.

On January 14, 2004, the PSCW authorized MGE to increase annual 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 annual revenues by \$27.1 million. The increase covered rising fuel costs and addressed increased system demands and costs to complete a new AMR project.

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**5. Capitalization Matters - MGE Energy.**

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

Under the Agreement, MGE Energy has sold 44,000 shares of its common stock during the three months ended June 30, 2004, for net proceeds of \$1.3 million. For the six months ended June 30, 2004, MGE Energy has sold 124,000 shares, for net proceeds of \$3.8 million.

MGE Energy also issues new shares of its common stock through its Dividend Reinvestment and Direct Stock Purchase Plan. For the three months ended June 30, 2004, MGE Energy has issued 181,000 new shares of common stock, through this plan, for net proceeds of \$5.5 million. For the six months ended June 30, 2004, MGE Energy has issued 326,000 shares for net proceeds of \$10.0 million.

**6. Supplemental Cash Flow Information - MGE Energy and MGE.**

Cash payments for interest, net of amounts capitalized, and cash payments (receipts) for income taxes were as follows:

<b>MGE Energy</b> <i>(In thousands)</i>	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2004	2003	2004	2003
Interest paid, net of amounts capitalized . . .	\$ 3,410	\$ 3,306	\$ 5,778	\$ 5,706
Income taxes paid . . . . .	3,850	6,250	3,850	7,000
Income taxes refunded . . . . .	-	-	-	(3,159)
<b>MGE</b> <i>(In thousands)</i>	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2004	2003	2004	2003
Interest paid, net of amounts capitalized . . .	\$ 3,272	\$ 3,346	\$ 5,554	\$ 5,764
Income taxes paid . . . . .	3,700	6,250	3,700	7,000
Income taxes refunded . . . . .	-	-	-	(3,159)

**7. Property, Plant, and Equipment - MGE Energy.**

MGE Energy, through its subsidiary MGE Power West Campus, calculates capitalized interest in accordance with SFAS No. 34, *Capitalization of Interest Cost*, on construction projects for periods where financing is provided by MGE Energy through interim debt. The interest rate capitalized is based upon the monthly short-term borrowing rate MGE Energy incurs for such funds and the interest rate related to MGE Power West Campus' long-term debt. For the six months ended June 30, 2004, MGE Energy recorded \$1.1 million in capitalized interest related to the cogeneration facility being constructed on the west campus of the UW.

## 8. Pension and Postretirement Plans - MGE.

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.

	Pension Benefits			
	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
(In thousands)	2004	2003	2004	2003
Components of net periodic benefit cost:				
Service cost .....	\$ 678	\$ 739	\$ 1,942	\$ 1,555
Interest cost .....	1,438	1,735	4,118	3,651
Expected return on assets .....	(1,506)	(1,519)	(4,311)	(3,196)
Amortization of:				
Transition obligation .....	41	23	116	48
Prior service cost .....	69	104	197	219
Actuarial gain .....	142	312	405	657
SFAS 87 cost .....	862	1,394	2,467	2,934
SFAS 88 charges:				
Special termination benefit .....	-	-	-	127
Net periodic benefit cost .....	<u>\$ 862</u>	<u>\$ 1,394</u>	<u>\$ 2,467</u>	<u>\$ 3,061</u>
	Postretirement Benefits			
	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
(In thousands)	2004	2003	2004	2003
Components of net periodic benefit cost:				
Service cost .....	\$ 451	\$ 372	\$ 970	\$ 803
Interest cost .....	753	670	1,621	1,444
Expected return on assets .....	(181)	(129)	(389)	(279)
Amortization of:				
Transition obligation .....	93	90	200	193
Prior service cost .....	41	39	87	84
Actuarial gain .....	262	238	564	513
SFAS 87 cost .....	1,419	1,280	3,053	2,758
SFAS 88 charges:				
Special termination benefit .....	-	-	-	-
Net periodic benefit cost .....	<u>\$ 1,419</u>	<u>\$ 1,280</u>	<u>\$ 3,053</u>	<u>\$ 2,758</u>

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. FASB Staff Position No. (FSP) No. 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. FSP No. 106-2 is effective as of the first interim or annual period beginning after June 15, 2004.

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According to the FSP, if a company concludes that its single-employer defined benefit postretirement health care plan provides a drug benefit that is actuarially equivalent to the Medicare Part D benefit, the employer should recognize the subsidy in the measurement of the APBO under SFAS 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*. The resulting reduction of the APBO should be accounted for as an actuarial gain. The subsidy's reduction of the employer's share of future costs under the plan should be reflected in current-period service cost.

According to the FSP, if a company concludes that its drug benefits are not actuarially equivalent, no accounting for the subsidy is required.

MGE's APBO or net periodic benefit cost at June 30, 2004, do not reflect any amount associated with this subsidy as MGE is currently unable to conclude whether the benefits provided by the plan are actuarially equivalent to the Medicare Part D benefit under the act. MGE will adopt the standards of this FSP for the period ending September 30, 2004.

**9. Adoption of Accounting Principles and Recently Issued Accounting Pronouncements - MGE Energy and MGE.**

**a. SFAS No. 143.**

In 2001, the FASB issued SFAS No. 143, *Accounting for Asset Retirement Obligations*. SFAS No. 143 provides accounting requirements for retirement obligations associated with tangible long-lived assets. MGE Energy and MGE were required to adopt SFAS No. 143 as of January 1, 2003. Retirement obligations associated with long-lived assets included within the scope of SFAS No. 143 are those for which there is a legal obligation under existing or enacted law, statute, written or oral contract, or by legal construction under the doctrine of promissory estoppel.

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. At June 30, 2004, this liability is estimated at \$1.4 million and 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. MGE applies SFAS No. 71 and recognizes regulatory assets or liabilities for the timing differences between when we recover legal asset retirement obligations in rates and when MGE would recognize these costs under SFAS No. 143.

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, 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 following table shows costs as of December 31, 2003, and changes to the asset retirement obligation and accumulated depreciation during the six months ended June 30, 2004.

	(a)	(b)	(c) (a + b)	(d)
(In thousands)	Original Asset Retirement Obligation	Accumulated Accretion	Asset Retirement Obligation	Accumulated Depreciation-Related Asset
Balance, December 31, 2003 . . . . .	\$ 686	\$ 675	\$ 1,361	\$ 175
Changes through June 30, 2004 . . . . .	-	43	43	13
Balance, June 30, 2004 . . . . .	<u>\$ 686</u>	<u>\$ 718</u>	<u>\$ 1,404</u>	<u>\$ 188</u>

As of June 30, 2004, MGE's regulatory asset, included in deferred charges, is the total accumulated accretion (\$0.7 million) and accumulated depreciation (\$0.2 million) or \$0.9 million.

Accumulated costs of removal that are non-SFAS 143 obligations are classified within the financial statements as regulatory liabilities. At June 30, 2004, and December 31, 2003, there were \$17.7 million and \$18.2 million of these costs recorded as regulatory liabilities within the financial statements, respectively.

**b. FIN No. 45.**

In November 2002, the FASB issued FIN No. 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 \$7.5 million of the financing program receivables, until February 28, 2005 (see Footnote 14.e.). 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 \$0.4 million in 2004, \$0.9 million in 2005, 2006, and 2007, and \$1.0 million in 2008.

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**c. FIN No. 46R.**

In January 2003, the FASB issued FIN No. 46, *Consolidation of Variable Interest Entities - An Interpretation of ARB No. 51*. In December 2003, the FASB issued the updated and final interpretation, FIN No. 46R. FIN No. 46R 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 No. 46 was applicable immediately to VIEs created or obtained after January 31, 2003. FIN No. 46R 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, a subsidiary of MGE Energy, is a VIE of MGE pursuant to FIN No. 46R, as the equity investment by MGE Energy (through its wholly owned subsidiary MGE Power) in MGE Power West Campus 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 No. 46R 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 65% of the total Shared Savings program balance and has determined that the provisions of FIN No. 46R are not applicable via the "business scope exception." For the remaining 35% 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 under the provisions of FIN No. 46R.

**10. 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 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, which will be used to meet the growing needs for air-conditioning and steam-heat capacity for the UW 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 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 spring 2005. In the second quarter of 2004, MGE Construct received a service fee of \$0.7 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. MGE Construct has received \$1.4 million (pretax) in service fees for the six months ended June 30, 2004.

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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 \$3.1 million for the six months ended June 30, 2004. These amounts are classified as regulatory assets within the financial statements.

MGE Energy, MGE Power West Campus, and MGE Construct have assumed certain risks in regard to some of the executed agreements related to the WCCF. In the EPC Agreement, MGE Power West Campus is responsible for cost overruns and MGE Construct is responsible for the entire construction process for the facility, including paying liquidated damages relating to failure to achieve the Mechanical Completion Date Guarantee and/or the Acceptance Test Capacity Guarantee. MGE Energy has guaranteed 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 June 30, 2004, MGE Power West Campus had incurred \$77.9 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.

#### **11. ATC - MGE.**

As of June 30, 2004, MGE holds a 5% interest in ATC and accounts for its investment in that interest under the equity method of accounting due to its ability to exercise significant control over management activities. MGE has a seat on the board of directors and owns 20% of the voting stock of ATC Management, Inc., which manages and operates ATC. 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. During the three and six months ended June 30, 2004, MGE recorded pretax equity earnings from its investment in ATC of \$0.9 million and \$2.0 million, respectively. MGE recorded transmission expense from ATC of \$3.4 million and \$6.7 million for the three and six months ended June 30, 2004, respectively.

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 to ATC for transmission equipment related to WCCF in the amount of \$2.0 million for the six months ended June 30, 2004. The total advanced to ATC for this project is \$12.5 million as of June 30, 2004. MGE will be reimbursed by ATC upon completion of the project.

MGE has agreed to provide to ATC an additional capital commitment of \$3.6 million in 2004. In the second quarter of 2004, MGE made its second of four capital installments. MGE has made \$1.8 million in capital contributions for the six-month period ended June 30, 2004. MGE has a remaining capital commitment of \$1.8 million for 2004.

#### **12. 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. The plan includes three new 600-MW coal-fired plants to be located in Wisconsin. 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.

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The PSCW issued an order in November 2003 approving We Energies' request for a CPCN for Units 1 and 2. Four appeals have been filed challenging the order. In addition, two lawsuits have been filed in Dane County Circuit Court against the DNR, contending that the DNR did not comply with state laws when it participated with the PSCW in preparing the environmental impact statement for Units 1 and 2. Also, several parties have sought to contest the issuance of various environmental permits needed for the construction of the units. The resolution of these proceedings as well as the risks generally associated with construction of the units may adversely affect the costs and completion times for the units. At present, Unit 1 is scheduled to begin operating in 2009 and Unit 2 is scheduled to begin operating in 2010.

The PSCW issued an order on June 25, 2004, approving MGE's participation in Units 1 and 2 (should MGE choose to exercise its options) and approving a facility lease agreement between MGE Power Elm Road (a nonutility 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, a return on equity of 12.7%, a lease term of 30 years, and a 5% rent reduction in the first five years. MGE anticipates making a decision on whether to exercise the option by the middle of 2005. 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. A substantial portion of those capital costs would be incurred from 2005 through 2009, with more than half expected to be incurred during 2006 and 2007. (See Footnote 15 for subsequent event.)

### **13. Segment Information - MGE Energy and MGE.**

MGE Energy and MGE operate in three business segments: electric utility operations, gas utility operations, and nonregulated energy operations. 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.

The nonregulated energy operations are conducted through subsidiaries of MGE Energy other than MGE. These subsidiaries have been formed to own and construct new electric generating capacity. At present, they are undertaking the construction of WCCF, which started in the fall of 2003. The following table shows key information about all three of these segments, including the distribution of net assets, for the six months ended June 30, 2003 and 2004.

MGE's 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. Corporate assets consist primarily of cash and cash equivalents and deferred taxes.

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

<i>(In thousands)</i>				
<b>MGE Energy</b>	Electric	Gas	Nonregulated	Total
<b><i>Six Months Ended June 30, 2004</i></b>				
Gross operating revenues . . . . .	\$ 121,576	\$ 103,194	\$ 1,364	\$ 226,134
Interdepartmental revenues . . . . .	(239)	(5,200)	-	(5,439)
Depreciation and amortization . . . . .	(8,573)	(3,638)	-	(12,211)
Other operating expenses . . . . .	(91,876)	(81,922)	(166)	(173,964)
Operating income . . . . .	<u>\$ 20,888</u>	<u>\$ 12,434</u>	<u>\$ 1,198</u>	<u>\$ 34,520</u>
<b><i>Six Months Ended June 30, 2003</i></b>				
Gross operating revenues . . . . .	\$ 114,951	\$ 99,878	\$ -	\$ 214,829
Interdepartmental revenues . . . . .	(245)	(3,442)	-	(3,687)
Depreciation and amortization . . . . .	(8,325)	(3,436)	-	(11,761)
Other operating expenses . . . . .	(90,472)	(79,753)	(72)	(170,297)
Operating income . . . . .	<u>\$ 15,909</u>	<u>\$ 13,247</u>	<u>\$ (72)</u>	<u>\$ 29,084</u>

The electric and gas utility operations segments represent substantially all of the revenue-generating segments for MGE and substantially all of the revenue for MGE Energy. The following table shows segment information for MGE's operations:

<i>(In thousands)</i>				
<b>MGE</b>	Electric	Gas	Nonregulated	Total
<b><i>Six Months Ended June 30, 2004</i></b>				
Gross operating revenues . . . . .	\$ 121,576	\$ 103,194	\$ -	\$ 224,770
Interdepartmental revenues . . . . .	(239)	(5,200)	-	(5,439)
Depreciation and amortization . . . . .	(8,573)	(3,638)	-	(12,211)
Other operating expenses . . . . .	(98,266)	(86,361)	-	(184,627)
Operating income . . . . .	<u>\$ 14,498</u>	<u>\$ 7,995</u>	<u>\$ -</u>	<u>\$ 22,493</u>
<b><i>Six Months Ended June 30, 2003</i></b>				
Gross operating revenues . . . . .	\$ 114,951	\$ 99,878	\$ -	\$ 214,829
Interdepartmental revenues . . . . .	(245)	(3,442)	-	(3,687)
Depreciation and amortization . . . . .	(8,325)	(3,436)	-	(11,761)
Other operating expenses . . . . .	(94,860)	(84,577)	-	(179,437)
Operating income . . . . .	<u>\$ 11,521</u>	<u>\$ 8,423</u>	<u>\$ -</u>	<u>\$ 19,944</u>

(In thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
<b>MGE Energy</b>				
Electric operating income	\$ 10,511	\$ 10,809	\$ 20,888	\$ 15,909
Gas operating income	(410)	879	12,434	13,247
Nonregulated operating income (loss)	594	(55)	1,198	(72)
Consolidated operating income	10,695	11,633	34,520	29,084
Other income, net	1,190	885	2,769	1,726
Interest expense, net	(2,724)	(2,876)	(5,575)	(5,752)
Income tax provision	(3,481)	(3,809)	(12,390)	(9,850)
Net income	<u>\$ 5,680</u>	<u>\$ 5,833</u>	<u>\$ 19,324</u>	<u>\$ 15,208</u>

#### **MGE**

Electric operating income	\$ 7,349	\$ 7,439	\$ 14,498	\$ 11,521
Gas operating income	31	760	7,995	8,423
Nonregulated operating income	-	-	-	-
Consolidated operating income	7,380	8,199	22,493	19,944
Other income and deductions	725	542	1,344	1,051
Interest expense, net	(2,782)	(2,876)	(5,579)	(5,747)
Net income	<u>\$ 5,323</u>	<u>\$ 5,865</u>	<u>\$ 18,258</u>	<u>\$ 15,248</u>

(In thousands)			Assets not	Non-	
<b>MGE Energy</b>	Electric	Gas	Allocated	regulated	Total
<b>Assets:</b>					
June 30, 2004	\$ 455,776	\$ 159,572	\$ 41,372	\$ 89,907	\$ 746,627
December 31, 2003	445,728	165,577	55,839	54,543	721,687
<b>Capital Expenditures:</b>					
Six Months ended June 30, 2004	17,256	5,275	-	27,504	50,035
Year ended December 31, 2003	40,833	13,875	-	28,262	82,970

#### **MGE**

<b>Assets:</b>					
June 30, 2004	\$ 455,776	\$ 159,572	\$ 43,175	\$ 78,819	\$ 737,342
December 31, 2003	445,728	165,577	55,839	48,928	716,072
<b>Capital Expenditures:</b>					
Six Months ended June 30, 2004	17,256	5,275	-	27,504	50,035
Year ended December 31, 2003	40,833	13,875	-	28,262	82,970

#### **14. Commitments and Contingencies - MGE Energy and MGE.**

##### **a. Coal Contracts.**

MGE has no coal contracts that contain minimum purchase or fixed obligations. Fuel procurement for MGE's jointly owned Columbia is handled by Alliant, the operating company. If any minimum purchase obligations must be paid under these contracts, management believes such obligations would be considered costs of service and recoverable in rates.

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**b. Energy Commitments.**

MGE has several purchased power and transmission contracts to help meet future electric supply requirements. As of June 30, 2004, MGE's total annual commitments for purchased power contracts for capacity and transmission are estimated to be \$16.8 million in 2004, \$14.5 million in 2005, \$14.6 million in 2006, \$11.3 million in 2007, and \$9.6 million in 2008. Management expects to recover these costs in future customer rates.

**c. Natural Gas Transportation and Storage Contracts.**

MGE's natural gas supply transportation and storage contracts require fixed monthly payments for firm supply and firm 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. The annual payments are estimated to be \$15.1 million in 2004, \$14.2 million in 2005, \$14.5 million in 2006, \$14.4 million in 2007, and \$14.2 million in 2008. Management expects to recover these costs in future customer rates.

**d. Environmental.**

MGE is subject to local, state, and federal regulations concerning air quality, water quality, and solid waste disposal. 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 believes it has met the requirements of current environmental regulations. 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.

The EPA and the DNR regulate pollution and environmental control matters at MGE's electric generating plants. The DNR has primary jurisdiction over air and water quality as well as solid and hazardous waste standards.

The ongoing issue of global warming could result in significant costs to reduce CO<sub>2</sub> emissions from fossil-fueled generation sources such as coal and gas-fired plants. MGE does not yet know the amounts of these expenditures or the period of time over which they may be required.

The National Environmental Policy Act and the Wisconsin Environmental Policy Act require MGE to conduct a complete environmental review and issue a detailed environmental impact statement before obtaining necessary authorizations or permits from regulatory agencies for certain projects. This may apply to new projects such as generating plants, electric transmission lines, or other major actions that could significantly affect the environment.

***Air quality***

*Eight-hour ozone standard.* In 1997, the EPA promulgated a new eight-hour ozone ambient air-quality standard. In April 2004, the EPA designated Dane County as in attainment with that eight-hour ozone standard based upon data showing Dane County air quality to be in attainment with that standard. This designation could be revised based upon future air-quality data.

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Dane County ozone levels have been increasing over time. MGE is working with the DNR and other Dane County air-emission sources to make voluntary reductions of ozone precursor emissions and prevent the county from being classified as a nonattainment area. If Dane County were classified as a nonattainment area, MGE facilities in Dane County may need to meet new limits for ozone precursor emissions.

*Proposed and final MACT standards.* Section 112 of the 1990 Clean Air Act Amendments requires the EPA to develop standards to control major sources of hazardous air pollutants to levels generally consistent with the lowest-emitting facilities in similar source categories. MGE operates several sources that may be subject to MACT standards, including electric steam generating units; combustion turbines; reciprocating internal combustion engines; and industrial, commercial, and institutional boilers. All sources, except 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 other than those being constructed. The EPA has signed final MACT standards for electric-steam generating units, and MGE will be required to comply with these new limits in 2007 if the rules are published in the same form. Complying with the MACT standards would likely increase capital expenditures and operating and maintenance expenses.

*Proposed Wisconsin mercury emission reduction rule.* The DNR has promulgated an administrative rule (NR 446) that requires reduction of mercury emissions of 40% by 2010 and 75% by 2015 for "major utilities" located in Wisconsin, i.e., those investor-owned public utilities emitting 100 pounds or more of mercury annually on a system-wide basis. The rule allows each utility to average their mercury emission reduction requirement across their 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 owners choose to control mercury emissions at Columbia.

*NO<sub>x</sub> SIP Call.* On October 27, 1998, the EPA issued the "NO<sub>x</sub> SIP Call" rule that imposed a NO<sub>x</sub> emission budget for emission sources in Wisconsin. The NO<sub>x</sub> SIP Call was premised upon two theories: the downwind contribution of Wisconsin air emissions to existing one-hour ozone nonattainment areas and the downwind contribution of Wisconsin air emissions to potential future eight-hour nonattainment areas.

On March 2, 2000, the Court of Appeals for the District of Columbia held that the EPA "acted unlawfully by including Wisconsin in the [NO<sub>x</sub>] SIP Call" for purposes of the State's alleged impacts to downwind one-hour ozone nonattainment areas. However, that portion of the rule concerning Wisconsin's alleged impacts on downwind, eight-hour ozone nonattainment areas has been stayed. If that stay is lifted and that portion of the NO<sub>x</sub> SIP Call concerning eight-hour ozone nonattainment areas is upheld, the resulting NO<sub>x</sub> emission budget for Wisconsin could potentially affect the level of permissible NO<sub>x</sub> emissions from Blount, Columbia, and WCCF. The new NO<sub>x</sub> limits could increase capital expenditures and operating and maintenance expenses at those facilities.

*Clean Air Interstate Rule.* In January 2004, the EPA proposed Interstate Air Quality rules that would mitigate the transport of fine particulate matter and ozone pollution by imposing emission reduction requirements on SO<sub>2</sub> and NO<sub>x</sub> in 29 eastern states and the District of Columbia. These reductions would be implemented in two phases through a cap-and-trade system. SO<sub>2</sub> emissions would be reduced by 3.6 million tons by 2010 (approximately 40% below current levels) and by another 2 million tons per year when the rules are fully implemented (approximately 70% below current levels). Emissions of NO<sub>x</sub> would be cut by 1.5 million tons by 2010 (approximately 55% below current levels) and 1.8 million tons annually in 2015 (approximately 65% below current levels). The EPA is expected to finalize the rule by the end of 2005. Complying with the rule would likely increase capital expenditures as well as operating and maintenance expenses at Blount and Columbia.



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In a separate but closely related action, the EPA also proposed a Utility Mercury Reduction Rule for controlling mercury emissions from utility boilers. The draft rule proposes several control options. The EPA is expected to finalize the rule by the end of 2004. Complying with the rule would likely increase capital expenditures as well as operating and maintenance expenses at Blount and Columbia.

*Columbia.* In December 2000, February 2001, June 2002, and January 2003, Alliant received Requests for Information from the EPA seeking information concerning Columbia's compliance with the Clean Air Act. The requests appear to be part of an EPA initiative to assess the regulatory consequences of past investments in utility generation, energy efficiency, maintenance, and environmental protection within the utility sector. WPL, the plant operator, has responded to all requests, but MGE has not been informed of any response from the EPA. The plant operator 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 and general water-quality standards. The regulations limit discharges from MGE's plants into Lake Monona and other Wisconsin waters.

The categorical-effluent discharge standards require each discharger to use 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.

On March 25, 2004, the State filed a complaint in state court against Alliant, as operator of Columbia, seeking forfeitures, penalties, and injunctive relief for exceeding limits in its Wisconsin Pollutant Discharge Elimination System permit. In addition, Alliant and WPL were named in a Federal Water Pollution Control Act citizen suit action alleging similar violations. In July 2004, Alliant, WDOJ, and WELA settled the matter for \$150,000 and a commitment to implement upgrades to the facility's wastewater system. MGE owns a 22% share of Columbia along with the other co-owners Alliant and WPSC. MGE has recorded a liability at June 30, 2004, for its pro-ratable share of the monetary settlement.

EPA has promulgated new rules establishing performance standards for cooling water intake structures at large power plants. The rule is currently subject to a legal challenge by a coalition of states and environmental groups. The rule, as currently drafted, applies to facilities that can withdraw at least 50 million gallons per day of water and use 25% or more of that withdrawal for cooling. The EPA water rule may have an impact on MGE's Blount plant that may result in additional capital expenditures. MGE cannot predict at this time what the impact would be.

### ***Solid waste***

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.

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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, 2003, MGE accrued a \$0.1 million liability for this matter.

As a result of the Blount 69-kV transmission substation expansion, coal tar-contaminated soil and debris within the excavation zone were removed and disposed of in accordance with a DNR-approved "Removal Action Work Plan." MGE has paid \$1.4 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.

### ***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 its Blount plant. Among other things, the five-year agreement requires MGE to evaluate combustion efficiency improvements, enhance new pollution control 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 will increase capital expenditures and operating and maintenance expenses over the next five years.

As part of the agreement, MGE conducted a voluntary audit of Blount's compliance with various environmental laws. The auditors identified several conformance exceptions which were 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 further action by state regulators.

### **e. Chattel Paper Agreement - MGE.**

MGE makes available to qualifying customers a financing program for purchasing and installing 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 \$7.5 million of the financing program receivables, until February 28, 2005. At June 30, 2004, MGE had sold an outstanding \$6.3 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. MGE has recorded a servicing asset of \$0.3 million and \$0.2 million as of June 30, 2004 and 2003, respectively.

The loan assets are sold to the financial institution at cost, which approximates fair value in view of their market rates of interest. During the six months ended June 30, 2004 and 2003, MGE received approximately \$0.6 million and \$0.4 million, respectively, of cash from the financial institution for the sale of loan assets. During those same periods, payments of \$1.3 million and \$1.0 million, respectively, were made by MGE to the financial institution.

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**f. West Campus Cogeneration Facility.**

***Petition for Judicial Review***

On November 6, 2003, Friends of Responsible Energy (FORE), an unincorporated citizen association, filed a petition with the Dane County, Wisconsin, Circuit Court seeking judicial review of various decisions made by the PSCW, the DNR, the UW, and the Wisconsin Department of Administration in connection with the WCCF. Those decisions include the grant of a CPCN by the PSCW and various environmental determinations made by the governmental parties. FORE alleges that those decisions were arbitrary, capricious, and contrary to law and seeks to have them set aside or remanded for further review.

MGE Energy, along with MGE and MGE Power West Campus, has intervened as a party to the proceeding. MGE Energy believes the suit is not likely to cause any material adverse change in the WCCF or its construction schedule.

***WCCF Purchase Commitments***

MGE has entered into various contracts for the purchase of gas and steam turbines and miscellaneous equipment for the WCCF. These contracts have been assigned or are in the process of being assigned to MGE Construct. MGE Construct has entered into a contract to purchase chiller equipment. All contracts are summarized in the following table.

<i>(In thousands)</i>		Payments through	Remaining
	Contract Total	June 30, 2004	Contract Amounts
Gas turbines . . . . .	\$ 30,190	\$ 30,060	\$ 130
Steam turbine . . . . .	7,805	7,805	-
Heat-recovery steam generators . . . . .	11,993	11,993	-
Chiller equipment . . . . .	6,689	6,020	669
Project management . . . . .	8,400	6,001	2,399
Miscellaneous equipment . . . . .	31,161	21,366	9,795
Total . . . . .	<u>\$ 96,238</u>	<u>\$ 83,245</u>	<u>\$ 12,993</u>

**15. Subsequent Events.**

***Fuel Credit***

On July 22, 2004, the PSCW decided to reopen MGE's current rate order docket to commence a limited scope proceeding under fuel rules to determine if a fuel credit is required for 2004. Under fuel rules, if electric fuel costs are outside a 3.0% annual threshold set by the PSCW, MGE may request a fuel surcharge or may be required to return a fuel credit to its customers. If a determination is made by the PSCW in this proceeding that a fuel credit is required, the time period for determining the credit begins July 22, 2004.

The Company is unable to estimate the financial impact of these proceedings at this time.

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***Credit Agreement***

On July 14, 2004, MGE entered into a \$45 million, three-year, unsecured revolving credit agreement with a group of banks. It is expected that the credit agreement will be used principally to support MGE's commercial paper program. Interest rates on the advances under the credit agreement are based on either the London Interbank Offering Rate (LIBOR) or prime plus, in the case of the LIBOR-based rate, an adder based upon the credit rating of MGE at the time of borrowing. The credit agreement requires that MGE maintain a ratio of consolidated indebtedness to consolidated total capitalization of not more than 0.65 to 1.00. That ratio excludes amounts attributable to MGE Power West Campus, which is consolidated into MGE as a result of the application of FIN No. 46R. The credit agreement also includes restrictions on mergers, asset sales, and liens. The new credit facility replaces \$40 million of unsecured, uncommitted lines of credit.

***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 increases MGE's wind power output capacity from 12 MW to 52 MW.

***Power the Future Participation***

On July 23, 2004, a petition was filed by one individual in Dane County Circuit Court challenging the PSCW's order authorizing MGE's participation in Units 1 and 2 of We Energies' Power the Future Plan.

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## **Item 2. 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 132,000 customers in Dane County, Wisconsin, including the city of Madison, and purchases and distributes natural gas to more than 129,000 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 campus.

MGE's electric and gas utility operations represent a substantial part of our assets, liabilities, revenues, and expenses. Consequently, the following discussion focuses mainly on the results of operations and financial condition of MGE.

### **Executive Summary - MGE Energy and MGE**

In the second quarter of 2004, our utility operations experienced an increase in electric retail sales volumes of 2.8% while retail gas deliveries decreased 10.9%. Electric revenues increased \$2.8 million for the three months ended June 30, 2004, due to the increase in retail volumes as well as increases in rates, while gas revenues decreased \$0.7 million due to a decline in gas deliveries. Total operation and maintenance expenses increased \$1.2 million due to higher uncollectible accounts, higher distribution and maintenance costs, and higher administrative costs. MGE Energy also experienced lower interest costs as a result of the generally lower interest rates for our variable-rate debt during the quarter resulting in a \$0.2 million decrease in interest expense.

We anticipate relying on short- and long-term borrowings to support construction of WCCF and the associated capital expenditures. We also anticipate a need for additional equity capital during 2004 beyond the amounts we are able to raise through our Dividend Reinvestment and Direct Stock Purchase Plan.

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. MGE plans to meet this challenge by building more efficient generation projects and continuing its efforts to control operational costs. We believe it is critical to maintain both a strong credit standing and financial strength in MGE as well as in the parent company in order to accomplish these goals.

### ***Results of Operations***

Substantially all of MGE Energy's results of operations are attributable to the operations of its utility subsidiary MGE. MGE Energy's other significant business activity relates to the development of a cogeneration project, which is under construction. Consequently, the following discussion focuses mainly on MGE's results of operations for the three and six months ended June 30, 2004, in comparison to the same periods in the prior year.

## Electric Utility Operations

### Electric sales and revenues

The following tables compare MGE's electric retail revenues and electric kWh sales by customer class for the periods indicated:

(In thousands)	Revenues			kWh Sales		
	Three months ended June 30,			Three months ended June 30,		
	2004	2003	% Change	2004	2003	% Change
Residential .....	\$ 20,086	\$ 18,968	5.9	174,491	173,634	0.5
Commercial .....	30,889	28,878	7.0	407,853	394,485	3.4
Industrial .....	4,358	4,181	4.2	83,532	83,556	0.0
Other - retail/municipal .....	4,894	4,483	9.2	84,807	78,893	7.5
Total retail .....	60,227	56,510	6.6	750,683	730,568	2.8
Sales for resale .....	590	1,582	(62.7)	10,098	38,060	(73.5)
Other revenues .....	609	515	18.3	-	-	-
Total .....	<u>\$ 61,426</u>	<u>\$ 58,607</u>	4.8	<u>760,781</u>	<u>768,628</u>	(1.0)

(In thousands)	Revenues			kWh Sales		
	Six months ended June 30,			Six months ended June 30,		
	2004	2003	% Change	2004	2003	% Change
Residential .....	\$ 41,754	\$ 38,433	8.6	382,026	373,699	2.2
Commercial .....	58,187	55,165	5.5	814,197	790,002	3.1
Industrial .....	7,793	7,636	2.1	158,839	155,151	2.4
Other - retail/municipal .....	8,702	8,281	5.1	158,002	150,587	4.9
Total retail .....	116,436	109,515	6.3	1,513,064	1,469,439	3.0
Sales for resale .....	830	4,052	(79.5)	18,101	81,551	(77.8)
Other revenues .....	4,071	1,139	257.4	-	-	-
Total .....	<u>\$ 121,337</u>	<u>\$ 114,706</u>	5.8	<u>1,531,165</u>	<u>1,550,990</u>	1.3

Electric operating revenues were up \$2.8 million or 4.8% for the three months ended June 30, 2004, and \$6.6 million or 5.8% for the six months ended June 30, 2004, compared to the same periods in the prior year. The increase was due to the following factors:

(In millions)	Three months ended June 30, 2004	Six months ended June 30, 2004
Increase in retail rates .....	\$2.2	\$3.7
Increase in retail volume .....	1.5	3.3
Increase in other electric revenues .....	0.1	2.9
(Decrease) in sales for resale .....	(1.0)	(3.3)
	<u>\$2.8</u>	<u>\$6.6</u>

- **Rates.** The PSCW authorized increases in MGE's electric rates effective January 14, 2004, and March 1, 2003, to cover rising fuel costs for electric generation and increased system demands. Retail revenues reflect a fuel credit in the amount of \$3.1 million, which was refunded to customers in the first quarter of 2004. The liability for this fuel credit was previously accrued from August 2003 through January 2004 as a decrease to other electric revenues (see Footnote 4 - Rate Matters).
- **Volume.** There was a 3.0% increase in total retail sales volumes for the six months ended June 30, 2004, which is mainly attributable to increases in sales from large commercial customers and sales from residential customers.

- *Other effects.* Other electric revenues increased for the six months ended June 30, 2004, compared to the same period in the prior year due to the reversal of the fuel credit liability, which was refunded to customers in the first quarter of 2004. The actual fuel refund decreased retail revenues and is offset by an increase in other electric revenues.
- *Sales for resale.* The decrease in sales for resale reflects 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 through August 2003. Sales for resale also include transactions conducted on the PJM market.

On May 1, 2004, PJM began managing the flow of wholesale electricity over ComEd's transmission lines and administering open, competitive wholesale electricity trading markets. MGE has three purchase power agreements that are impacted by ComEd's integration into the PJM market. MGE has recorded certain transactions on the PJM market on a net basis resulting in a \$1.2 million reduction to sales for resale and purchased power expense for the three and six months ended June 30, 2004.

### ***Electric fuel and purchased power***

Fuel used for electric generation increased \$2.3 million or 24.4% during the three months ended June 30, 2004, and \$3.0 million or 14.9% during the six months ended June 30, 2004, compared to the same periods in the prior year. This increase is primarily due to the increase in electric generation at MGE's base-load plants. MGE's internal generation increased 7.1% for the six months ended June 30, 2004, 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 frequently during the first quarter of 2003 but back on line for the first quarter of 2004.

Purchased power expense increased \$0.3 million for the three months ended June 30, 2004. This increase represents a 11% increase in the per-unit cost, offset by a 8% decrease in the volume of purchased power. Purchased power expense decreased \$2.1 million for the six months ended June 30, 2004. The decrease is due to a 15% decrease in the volume of purchased power offset by a 8% increase in per-unit cost. These aforementioned fluctuations include a \$1.2 million reduction to purchased power expense which resulted from recording certain transactions on the PJM market on a net basis.

### **Gas Utility Operations**

#### ***Gas deliveries and revenues***

The following tables compare MGE's gas retail revenues and gas delivered by customer class for the periods indicated:

<i>(In thousands)</i>	Revenues			Therms delivered		
	Three months ended June 30,			Three months ended June 30,		
	2004	2003	% Change	2004	2003	% Change
Residential . . . . .	\$ 13,362	\$ 13,893	(3.8)	11,591	13,283	(12.7)
Commercial/industrial . . . . .	8,984	9,203	(2.4)	10,808	11,847	(8.8)
Total retail . . . . .	22,346	23,096	(3.2)	22,399	25,130	(10.9)
Gas transportation . . . . .	653	717	(8.9)	9,151	9,596	(4.6)
Other revenues . . . . .	307	228	34.6	-	-	
Total . . . . .	<u>\$ 23,306</u>	<u>\$ 24,041</u>	(3.1)	<u>31,550</u>	<u>34,726</u>	(9.1)
Heating degree days (normal 861) . . . . .				852	975	(12.6)

(In thousands)	Revenues			Therms delivered		
	Six months ended June 30,			Six months ended June 30,		
	2004	2003	% Change	2004	2003	% Change
Residential .....	\$ 56,811	\$ 56,158	1.2	56,491	61,308	(7.9)
Commercial/industrial .....	38,440	37,249	3.2	47,601	49,912	(4.6)
Total retail .....	95,251	93,407	2.0	104,092	111,220	(6.4)
Gas transportation .....	1,734	1,768	(1.9)	24,816	25,878	(4.1)
Other revenues .....	1,009	1,261	(20.0)	-	-	
Total .....	<u>\$ 97,994</u>	<u>\$ 96,436</u>	1.6	<u>128,908</u>	<u>137,098</u>	(6.0)
Heating degree days (normal 4,406) .....				4,412	4,736	(6.8)

Gas revenues decreased \$0.7 million, or 3.1%, for the three months ended June 30, 2004, and increased \$1.6 million or 1.6% for the six months ended June 30, 2004, compared to the same periods in the prior year. These changes are related to the following factors:

(In millions)	Three months ended June 30, 2004	Six months ended June 30, 2004
Gas costs/rates .....	\$1.6	\$7.8
Gas deliveries .....	(2.4)	(6.0)
Other miscellaneous effects .....	0.1	(0.2)
Total .....	<u>(\$0.7)</u>	<u>\$1.6</u>
Average rate per therm .....	\$0.998	\$0.915

- *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. The average rate per therm for the six months ended June 30, 2004, increased 9.0% compared to the same period in the prior year.
- *Retail gas deliveries.* The 6.4% decrease in retail gas deliveries for the six months ended June 30, 2004, was mainly the result of cooler temperatures, reflected by a 6.8% decrease in the number of heating degree days during the six months ended June 30, 2004, compared to the same period in the prior year.

### ***Natural gas purchased***

For the three months ended June 30, 2004, natural gas purchases decreased by \$0.5 million, mainly due to a 10.9% decrease in the volume of gas purchased during the period. For the six months ended June 30, 2004, natural gas purchases increased by \$0.4 million due to a \$2.9 million increase in the cost of natural gas offset by a \$2.5 million decrease in the volume of gas purchased.

### **Other Nonregulated Revenues - MGE Energy**

For the three and six months ended June 30, 2004, MGE Construct received \$0.7 million and \$1.4 million, respectively, from the State. These payments were for services rendered in relation to MGE Construct's role as EPC contractor for the WCCF.



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## **Operations and Maintenance Expense - MGE**

Operations and maintenance expense increased \$1.2 million and \$1.7 million for the three and six months ended June 30, 2004, compared to the same periods in the prior year, respectively. These increases are primarily attributable to increases in electric production expenses, overhead line maintenance expense, and administrative and customer service expenses. These increases are partially offset by reductions in operational expenses at Columbia.

## **Depreciation and Amortization - MGE Energy and MGE**

For the three months ended June 30, 2004, depreciation expense increased by \$0.1 million or 1.7% compared to the same period in the prior year. For the six months ended June 30, 2004, depreciation expense increased \$0.5 million or 3.8% from the same period in the prior year. These increases are attributable to an increase in the gross property, plant, and equipment balance between the two periods.

## **Other General Taxes - MGE Energy**

The 8.8% increase in other general taxes for MGE Energy for both the three and six months ended June 30, 2004, compared to the same periods in the prior year is due to an increase in MGE's license fee tax. Wisconsin's license fee tax is in lieu of property tax on utility property. The tax is estimated and prepaid one year ahead of expense recognition, then finally determined as a percentage of adjusted operating revenues from the prior calendar year and amortized to expense on a straight-line basis.

## **Income Taxes - MGE Energy**

MGE Energy's effective income tax rate is 39.1% for the six months ended June 30, 2004. This is comparable to the effective income tax rate for the six months ended June 30, 2003 (39.3%).

## **Other Income - MGE Energy**

For the three months ended June 30, 2004, MGE Energy's other income increased \$0.3 million due to an increase in ATC earnings, compared to the prior year, and a gain on investments. For the six months ended June 30, 2004, other income increased \$1.0 million. Factors contributing to this increase include a gain on the sale of assets of \$0.6 million, an increase in ATC earnings of \$0.2 million, and a gain on investments.

## **Interest Expense - MGE Energy**

During the three and six months ended June 30, 2004, MGE Energy's net interest expense decreased \$0.2 million compared to the same periods in the prior year. The decrease is due to lower interest rates on variable rate long-term debt.

## **Contractual Obligations and Commercial Commitments - MGE Energy and MGE**

There were no material changes, other than from the normal course of business, to MGE Energy's and MGE's contractual obligations (representing cash obligations that are considered to be firm commitments) and commercial commitments (representing commitments triggered by future events) during the three and six months ended June 30, 2004. Further discussion of the contractual obligations and commercial commitments is included in MGE Energy's and MGE's annual reports on Form 10-K for the year ended December 31, 2003.

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## ***Liquidity and Capital Resources***

### **Cash Flows**

The following summarizes cash flows during the six months ended June 2004 and 2003, respectively:

<i>(Thousands of dollars)</i>	MGE Energy		MGE	
	2004	2003	2004	2003
Cash provided by (used for):				
Operating activities . . . . .	\$ 55,290	\$ 55,266	\$ 49,022	\$ 56,067
Investing activities . . . . .	(52,625)	(56,467)	(53,237)	(26,811)
Financing activities . . . . .	(1,795)	8,522	4,607	(22,105)

### **Cash Provided by Operating Activities**

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 MGE Energy's operating activities was \$55.3 million for the six months ended June 30, 2004. Current assets decreased \$21.3 million for the six months ended June 30, 2004, primarily due to decreases in unbilled and billed receivables (\$12.9 million), stored natural gas and materials (\$3.8 million), and prepayments (\$4.6 million). Current liabilities increased \$0.8 million for the six months ended June 30, 2004, primarily due to a increase in accounts payable.

As of June 30, 2004, MGE Energy had a working capital deficit (current liabilities exceed current assets) of \$11.9 million. MGE Energy is currently financing the majority of capital commitments of WCCF with a short-term bank line of credit. During the next year, MGE Energy plans to issue both long-term debt and equity securities to reduce the existing short-term bank loans and to fund future capital expenditures.

### **Cash Used for Investing Activities**

Cash used for MGE Energy's investing activities decreased \$3.8 million or 6.8% for the six months ended June 30, 2004, compared to the same period in the prior year. This decrease is primarily attributable to a \$3.7 million decrease in capital expenditures for the six months ended June 30, 2004, compared to the same period in the prior year. Capital expenditures related to WCCF decreased \$0.4 million for the six months ended June 30, 2004, compared to the same period in the prior year. In 2003, MGE Energy's capital expenditures related to WCCF included the State's portion. In November 2003, the State reimbursed MGE Construct for its share of construction costs incurred throughout 2003. MGE Construct now bills the State monthly for its share of the cost of WCCF in accordance with the EPC Agreement. MGE utility plant additions also decreased \$3.3 million during the six months ended June 30, 2004, compared to the same period in the prior year. Additional factors contributing to a decrease in cash used for investing activities for the six-month period ended June 30, 2004, include \$0.6 million in proceeds for the sale of property, a \$0.6 million reduction in advances to ATC related to WCCF, and \$0.7 million in additional cash received from other investing activities. These changes were offset by two additional capital contributions made by MGE to ATC for the six months ended June 30, 2004. Total capital contributions to ATC for the six-month period were \$1.8 million.

Cash used for MGE's investing activities increased \$26.4 million or 98.6% for the six months ended June 30, 2004, compared to the same period in the prior year. As of December 31, 2003, MGE Power West Campus is being consolidated into MGE in accordance with FIN No. 46R (see Footnote 9.c.) Therefore, for the six months ended June 30, 2004, MGE's cash used for investing activities includes the capital expenditures related to WCCF. MGE also made two additional capital contributions to ATC totaling \$1.8 million. These uses of cash were offset by a \$0.6 million reduction in advances to ATC related to WCCF, \$0.7 million in additional cash provided by other investing activities, and a \$3.3 million reduction in utility plant additions.

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## Cash Provided by (Used for) Financing and Capital Resources

Cash used for MGE Energy's financing activities was \$1.8 million for the six months ended June 30, 2004, compared to cash provided by financing activities of \$8.5 million for the same period in the prior year. During the six months ended June 30, 2004, MGE recorded net debt repayments of \$2.8 million compared to net borrowings of \$11.9 million for the same period in the prior year. During the second quarter of 2004, MGE repaid \$5.0 million of the current portion of their long-term debt, offset by interim borrowings of \$2.2 million. Proceeds from the issuance of common stock increased \$5.1 million for the six months ended June 30, 2004, when compared to the same period in the prior year. This increase is a result of shares issued under the Distribution Agreement through BOCM and increased shares issued through the Dividend Reinvestment and Direct Stock Purchase Plan. Cash dividends for the six months ended June 30, 2004, increased \$0.7 million or 5.5% compared to the same period in the prior year.

MGE Energy has an established line of credit in the amount of \$60 million for the temporary financing of the capital commitments for the WCCF. At June 30, 2004, MGE Energy had \$33.4 million drawn on this line of credit and recorded as bank loans outstanding.

Cash provided by MGE's financing activities increased \$26.7 million for the six months ended June 30, 2004, compared to the same period in the prior year. This change is primarily the result of the consolidation of MGE Power West Campus into MGE in accordance with FIN No. 46R. MGE's financing activities includes an equity contribution made from MGE Energy to WCCF for \$26.8 million and \$0.3 million of affiliate financing for WCCF. Cash dividends to the parent decreased \$5.4 million for the six months ended June 30, 2004, compared to the same period in the prior year. These changes were offset by additional debt repayments of \$6.5 million.

Bank lines of credit available to MGE as of June 30, 2004, were \$40 million. MGE also has a letter of credit with a commercial bank (established as collateral for equipment purchases) that ATC will use to provide necessary system upgrades for the WCCF.

## Capitalization Ratios

MGE Energy's capitalization ratios were as follows:

	MGE Energy	
	June 30, 2004	Dec. 31, 2003
Common shareholders' equity .....	53.1%	50.9%
Long-term debt* .....	40.6%	43.0%
Short-term debt .....	6.3%	6.1%

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

## MGE Energy's and MGE's Capital Requirements

MGE Energy's and MGE's liquidity is primarily affected by their capital requirements. During the six months ended June 30, 2004, capital expenditures for MGE Energy and MGE totaled \$50.0 million, which included \$29.3 million of capital expenditures for WCCF and \$20.7 million of capital expenditures for utility operations.

MGE Energy's and MGE's 2004 capital commitments related to WCCF are estimated to be \$27.1 million. MGE Energy plans to finance these capital expenditures through the issuance of both debt and equity securities. MGE Energy has a current shelf registration statement for the sale of \$176 million of equity and debt securities that is effective with the SEC. MGE Energy expects to use the proceeds from securities sold under the registration statement to finance future capital expenditures, redeem or refund debt incurred in connection with the WCCF, or for other general corporate purposes.

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MGE anticipates 2004 regulated capital expenditures will be approximately \$45 million. MGE uses its internally generated funds and short-term debt to satisfy a majority of its capital requirements. For larger capital investments, MGE would expect to finance these with additional long-term debt and capital contributions from MGE Energy.

The following table shows MGE's current credit ratings. MGE Energy is not yet rated because it has not issued any debt securities.

	<u>Standard &amp; Poor's</u>	<u>Moody's</u>
First Mortgage Bonds . . . . .	AA	Aa2
Unsecured Medium Term Notes . . . . .	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, is dependent on its securities' ratings. None of MGE's borrowings is subject to default or prepayment due to downgrading of securities' ratings, although MGE's future interest expense may be affected by a change in those ratings.

### **WCCF**

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. MGE Construct bills the State monthly for its share of the cost of WCCF in accordance with the EPC Agreement. As of June 30, 2004, MGE Power West Campus had incurred \$77.9 million of costs on the project, which is reflected in construction work in progress on MGE Energy's and MGE's consolidated balance sheets. For the six months ended June 30, 2004, MGE Construct received a service fee of \$1.4 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.

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 entire construction process for the 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.

### **Adoption of Accounting Principles**

#### ***SFAS No. 143***

In 2001, the FASB issued SFAS No. 143, *Accounting for Asset Retirement Obligations*. SFAS No. 143 provides accounting requirements for retirement obligations associated with tangible long-lived assets. MGE Energy and MGE were required to adopt SFAS No. 143 as of January 1, 2003. Retirement obligations associated with long-lived assets included within the scope of SFAS No. 143 are those for which there is a legal obligation under existing or enacted law, statute, written or oral contract, or by legal construction under the doctrine of promissory estoppel.

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 the photovoltaic generating facilities, all of which are located on property not owned by MGE. At June 30, 2004, this liability is estimated at \$1.4 million and 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. MGE applies SFAS No. 71 and recognizes regulatory assets or liabilities for the timing differences between when we recover legal asset retirement obligations in rates and when MGE would recognize these costs under SFAS No. 143.

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, aboveground and underground storage tanks, facilities located at Columbia (co-owned with Alliant and Wisconsin Public Service Corporation), 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 following table shows costs as of December 31, 2003, and changes to the asset retirement obligation and accumulated depreciation during the six months ended June 30, 2004.

	(a)	(b)	(c) (a + b)	(d)
(In thousands)	Original Asset Retirement Obligation	Accumulated Accretion	Asset Retirement Obligation	Accumulated Depreciation- Related Asset
Balance, December 31, 2003 . . . . .	\$ 686	\$ 675	\$ 1,361	\$ 175
Changes through June 30, 2004 . . . .	-	43	43	13
Balance, June 30, 2004 . . . . .	<u>\$ 686</u>	<u>\$ 718</u>	<u>\$ 1,404</u>	<u>\$ 188</u>

As of June 30, 2004, MGE's regulatory asset, included in deferred charges, is the total accumulated accretion (\$0.7 million) and accumulated depreciation (\$0.2 million) or \$0.9 million.

Accumulated costs of removal that are non-SFAS 143 obligations are classified within the financial statements as regulatory liabilities. At June 30, 2004, and December 31, 2003, there were \$17.7 million and \$18.2 million of these costs recorded as regulatory liabilities within the financials statements, respectively.

#### **FIN No. 45.**

In November 2002, the FASB issued FIN No. 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.

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 \$7.5 million of the financing program receivables, until February 28, 2005. Loans totaling \$0.6 million have been sold to the financial institution during 2004. The liability for the fair value of the obligation associated with these loans is not material.

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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 \$0.4 million in 2004, \$0.9 million in 2005, 2006, and 2007, and \$1.0 million in 2008.

***FIN No. 46R.***

In January 2003, the FASB issued FIN No. 46, *Consolidation of Variable Interest Entities - An Interpretation of ARB No. 51*. In December 2003, the FASB issued the updated and final interpretation, FIN No. 46R. FIN No. 46R 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 No. 46 was applicable immediately to VIEs created or obtained after January 31, 2003. FIN No. 46R 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 of MGE pursuant to FIN No. 46R, as the equity investment by MGE Energy in MGE Power West Campus 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 No. 46R 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 65% of the total Shared Savings program balance and has determined that the provisions of FIN No. 46R are not applicable via the "business scope exception." For the remaining 35% 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 No. 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. FASB Staff Position No. (FSP) No. 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. FSP No. 106-2 is effective as of the first interim or annual period beginning after June 15, 2004 (see Footnote 8 for further discussion).

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## Regulatory Issues - Transmission

The Midwest ISO is in the process of developing a bid-based energy market, which is currently proposed to be implemented on March 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 certain states. It is expected that the LMP system will include the ability to mitigate or eliminate congestion costs through the use of FTRs. The Midwest ISO will initially allocate FTRs, and it is anticipated that additional FTRs will be available through an auction-based system run by the Midwest ISO. It is unknown at this time the quantity of FTRs that will be allocated by the Midwest ISO or what the financial impact of the LMP congestion pricing system might have on MGE.

ComEd and AEP (PJM companies) have joined PJM rather than the Midwest ISO and have filed with FERC a "Hold Harmless Proposal." Had the PJM companies joined the Midwest ISO instead, both Wisconsin and Michigan utilities would have received a portion of the revenues for point-to-point transmission service for certain transactions under the "Agreement of Transmission Owners of the Midwest ISO." A group of Wisconsin and Michigan utilities (which includes MGE) formed a coalition ("WI/MI Coalition") and filed a Hold Harmless Agreement counterproposal with FERC.

On March 18, 2004, FERC rejected the PJM companies Hold Harmless Proposal, finding that it did not adequately hold the WI/MI Coalition harmless from adverse impacts associated with transmission congestion and loop flow from the PJM companies RTO choices and that a trial-type evidentiary hearing should be held to address these issues. The FERC decision suggested that the PJM companies propose a "Service Agreement" which adopts the Hold Harmless Proposal, subject to the outcome of various proceedings, and that the proposal contains a contractual mechanism to ensure the PJM companies provide appropriate compensation to the WI/MI Coalition for adverse impacts. On April 6, 2004, the PJM companies filed with FERC a "Hold Harmless Service Agreement" for PJM's tariff. On April 27, 2004, FERC accepted the Hold Harmless Service Agreement subject to refund and the outcome of a hearing on the question of the appropriate compensation to the WI/MI Coalition for any adverse impacts related to ComEd's decision to join PJM.

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### **Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

#### **Market Risks**

MGE Energy, through MGE, and MGE are potentially exposed to market risks associated with interest rates, commodity prices, weather, regulatory recovery, and equity returns. Neither MGE Energy nor MGE have any current exposure to foreign currency risk. MGE manages some risk exposure through risk management policies and uses derivative instruments.

#### **Interest Rate Risk**

MGE Energy and MGE manage interest rate risk by limiting their variable rate exposure and by 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. MGE has \$15.0 million in variable rate long-term debt outstanding as of June 30, 2004. Borrowing levels under commercial paper arrangements vary from period to period depending upon capital investments and other factors.

#### **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. 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 fall outside a 3.0% bandwidth set by the PSCW, MGE can apply for a fuel surcharge or may be required to issue a fuel credit to its customers. Under the PGA clause 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 2003, the PSCW approved MGE's Electric Procurement Risk Management Program, with conditions, through December 31, 2004. No transactions have occurred under this program through June 30, 2004.

#### **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) are 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 margins.

#### **Regulatory Recovery Risk**

MGE burns natural gas in several of its peak electric generation facilities as a supplemental fuel, and in many cases, the cost of purchased power is tied to the cost of natural gas. MGE bears regulatory risk for the recovery from customers of such fuel and purchased power costs when they are higher than the base rate established in its current rate structure.



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## **Equity Price Risks**

MGE currently funds its liabilities related to employee benefits through contributions to, and investment earnings on, trust funds. Changes in the market value of the employee benefits trust funds affect MGE's expense and annuity payment. MGE seeks to mitigate some of its risk in this matter through future rate actions by the PSCW.

## **Credit Risks**

Credit risk is the loss that may result from counterparty nonperformance. MGE Energy, through 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.

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#### **Item 4. Controls and Procedures.**

During the second quarter of 2004, each registrant's management, including its 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 by each registrant to ensure that material information relating to that registrant, including its subsidiaries, is made known to that registrant's management, including its principal executive officer and its principal financial officer, by other employees of that registrant and its subsidiaries, 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. Each registrant's controls and procedures can only provide reasonable, not absolute, assurance that the above objectives have been met. 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 June 30, 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. Each registrant intends to continually strive to improve its disclosure controls and procedures to enhance the quality of its financial reporting.

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## PART II. OTHER INFORMATION.

### Item 1. Legal Proceedings.

#### *MGE Energy and MGE*

Both WELA and the WDOJ had filed complaints in federal and state courts, respectively, against WPL and Alliant alleging violations of the Federal Water Pollution Control Act at the Columbia generating station. In July 2004, Alliant, WELA, and WDOJ settled the actions for \$150,000 and Alliant's commitment to implement upgrades to Columbia's wastewater system. MGE owns a 22% share of Columbia along with the other co-owners, Alliant and WPSC. MGE has recorded a liability at June 30, 2004, for their pro-ratable share of the monetary settlement.

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

MGE Energy's Annual Meeting of Shareholders was held on May 11, 2004, in Middleton, Wisconsin.

Shareholders voted for the election of three persons to serve as Class III Directors to hold office until 2007. Listed below are the nominees for Class III Directors and the results of the voting.

	<u>For</u>	<u>Withhold Authority</u>
Richard E. Blaney	14,613,448	326,936
Frederic E. Mohs	14,583,484	356,900
F. Curtis Hastings	14,625,372	315,012

No votes were cast for any other nominee. The directors continuing office until the 2005 annual meeting are Regina M. Millner and Donna K. Sollenberger. David C. Mebane retired from the board on May 11, 2004. The directors continuing in office until the 2006 annual meeting are John R. Nevin, H. Lee Swanson, and Gary J. Wolter.

On May 11, 2004, MGE Energy, as MGE's sole shareholder, executed a shareholder's consent electing Richard E. Blaney, Frederic E. Mohs, and F. Curtis Hastings as Class III Directors to the Board of Directors of MGE. The remaining persons on MGE's Board of Directors who continued in office as directors are Regina M. Millner, John R. Nevin, Donna K. Sollenberger, H. Lee Swanson, and Gary J. Wolter.

### Item 6. Exhibits and Reports on Form 8-K.

#### *Item 6(a) - Exhibits*

##### 10.1 Credit Agreement

Statements regarding computation of ratio of earnings to fixed charges:

##### 12.1 MGE Energy, Inc.

##### 12.2 Madison Gas and Electric Company

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Certifications Pursuant to Rule 13a-14(a) and 15d-14(a) of the Securities and Exchange Act of 1934 as to the Quarterly Report on Form 10-Q for the quarter ended June 30, 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 Quarterly Report on Form 10-Q for the quarter ended June 30, 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

***Item 6(b) - Reports on Form 8-K***

On April 30, 2004, MGE Energy, Inc. and Madison Gas and Electric Company furnished a Current Report on Form 8-K dated April 30, 2004, reporting the issuance of a press release announcing MGE Energy, Inc.'s earnings for the first quarter.

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## **Signatures - MGE Energy, Inc.**

Pursuant to the requirements 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.**

Date: August 9, 2004

/s/ Gary J. Wolter

Gary J. Wolter  
Chairman, President and Chief Executive Officer  
(Duly Authorized Officer)

Date: August 9, 2004

/s/ Terry A. Hanson

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

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## **Signatures - Madison Gas and Electric Company**

Pursuant to the requirements 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**

Date: August 9, 2004

/s/ Gary J. Wolter

Gary J. Wolter  
Chairman, President and Chief Executive Officer  
(Duly Authorized Officer)

Date: August 9, 2004

/s/ Terry A. Hanson

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