

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, 2016

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

For the transition period from _____ to _____

| Commission File No. | Name of Registrant, State of Incorporation, Address of Principal Executive Offices, and Telephone No. | IRS Employer Identification No. |
|------------------------|---|------------------------------------|
| 000-49965 | MGE Energy, Inc. (a Wisconsin Corporation) 133 South Blair Street Madison, Wisconsin 53788 (608) 252-7000 mgeenergy.com | 39-2040501 |
| 000-1125 | Madison Gas and Electric Company (a Wisconsin Corporation) 133 South Blair Street Madison, Wisconsin 53788 (608) 252-7000 mge.com | 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 (or for such shorter period that the registrant was required to file such reports), and (2) have been subject to such filing requirements for the past 90 days: Yes No

Indicate by check mark whether the registrants have submitted electronically and posted on their corporate Web sites, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrants were required to submit and post such files): Yes No

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

| | Large Accelerated Filer | Accelerated Filer | Non-accelerated Filer | Smaller Reporting Company |
|--|-------------------------|-------------------|-----------------------|------------------------------|
| MGE Energy, Inc. | X | | | |
| Madison Gas and Electric Company | | | X | |

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act):
 MGE Energy, Inc. and Madison Gas and Electric Company: Yes No

Number of Shares Outstanding of Each Class of Common Stock as of July 31, 2016

| | |
|--|--|
| MGE Energy, Inc. | Common stock, \$1.00 par value, 34,668,370 shares outstanding. |
| Madison Gas and Electric Company | Common stock, \$1.00 par value, 17,347,894 shares outstanding (all of which are owned beneficially and of record by MGE Energy, Inc.). |

Table of Contents

| | |
|---|----|
| PART I. FINANCIAL INFORMATION..... | 3 |
| Filing Format | 3 |
| Forward-Looking Statements..... | 3 |
| Where to Find More Information..... | 3 |
| Definitions, Abbreviations, and Acronyms Used in the Text and Notes of this Report..... | 4 |
| Item 1. Financial Statements..... | 6 |
| MGE Energy, Inc. | 6 |
| Consolidated Statements of Income (unaudited) | 6 |
| Consolidated Statements of Comprehensive Income (unaudited)..... | 6 |
| Consolidated Statements of Cash Flows (unaudited)..... | 7 |
| Consolidated Balance Sheets (unaudited)..... | 8 |
| Consolidated Statements of Common Equity (unaudited)..... | 9 |
| Madison Gas and Electric Company | 10 |
| Consolidated Statements of Income (unaudited) | 10 |
| Consolidated Statements of Comprehensive Income (unaudited)..... | 10 |
| Consolidated Statements of Cash Flows (unaudited)..... | 11 |
| Consolidated Balance Sheets (unaudited)..... | 12 |
| Consolidated Statements of Common Equity (unaudited)..... | 13 |
| MGE Energy, Inc., and Madison Gas and Electric Company | 14 |
| Notes to Consolidated Financial Statements (unaudited)..... | 14 |
| Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations. | 31 |
| Item 3. Quantitative and Qualitative Disclosures About Market Risk | 46 |
| Item 4. Controls and Procedures. | 48 |
| PART II. OTHER INFORMATION..... | 49 |
| Item 1. Legal Proceedings..... | 49 |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds. | 49 |
| Item 4. Mine Safety Disclosures. | 49 |
| Item 6. Exhibits..... | 49 |
| Signatures - MGE Energy, Inc. | 51 |
| Signatures - Madison Gas and Electric Company..... | 52 |

PART I. FINANCIAL INFORMATION.

Filing Format

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

Forward-Looking Statements

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

The factors that could cause actual results to differ materially from the forward-looking statements made by a registrant include (a) those factors discussed in the Registrants' 2015 Annual Report on Form 10-K: Item 1A. Risk Factors, Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations, as updated by Part I, Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations in this report, and Item 8. Financial Statements and Supplementary Data – Note 18, as updated by Part I, Item 1. Financial Statements – Note 7 in this report, and (b) other factors discussed herein and in other filings made by that registrant with the SEC.

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

Where to Find More Information

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

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

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

MGE Energy and Subsidiaries:

| | |
|---------------------------|---|
| CWDC | Central Wisconsin Development Corporation |
| MAGAEL | MAGAEL, LLC |
| MGE | Madison Gas and Electric Company |
| MGE Energy | MGE Energy, Inc. |
| MGE Power | MGE Power, LLC |
| MGE Power Elm Road | MGE Power Elm Road, LLC |
| MGE Power West Campus | MGE Power West Campus, LLC |
| MGE Services | MGE Services, LLC |
| MGE State Energy Services | MGE State Energy Services, LLC |
| MGE Transco | MGE Transco Investment, LLC |
| NGV Fueling Services | NGV Fueling Services, LLC |
| North Mendota | North Mendota Energy & Technology Park, LLC |

Other Defined Terms:

| | |
|---------------------------|--|
| AFUDC | Allowance for Funds Used During Construction |
| ATC | American Transmission Company LLC |
| BART | Best Available Retrofit Technology |
| Blount | Blount Station |
| CAVR | Clean Air Visibility Rule |
| CCR | Coal Combustion Residual |
| Codification | Financial Accounting Standards Board Accounting Standards Codification |
| Columbia | Columbia Energy Center |
| Cooling degree days | Measure of the extent to which the average daily temperature is above 65 degrees Fahrenheit, which is considered an indicator of possible increased demand for energy to provide cooling |
| CPP | Clean Power Plan |
| CSAPR | Cross-State Air Pollution Rule |
| Dth | Dekatherms, a quantity measure used in respect of natural gas |
| EGUs | Electric Generating Units |
| ELG | Effluent Limitations Guidelines |
| Elm Road Units | Elm Road Generating Station |
| EPA | United States Environmental Protection Agency |
| FASB | Financial Accounting Standards Board |
| FERC | Federal Energy Regulatory Commission |
| FTR | Financial Transmission Rights |
| GHG | Greenhouse Gas |
| Heating degree days (HDD) | Measure of the extent to which the average daily temperature is below 65 degrees Fahrenheit, which is considered an indicator of possible increased demand for energy to provide heating |
| IRS | Internal Revenue Service |
| kWh | Kilowatt-hour, a measure of electric energy produced |
| MISO | Midcontinent Independent System Operator (a regional transmission organization) |
| MW | Megawatt, a measure of electric energy generating capacity |
| MWh | Megawatt-hour, a measure of electric energy produced |
| NAAQS | National Ambient Air Quality Standards |
| NO ₂ | Nitrogen Dioxide |
| NO _x | Nitrogen Oxides |

| | |
|-----------------|--|
| PGA | Purchased Gas Adjustment clause, a regulatory mechanism used to reconcile natural gas costs recovered in rates to actual costs |
| PJM | PJM Interconnection, LLC (a regional transmission organization) |
| PM | Particulate Matter |
| PPA | Purchased Power Agreement |
| ppb | Parts Per Billion |
| PSCW | Public Service Commission of Wisconsin |
| ROE | Return on Equity |
| SCR | Selective Catalytic Reduction |
| SEC | Securities and Exchange Commission |
| SO ₂ | Sulfur Dioxide |
| the State | State of Wisconsin |
| Stock Plan | Direct Stock Purchase and Dividend Reinvestment Plan of MGE Energy |
| UW | University of Wisconsin at Madison |
| VIE | Variable Interest Entity |
| WCCF | West Campus Cogeneration Facility |
| WDNR | Wisconsin Department of Natural Resources |
| Working capital | Current assets less current liabilities |
| WPDES | Wisconsin Pollutant Discharge Elimination System |
| WPL | Wisconsin Power and Light Company |
| XBRL | eXtensible Business Reporting Language |

Item 1. Financial Statements.

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

| | Three Months Ended | | Six Months Ended | |
|--|--------------------|------------------|------------------|------------------|
| | June 30, | | June 30, | |
| | 2016 | 2015 | 2016 | 2015 |
| Operating Revenues: | | | | |
| Electric revenues..... | \$ 100,615 | \$ 101,457 | \$ 194,305 | \$ 201,663 |
| Gas revenues | 20,961 | 20,669 | 74,798 | 90,597 |
| <i>Total Operating Revenues</i> | <u>121,576</u> | <u>122,126</u> | <u>269,103</u> | <u>292,260</u> |
| Operating Expenses: | | | | |
| Fuel for electric generation..... | 15,049 | 12,677 | 27,062 | 24,569 |
| Purchased power | 14,861 | 21,265 | 29,531 | 44,130 |
| Cost of gas sold | 6,410 | 6,650 | 38,933 | 53,569 |
| Other operations and maintenance | 40,963 | 41,500 | 83,693 | 82,174 |
| Depreciation and amortization | 11,114 | 10,995 | 22,146 | 21,844 |
| Other general taxes..... | 4,967 | 4,990 | 9,995 | 10,074 |
| <i>Total Operating Expenses</i> | <u>93,364</u> | <u>98,077</u> | <u>211,360</u> | <u>236,360</u> |
| Operating Income | <u>28,212</u> | <u>24,049</u> | <u>57,743</u> | <u>55,900</u> |
| Other income, net | 2,179 | 2,446 | 4,621 | 4,551 |
| Interest expense, net..... | (4,957) | (5,008) | (9,957) | (10,099) |
| Income before income taxes | 25,434 | 21,487 | 52,407 | 50,352 |
| Income tax provision..... | (9,284) | (8,008) | (19,229) | (18,595) |
| Net Income | <u>\$ 16,150</u> | <u>\$ 13,479</u> | <u>\$ 33,178</u> | <u>\$ 31,757</u> |
| Earnings Per Share of Common Stock | | | | |
| (basic and diluted) | <u>\$ 0.47</u> | <u>\$ 0.39</u> | <u>\$ 0.96</u> | <u>\$ 0.92</u> |
| Dividends per share of common stock..... | <u>\$ 0.295</u> | <u>\$ 0.283</u> | <u>\$ 0.590</u> | <u>\$ 0.565</u> |
| Weighted Average Shares Outstanding | | | | |
| (basic and diluted) | <u>34,668</u> | <u>34,668</u> | <u>34,668</u> | <u>34,668</u> |

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

MGE Energy, Inc.
Consolidated Statements of Comprehensive Income (unaudited)
(In thousands)

| | Three Months Ended | | Six Months Ended | |
|--|--------------------|------------------|------------------|------------------|
| | June 30, | | June 30, | |
| | 2016 | 2015 | 2016 | 2015 |
| Net Income | \$ 16,150 | \$ 13,479 | \$ 33,178 | \$ 31,757 |
| Other comprehensive income, net of tax: | | | | |
| Unrealized gain (loss) on available-for-sale securities, net of tax ((\$7) and \$7, and \$104 and \$64, respectively)..... | 10 | (11) | (154) | (95) |
| Comprehensive Income | <u>\$ 16,160</u> | <u>\$ 13,468</u> | <u>\$ 33,024</u> | <u>\$ 31,662</u> |

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

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

| | Six Months Ended | |
|--|-------------------|------------------|
| | June 30, | |
| | 2016 | 2015 |
| Operating Activities: | | |
| Net income | \$ 33,178 | \$ 31,757 |
| Items not affecting cash: | | |
| Depreciation and amortization | 22,146 | 21,844 |
| Deferred income taxes | 9,522 | 6,201 |
| Provision for doubtful receivables..... | 483 | 85 |
| Employee benefit plan expenses | 30 | 1,660 |
| Equity earnings in ATC | (4,000) | (4,170) |
| Other items..... | 392 | (772) |
| Changes in working capital items: | | |
| Decrease in current assets | 27,585 | 29,599 |
| Increase (decrease) in current liabilities | 12,230 | (14,789) |
| Dividend income from ATC | 2,728 | 2,891 |
| Cash contributions to pension and other postretirement plans | (12,096) | (11,626) |
| Other noncurrent items, net..... | 1,316 | 10,313 |
| <i>Cash Provided by Operating Activities</i> | 93,514 | 72,993 |
| Investing Activities: | | |
| Capital expenditures..... | (40,791) | (33,211) |
| Capital contributions to investments | (998) | (538) |
| Other..... | (184) | (52) |
| <i>Cash Used for Investing Activities</i> | (41,973) | (33,801) |
| Financing Activities: | | |
| Cash dividends paid on common stock..... | (20,454) | (19,589) |
| Repayment of long-term debt..... | (2,123) | (2,080) |
| Repayment of short-term debt | - | (7,000) |
| Other..... | (40) | (487) |
| <i>Cash Used for Financing Activities</i> | (22,617) | (29,156) |
| Change in cash and cash equivalents | 28,924 | 10,036 |
| Cash and cash equivalents at beginning of period | 81,384 | 65,755 |
| Cash and cash equivalents at end of period | \$ 110,308 | \$ 75,791 |
| Supplemental disclosures of cash flow information: | | |
| Significant noncash investing activities: | | |
| Accrued capital expenditures..... | \$ 7,091 | \$ 2,409 |

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

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

| | June 30, | December 31, |
|--|-----------------|---------------------|
| | 2016 | 2015 |
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents..... | \$ 110,308 | \$ 81,384 |
| Accounts receivable, less reserves of \$3,047 and \$3,052, respectively | 31,444 | 37,112 |
| Other accounts receivable, less reserves of \$506 and \$642, respectively..... | 6,765 | 7,477 |
| Unbilled revenues | 25,653 | 25,008 |
| Materials and supplies, at average cost | 20,825 | 19,155 |
| Fossil fuel, at average cost | 9,502 | 13,110 |
| Stored natural gas, at average cost..... | 10,029 | 16,145 |
| Prepaid taxes | 19,831 | 35,252 |
| Regulatory assets - current | 7,170 | 9,538 |
| Other current assets..... | 13,402 | 10,570 |
| <i>Total Current Assets</i> | 254,929 | 254,751 |
| Regulatory assets..... | 147,157 | 148,199 |
| Other deferred assets and other..... | 6,372 | 6,377 |
| Property, Plant, and Equipment: | | |
| Property, plant, and equipment, net | 1,234,587 | 1,217,094 |
| Construction work in progress | 32,187 | 26,351 |
| <i>Total Property, Plant, and Equipment</i> | 1,266,774 | 1,243,445 |
| Investments | 75,347 | 73,631 |
| Total Assets | \$ 1,750,579 | \$ 1,726,403 |
| LIABILITIES AND CAPITALIZATION | | |
| Current Liabilities: | | |
| Long-term debt due within one year | \$ 34,294 | \$ 4,266 |
| Accounts payable..... | 46,304 | 40,830 |
| Accrued interest and taxes..... | 4,940 | 5,067 |
| Accrued payroll related items | 9,453 | 11,215 |
| Regulatory liabilities - current | 14,818 | 9,515 |
| Derivative liabilities | 8,650 | 8,343 |
| Other current liabilities | 10,099 | 4,910 |
| <i>Total Current Liabilities</i> | 128,558 | 84,146 |
| Other Credits: | | |
| Deferred income taxes | 370,516 | 360,785 |
| Investment tax credit - deferred | 999 | 1,050 |
| Regulatory liabilities | 22,138 | 20,785 |
| Accrued pension and other postretirement benefits | 63,085 | 75,680 |
| Derivative liabilities | 43,590 | 44,935 |
| Other deferred liabilities and other | 63,865 | 61,820 |
| <i>Total Other Credits</i> | 564,193 | 565,055 |
| Capitalization: | | |
| Common shareholders' equity..... | 703,028 | 690,458 |
| Long-term debt | 354,800 | 386,744 |
| <i>Total Capitalization</i> | 1,057,828 | 1,077,202 |
| Commitments and contingencies (see Footnote 7) | - | - |
| Total Liabilities and Capitalization | \$ 1,750,579 | \$ 1,726,403 |

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

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

| | Common Stock | | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income/(Loss) | Total |
|---|--------------|-----------|----------------------------------|----------------------|--|------------|
| | Shares | Value | | | | |
| 2015 | | | | | | |
| Beginning balance - December 31, 2014..... | 34,668 | \$ 34,668 | \$ 316,268 | \$ 308,007 | \$ 458 | \$ 659,401 |
| Cumulative effect of new accounting principle..... | | | | (142) | | (142) |
| Beginning balance - Adjusted | | | | 307,865 | | 659,259 |
| Net income..... | | | | 31,757 | | 31,757 |
| Other comprehensive loss..... | | | | | (95) | (95) |
| Common stock dividends declared (\$0.565 per share)..... | | | | (19,589) | | (19,589) |
| Ending balance - June 30, 2015 | 34,668 | \$ 34,668 | \$ 316,268 | \$ 320,033 | \$ 363 | \$ 671,332 |
| 2016 | | | | | | |
| Beginning balance - December 31, 2015..... | 34,668 | \$ 34,668 | \$ 316,268 | \$ 339,165 | \$ 357 | \$ 690,458 |
| Net income..... | | | | 33,178 | | 33,178 |
| Other comprehensive loss..... | | | | | (154) | (154) |
| Common stock dividends declared (\$0.590 per share)..... | | | | (20,454) | | (20,454) |
| Ending balance - June 30, 2016 | 34,668 | \$ 34,668 | \$ 316,268 | \$ 351,889 | \$ 203 | \$ 703,028 |

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

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

| | Three Months Ended | | Six Months Ended | |
|---|--------------------|------------------|------------------|------------------|
| | June 30, | | June 30, | |
| | 2016 | 2015 | 2016 | 2015 |
| Operating Revenues: | | | | |
| Electric revenues..... | \$ 100,622 | \$ 101,462 | \$ 194,318 | \$ 201,673 |
| Gas revenues | 20,967 | 20,671 | 74,814 | 90,604 |
| <i>Total Operating Revenues</i> | <u>121,589</u> | <u>122,133</u> | <u>269,132</u> | <u>292,277</u> |
| Operating Expenses: | | | | |
| Fuel for electric generation..... | 15,051 | 12,679 | 27,067 | 24,573 |
| Purchased power | 14,864 | 21,268 | 29,538 | 44,136 |
| Cost of gas sold | 6,415 | 6,654 | 38,949 | 53,577 |
| Other operations and maintenance | 40,712 | 41,236 | 83,114 | 81,708 |
| Depreciation and amortization | 11,102 | 10,984 | 22,122 | 21,821 |
| Other general taxes..... | 4,967 | 4,990 | 9,995 | 10,074 |
| Income tax provision | 8,464 | 7,041 | 17,554 | 16,817 |
| <i>Total Operating Expenses</i> | <u>101,575</u> | <u>104,852</u> | <u>228,339</u> | <u>252,706</u> |
| Operating Income | <u>20,014</u> | <u>17,281</u> | <u>40,793</u> | <u>39,571</u> |
| Other Income and Deductions: | | | | |
| AFUDC - equity funds..... | 263 | 167 | 524 | 295 |
| Equity in earnings in ATC | 1,767 | 2,289 | 4,000 | 4,170 |
| Income tax provision | (767) | (978) | (1,709) | (1,786) |
| Other income, net..... | (163) | (176) | (236) | (215) |
| <i>Total Other Income and Deductions</i> | <u>1,100</u> | <u>1,302</u> | <u>2,579</u> | <u>2,464</u> |
| Income before interest expense..... | <u>21,114</u> | <u>18,583</u> | <u>43,372</u> | <u>42,035</u> |
| Interest Expense: | | | | |
| Interest on long-term debt | 5,096 | 5,136 | 10,205 | 10,287 |
| Other interest, net..... | 14 | (17) | 51 | 15 |
| AFUDC - borrowed funds..... | (86) | (54) | (171) | (96) |
| <i>Net Interest Expense</i> | <u>5,024</u> | <u>5,065</u> | <u>10,085</u> | <u>10,206</u> |
| Net Income | <u>\$ 16,090</u> | <u>\$ 13,518</u> | <u>\$ 33,287</u> | <u>\$ 31,829</u> |
| Less: Net Income Attributable to Noncontrolling | | | | |
| Interest, net of tax | (5,952) | (6,626) | (12,204) | (13,179) |
| Net Income Attributable to MGE | <u>\$ 10,138</u> | <u>\$ 6,892</u> | <u>\$ 21,083</u> | <u>\$ 18,650</u> |

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

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

| | Three Months Ended | | Six Months Ended | |
|---|--------------------|------------------|------------------|------------------|
| | June 30, | | June 30, | |
| | 2016 | 2015 | 2016 | 2015 |
| Net Income | \$ 16,090 | \$ 13,518 | \$ 33,287 | \$ 31,829 |
| Other comprehensive income, net of tax: | | | | |
| Unrealized loss on available-for-sale securities, net of tax (\$6 and \$18, and \$26 and \$73, respectively)..... | (9) | (27) | (39) | (109) |
| Comprehensive Income | <u>\$ 16,081</u> | <u>\$ 13,491</u> | <u>\$ 33,248</u> | <u>\$ 31,720</u> |
| Less: Comprehensive Income Attributable to Noncontrolling Interest, net of tax..... | (5,952) | (6,626) | (12,204) | (13,179) |
| Comprehensive Income Attributable to MGE | <u>\$ 10,129</u> | <u>\$ 6,865</u> | <u>\$ 21,044</u> | <u>\$ 18,541</u> |

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

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

| | Six Months Ended | |
|--|------------------|------------------|
| | June 30, | |
| | 2016 | 2015 |
| Operating Activities: | | |
| Net income..... | \$ 33,287 | \$ 31,829 |
| Items not affecting cash: | | |
| Depreciation and amortization | 22,122 | 21,821 |
| Deferred income taxes | 8,894 | 3,909 |
| Provision for doubtful receivables..... | 483 | 85 |
| Employee benefit plan expenses | 30 | 1,660 |
| Equity earnings in ATC | (4,000) | (4,170) |
| Other items | 770 | (524) |
| Changes in working capital items: | | |
| Decrease in current assets..... | 27,628 | 35,282 |
| Increase (decrease) in current liabilities | 12,123 | (12,369) |
| Dividend income from ATC..... | 2,728 | 2,891 |
| Cash contributions to pension and other postretirement plans | (12,096) | (11,626) |
| Other noncurrent items, net..... | 1,240 | 10,204 |
| <i>Cash Provided by Operating Activities.....</i> | <i>93,209</i> | <i>78,992</i> |
| Investing Activities: | | |
| Capital expenditures..... | (40,791) | (33,211) |
| Capital contributions to investments | (710) | (355) |
| Other | (527) | (62) |
| <i>Cash Used for Investing Activities</i> | <i>(42,028)</i> | <i>(33,628)</i> |
| Financing Activities: | | |
| Cash dividends paid to parent by MGE | (25,000) | (10,000) |
| Distributions to parent from noncontrolling interest..... | (10,552) | (10,084) |
| Equity contribution received by noncontrolling interest..... | 710 | 2,875 |
| Repayment of long-term debt | (2,123) | (2,080) |
| Repayment of short-term debt | - | (7,000) |
| Other | (29) | (314) |
| <i>Cash Used for Financing Activities.....</i> | <i>(36,994)</i> | <i>(26,603)</i> |
| Change in cash and cash equivalents | 14,187 | 18,761 |
| Cash and cash equivalents at beginning of period..... | 26,760 | 4,562 |
| Cash and cash equivalents at end of period..... | \$ 40,947 | \$ 23,323 |
| Supplemental disclosures of cash flow information: | | |
| Significant noncash investing activities: | | |
| Accrued capital expenditures..... | \$ 7,091 | \$ 2,409 |

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

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

| | June 30, | December 31, |
|--|-----------------|---------------------|
| | 2016 | 2015 |
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 40,947 | \$ 26,760 |
| Accounts receivable, less reserves of \$3,047 and \$3,052, respectively | 31,444 | 37,112 |
| Affiliate receivables..... | 547 | 542 |
| Other accounts receivable, less reserves of \$506 and \$642, respectively..... | 6,745 | 7,390 |
| Unbilled revenues..... | 25,653 | 25,008 |
| Materials and supplies, at average cost | 20,825 | 19,155 |
| Fossil fuel, at average cost..... | 9,502 | 13,110 |
| Stored natural gas, at average cost..... | 10,028 | 16,145 |
| Prepaid taxes | 18,726 | 34,279 |
| Regulatory assets - current | 7,170 | 9,538 |
| Other current assets | 13,394 | 10,544 |
| <i>Total Current Assets</i> | 184,981 | 199,583 |
| Affiliate receivable long-term..... | 4,501 | 4,766 |
| Regulatory assets | 147,157 | 148,199 |
| Other deferred assets and other..... | 4,178 | 4,216 |
| Property, Plant, and Equipment: | | |
| Property, plant, and equipment, net | 1,233,966 | 1,216,415 |
| Construction work in progress | 32,187 | 26,351 |
| <i>Total Property, Plant, and Equipment</i> | 1,266,153 | 1,242,766 |
| Investments | 71,901 | 69,984 |
| Total Assets | \$ 1,678,871 | \$ 1,669,514 |
| LIABILITIES AND CAPITALIZATION | | |
| Current Liabilities: | | |
| Long-term debt due within one year | \$ 34,294 | \$ 4,266 |
| Accounts payable | 46,304 | 40,742 |
| Accrued interest and taxes..... | 4,889 | 5,021 |
| Accrued payroll related items | 9,453 | 11,215 |
| Regulatory liabilities - current | 14,818 | 9,515 |
| Derivative liabilities | 8,650 | 8,343 |
| Other current liabilities | 9,790 | 4,791 |
| <i>Total Current Liabilities</i> | 128,198 | 83,893 |
| Other Credits: | | |
| Deferred income taxes | 361,807 | 352,626 |
| Investment tax credit - deferred..... | 999 | 1,050 |
| Regulatory liabilities..... | 22,138 | 20,785 |
| Accrued pension and other postretirement benefits | 63,085 | 75,680 |
| Derivative liabilities | 43,590 | 44,935 |
| Other deferred liabilities and other | 63,864 | 61,817 |
| <i>Total Other Credits</i> | 555,483 | 556,893 |
| Capitalization: | | |
| Common shareholder's equity | 497,720 | 501,676 |
| Noncontrolling interest | 142,670 | 140,308 |
| <i>Total Equity</i> | 640,390 | 641,984 |
| Long-term debt | 354,800 | 386,744 |
| <i>Total Capitalization</i> | 995,190 | 1,028,728 |
| Commitments and contingencies (see Footnote 7) | - | - |
| Total Liabilities and Capitalization | \$ 1,678,871 | \$ 1,669,514 |

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

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

| | Common Stock | | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income/(Loss) | Non- Controlling Interest | Total |
|---|--------------|-----------|----------------------------------|----------------------|--|---------------------------------|------------|
| | Shares | Value | | | | | |
| 2015 | | | | | | | |
| Beginning balance - Dec. 31, 2014..... | 17,348 | \$ 17,348 | \$ 192,417 | \$ 276,662 | \$ 144 | \$ 125,689 | \$ 612,260 |
| Cumulative effect of new accounting principle | | | | (142) | | | (142) |
| Beginning balance - Adjusted | | | | 276,520 | | | 612,118 |
| Net income | | | | 18,650 | | 13,179 | 31,829 |
| Other comprehensive loss | | | | | (109) | | (109) |
| Cash dividends paid to parent | | | | | | | |
| by MGE | | | | (10,000) | | | (10,000) |
| Equity contribution received by | | | | | | | |
| noncontrolling interest | | | | | | 2,875 | 2,875 |
| Distributions to parent from | | | | | | | |
| noncontrolling interest | | | | | | (10,084) | (10,084) |
| Ending balance - June 30, 2015 | 17,348 | \$ 17,348 | \$ 192,417 | \$ 285,170 | \$ 35 | \$ 131,659 | \$ 626,629 |
| 2016 | | | | | | | |
| Beginning balance - Dec. 31, 2015..... | 17,348 | \$ 17,348 | \$ 192,417 | \$ 291,888 | \$ 23 | \$ 140,308 | \$ 641,984 |
| Net income | | | | 21,083 | | 12,204 | 33,287 |
| Other comprehensive loss | | | | | (39) | | (39) |
| Cash dividends paid to parent | | | | | | | |
| by MGE | | | | (25,000) | | | (25,000) |
| Equity contribution received by | | | | | | | |
| noncontrolling interest | | | | | | 710 | 710 |
| Distributions to parent from | | | | | | | |
| noncontrolling interest | | | | | | (10,552) | (10,552) |
| Ending balance - June 30, 2016 | 17,348 | \$ 17,348 | \$ 192,417 | \$ 287,971 | \$ (16) | \$ 142,670 | \$ 640,390 |

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

MGE Energy, Inc., and Madison Gas and Electric Company
Notes to Consolidated Financial Statements (unaudited)
June 30, 2016

1. Basis of Presentation - MGE Energy and MGE.

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

MGE Power Elm Road and MGE Power West Campus own electric generating assets and lease those assets to MGE. Both entities are variable interest entities under applicable authoritative accounting guidance. MGE is considered the primary beneficiary of these entities as a result of contractual agreements. As a result, MGE has consolidated MGE Power Elm Road and MGE Power West Campus. See Footnote 2 of Notes to Consolidated Financial Statements under Item 8, Financial Statements and Supplementary Data, of MGE Energy's and MGE's 2015 Annual Report on Form 10-K.

The accompanying consolidated financial statements as of June 30, 2016, and for the three and six months ended, are unaudited, but include all adjustments that MGE Energy and MGE management consider necessary for a fair statement of their respective financial statements. All adjustments are of a normal, recurring nature except as otherwise disclosed. The year-end consolidated balance sheet information was derived from the audited balance sheet appearing in MGE Energy's and MGE's 2015 Annual Report on Form 10-K, but does not include all disclosures required by accounting principles generally accepted in the United States of America. These notes should be read in conjunction with the financial statements and the notes on pages 55 through 105 of the 2015 Annual Report on Form 10-K.

2. Equity and Financing Arrangements - MGE Energy.

a. Common Stock.

MGE Energy sells shares of its common stock through its Stock Plan. Those shares may be newly issued shares or shares that MGE Energy has purchased in the open market for resale to participants in the Stock Plan. All sales under the Stock Plan are covered by a shelf registration statement that MGE Energy filed with the SEC. For both the six months ended June 30, 2016 and 2015, MGE Energy did not issue any new shares of common stock under the Stock Plan.

b. Dilutive Shares Calculation.

MGE Energy does not have any dilutive securities.

3. Investment in ATC - MGE Energy and MGE.

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

MGE Transco has accounted for its investment in ATC under the equity method of accounting. For the three and six months ended June 30, 2016 and 2015, MGE Transco recorded the following:

| | Three Months Ended | | Six Months Ended | |
|---|--------------------|----------|------------------|----------|
| | June 30, | | June 30, | |
| <i>(In thousands)</i> | 2016 | 2015 | 2016 | 2015 |
| Equity in earnings from investment in ATC | \$ 1,767 | \$ 2,289 | \$ 4,000 | \$ 4,170 |
| Dividends received from ATC | 1,863 | 1,471 | 2,728 | 2,891 |
| Capital contributions to ATC | 177 | 177 | 710 | 355 |

MGE Transco's investment in ATC as of June 30, 2016, and December 31, 2015, was \$71.4 million and \$69.5 million, respectively.

At June 30, 2016, MGE is the majority owner (51%), and MGE Energy, the holding company, is the minority owner (49%) of MGE Transco. MGE Energy's proportionate share of the equity and net income of MGE Transco is classified within the MGE financial statements as noncontrolling interest. MGE's ownership interest declined below a majority in July 2016 as a result of continued funding of ATC capital contributions by MGE Energy. As a result of the change in majority ownership in MGE Transco in July 2016, MGE will deconsolidate the noncontrolling interest within MGE's financial statements for MGE Energy's proportionate share of the equity in MGE Transco. As of June 30, 2016, the noncontrolling interest attributable to MGE Transco on MGE's consolidated balance sheet was \$24.9 million. No gain or loss was recognized in July 2016 due to MGE ceasing to have a controlling financial interest.

In June 2016, the PSCW accepted a staff recommendation to have MGE transfer its interest in ATC to MGE Energy. As a result, MGE's ownership interest in MGE Transco will be completely eliminated in favor of MGE Energy when the transfers are complete, which is anticipated to occur in 2016. The recommendation arose in the context of requests for regulatory approvals by several owners of ATC in connection with a reorganization of ATC designed to separate its existing Wisconsin-based transmission operations from its non-Wisconsin transmission development activities. The change will have no effect on MGE Energy's consolidated financial statements.

ATC's summarized financial data for the three and six months ended June 30, 2016 and 2015, is as follows:

| | Three Months Ended | | Six Months Ended | |
|---|--------------------|------------|------------------|------------|
| | June 30, | | June 30, | |
| <i>(In thousands)</i> | 2016 | 2015 | 2016 | 2015 |
| Operating revenues | \$ 154,225 | \$ 165,171 | \$ 318,465 | \$ 317,528 |
| Operating expenses | (81,698) | (80,326) | (160,763) | (160,277) |
| Other income (expense), net | 1,308 | (81) | 1,435 | (19) |
| Interest expense, net | (24,882) | (24,172) | (49,090) | (48,655) |
| Earnings before members' income taxes | \$ 48,953 | \$ 60,592 | \$ 110,047 | \$ 108,577 |

MGE receives transmission and other related services from ATC. During the three and six months ended June 30, 2016, MGE recorded \$7.4 million and \$14.7 million, respectively, for transmission services received compared to \$7.0 million and \$14.1 million for the comparable periods in 2015. MGE also provides a variety of operational, maintenance, and project management services for ATC, which is reimbursed by ATC. As of June 30, 2016, and December 31, 2015, MGE had a receivable due from ATC of \$0.2 million.

4. Taxes - MGE Energy and MGE.

MGE Energy's effective income tax rates for the three and six months ended June 30, 2016, were 36.5% and 36.7%, respectively, compared to 37.3% and 36.9% for the same periods in 2015. MGE's effective income tax rates for the three and six months ended June 30, 2016, were 36.5% and 36.7%, respectively, compared to 37.2% and 36.9% for the same periods in 2015. The decrease in the effective tax rates is due in part to higher estimated AFUDC equity earnings offset by a lower estimated domestic manufacturing deduction in 2016.

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

MGE maintains qualified and nonqualified pension plans, health care, and life insurance benefits. Additionally, MGE has defined contribution 401(k) benefit plans. MGE refined its methodology for using discount rates to measure the components of net periodic benefit cost for 2016. The refined methodology uses individual spot rates, instead of a weighted average of the yield curve spot rates, for measuring the service cost and interest cost components.

The following table presents the components of MGE Energy's and MGE's net periodic benefit costs recognized for the three and six months ended June 30, 2016 and 2015. A portion of the net periodic benefit cost is capitalized within the consolidated balance sheets.

| <i>(In thousands)</i> | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|----------|------------------------------|----------|
| | 2016 | 2015 | 2016 | 2015 |
| Pension Benefits | | | | |
| Components of net periodic cost: | | | | |
| Service cost | \$ 1,564 | \$ 2,039 | \$ 2,945 | \$ 3,837 |
| Interest cost | 3,494 | 3,902 | 6,583 | 7,342 |
| Expected return on assets | (6,329) | (6,438) | (11,922) | (12,115) |
| Amortization of: | | | | |
| Prior service cost | 3 | 6 | 5 | 12 |
| Actuarial loss | 1,534 | 1,513 | 2,890 | 2,847 |
| Net periodic cost | \$ 266 | \$ 1,022 | \$ 501 | \$ 1,923 |
| Postretirement Benefits | | | | |
| Components of net periodic (benefit) cost: | | | | |
| Service cost | \$ 399 | \$ 3 | \$ 723 | \$ 386 |
| Interest cost | 831 | 6 | 1,505 | 784 |
| Expected return on assets | (868) | (5) | (1,573) | (708) |
| Amortization of: | | | | |
| Transition obligation | 1 | - | 2 | 1 |
| Prior service benefit | (822) | (5) | (1,489) | (672) |
| Actuarial loss | 196 | 2 | 355 | 264 |
| Net periodic (benefit) cost | \$ (263) | \$ 1 | \$ (477) | \$ 55 |

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

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

In January 2016, 3,773 units were granted under the Director Incentive Plan and are subject to a three-year graded vesting schedule. In February 2016, 19,055 units were granted under the Performance Unit Plan and are subject to a five-year graded vesting schedule. On the grant date, MGE Energy and MGE measure the cost of the employee services received in exchange for a performance unit award based on the current market value of MGE Energy common stock. The fair value of the awards is re-measured quarterly, including at June 30, 2016, as required by applicable accounting standards. Changes in fair value as well as the original grant are recognized as compensation cost. Since this amount is re-measured throughout the vesting period, the compensation cost is subject to variability.

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

During the six months ended June 30, 2016 and 2015, MGE recorded \$1.8 million and \$0.1 million, respectively, in compensation expense as a result of awards under the plans. In January 2016, cash payments of \$1.2 million were distributed relating to awards that were granted in 2011. During the six months ended June 30, 2015, MGE recorded a \$0.2 million gain on 4,676 units forfeited. No forfeitures occurred during the six months ended June 30, 2016. At June 30, 2016, \$5.8 million of outstanding awards are vested, and of this amount, no cash settlements have occurred.

7. Commitments and Contingencies - MGE Energy and MGE.

a. Environmental.

MGE Energy and MGE are subject to frequently changing local, state, and federal regulations concerning air quality, water quality, land use, threatened and endangered species, hazardous materials handling, and solid waste disposal. These regulations affect the manner in which we conduct our operations, the costs of those operations, as well as capital and operating expenditures. Regulatory initiatives, proposed rules, and court challenges to adopted rules, have the potential to have a material effect on our capital expenditures and operating costs. These initiatives, proposed rules, and court challenges include:

EPA's Effluent Limitations Guidelines (ELG) and Standards for Steam Electric Power Generating Point Source Category

In November 2015, the EPA published its final rule setting Effluent Limitations Guidelines (ELG) for the steam electric power generating industry. The ELG rule establishes federal limits on the amount of metals and other pollutants that can be discharged in wastewater from new and existing steam electric generation plants. The ELG rule mostly covers pollutants that are captured by certain air pollution control systems and via wet ash handling systems at coal-burning power plants with units greater than 50 MW generation capacity. The operators of our Columbia and Elm Road Units have indicated that equipment upgrades may be necessary to comply with the new discharge standards. The rule will be applied to Wisconsin-based power plants as they renew their WPDES permits, beginning in 2018 but no later than 2023. Management believes that any compliance costs will be recovered in future rates based on previous treatment of environmental compliance projects.

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

Section 316(b) of the Clean Water Act requires that the cooling water intake structures at electric power plants meet best available technology standards so that mortality from entrainment (drawing aquatic life into a plant's cooling system) and impingement (trapping aquatic life on screens) are reduced. The EPA finalized its 316(b) rule for existing facilities in 2014. Section 316(b) requirements are implemented in Wisconsin through modifications to plants' WPDES permits, which govern plant wastewater discharges. WDNR is currently developing rules to implement the EPA 316(b) rule.

Our WCCF, Blount, and Columbia plants are considered existing plants under this rule. Our WCCF facility already employs a system that meets the 316(b) rule. Our Blount plant has conducted studies showing that it will likely be in compliance with this rule when its WPDES permit is renewed in 2017. The operator of our Columbia plant is conducting an intake study to demonstrate compliance with the 316(b) rule and/or identify design criteria needed to meet the new rule requirements prior to Columbia's 2017 WPDES permit renewal. The exact requirements at Blount and Columbia, however, will not be known until the WDNR finalizes its rule, approves the plant operators' approach, and those sites' WPDES permits are modified to account for this rule. Nonetheless, MGE expects that the 316(b) rule will not have material effects on its existing plants.

EPA's Greenhouse Gas (GHG) Reduction Guidelines under the Clean Air Act 111(d) Rule

In October 2015, the EPA published its Clean Power Plan (CPP) rule, which went into effect in December 2015, setting guidelines and approval criteria for states to use in developing plans to control GHG emissions from existing fossil fuel-fired electric generating units (EGUs) and systems. In October 2015, the EPA also published a proposed federal implementation plan under the CPP rule. The proposed federal implementation plan is designed to provide mass-based and rate-based emissions trading options to serve as a model and/or resource for states that are adopting their own plans, or for use by the EPA in states that do not implement their own plans under the finalized CPP. Implementation of the rule is expected to have a direct impact on existing coal and natural gas fired generating units, including possible changes in dispatch and additional operating costs.

On January 26, 2016, several parties filed a request for a stay of the CPP with the U.S. Supreme Court; and on February 9, 2016, the U.S. Supreme Court granted that request. The CPP may not be implemented until the Supreme Court lifts the stay, presumably after the courts ultimately resolve the underlying legality of the rule. Oral arguments are scheduled before the D.C. Circuit for September 27, 2016.

Given the pending legal proceedings and the need for a yet-to-be-developed state implementation plan or finalization of the federal implementation plan, the nature and timing of any final requirements is subject to uncertainty. If the rule remains substantially in its present form, it is expected to have a material impact on MGE.

National Ambient Air Quality Standards (NAAQS)

The EPA's NAAQS regulations have been developed to set ambient levels of six pollutants to protect sensitive populations (primary NAAQS) and the environment (secondary NAAQS) from the negative effects of exposure to these pollutants at higher levels. MGE is following developments for several NAAQS, including for particulate matter, nitrogen dioxide, sulfur dioxide, and ozone. Further discussion on ozone, sulfur dioxide, and nitrogen dioxide NAAQS follows. For additional information on the NAAQS process, see Footnote 18.c. of Notes to Consolidated Financial Statements under Item 8, Financial Statements and Supplementary Data, of MGE Energy's and MGE's 2015 Annual Report on Form 10-K.

Ozone NAAQS

In October 2015, the EPA revised the primary and secondary ozone NAAQS, lowering each to 70 ppb. The rule became effective in December 2015. Based on current ozone monitoring data, it appears that Milwaukee County (where our Elm Road Units are located) will likely not attain the lowered standards, and Dane and Columbia Counties (where our WCCF/Blount and Columbia Units are located, respectively) may or may not attain them. It is too early to determine, however, as final attainment designations for these three counties will be based upon air monitoring data for years 2014-2016 and must be approved by the EPA. Once these designations are complete, the State of Wisconsin will develop implementation plans for each county designated as nonattainment, which could affect operations and emission control obligations for plants located within the nonattainment counties. The State of Wisconsin has joined a lawsuit filed by several states challenging the EPA's new ozone standard, alleging that the new standard is not attainable and the EPA is not properly considering background levels in setting its ozone attainment levels. Briefings in this challenge began in April 2016 and will continue through the summer. The final briefs are scheduled to be filed in September 2016. MGE will continue to monitor legal developments, attainment designations, and any state actions and implementation plans.

Sulfur Dioxide (SO₂) NAAQS

In March 2015, the EPA identified MGE's Columbia Plant in Columbia County as a large stationary source of SO₂ that may exceed the one hour SO₂ NAAQS standard and was subject to a State of Wisconsin proposed county attainment/nonattainment determination. In September 2015, Wisconsin sent a letter to the EPA proposing that Columbia County be designated as being in attainment for SO₂ NAAQS based on recent modeling demonstrating that SO₂ pollution controls on the Columbia Plant had brought the county into attainment. In June 2016, the EPA issued a final rule classifying Columbia County as an unclassified/attainment area. In addition to the EPA's actions on SO₂ NAAQS, the WDNR is revising its state rules to incorporate the one hour SO₂ standard with a proposed final rule date of August 2016. MGE does not anticipate any material costs from this rule.

Nitrogen Dioxide (NO₂) NAAQS

The WDNR is revising its state rules to incorporate the EPA's one hour NO₂ NAAQS rule that was finalized in 2010. The effective date of the state rule was August 1, 2016. Wisconsin's NO₂ NAAQS rule may affect our stationary fossil-fuel generation sources by requiring that we demonstrate consistency with the NAAQS when applying for certain air permits. Preliminary assessments conducted by MGE suggest that these NAAQS rules will not have a material impact.

EPA's Cross-State Air Pollution Rule: Proposed Ozone Season Update based on 2008 Ozone NAAQS

The EPA's Cross-State Air Pollution Rule (CSAPR) is an interstate air pollution transport rule designed to reduce ozone and fine particulate (PM_{2.5}) air levels in areas that the EPA has determined are being affected by pollution from neighboring and upwind states. This is accomplished in the CSAPR through a reduction in SO₂ and Nitrogen Oxides (NO_x) from fossil-fuel fired power plants. NO_x and SO₂ contribute to fine particulate pollution, and NO_x contributes to ozone. Reductions are achieved through a cap and trade model. Individual plants can meet their caps through modifications and/or buying allowances on the market.

In December 2015, the EPA published a proposed rule to amend the existing CSAPR. The proposed rule is designed to incorporate 2008 Ozone NAAQS attainment levels (the current CSAPR is based on 1997 Ozone NAAQS levels) in 23 states, including Wisconsin, by further limiting ozone season NO_x levels through a reduction in NO_x allowances. The proposed rule also includes revisions to CSAPR that are designed to address issues remaining from the D.C. Circuit remand of CSAPR, including Wisconsin's inclusion in the NO_x ozone season portion of the rule.

The proposed rule would reduce summertime NO_x emissions from power plants starting in 2017. Initial review of this proposed rule shows that we will likely need to buy NO_x Ozone Season allowances to comply with the rule. Depending on the cost of allowances, this requirement could be material for MGE. It is however too soon to tell what costs MGE will incur as the rule is not finalized, all legal proceedings are not completed, and the allowances are not on the market yet. We expect to monitor the rule developments and the D.C. Circuit Court remand completion to help determine how this rule will ultimately affect MGE.

Clean Air Visibility Rule (CAVR)

Columbia may be subject to the best available retrofit technology (BART) regulations, a subsection of the EPA's Clean Air Visibility Rule (CAVR), which may require pollution control retrofits. Columbia's pollution control upgrades and the EPA's stance that compliance with the CSAPR equals compliance with BART should mean that Columbia will not need to do additional work to meet BART requirements. In February 2016, the EPA submitted a proposed revision to the CAVR. The proposed revision would move state plan due dates from July 2018 to July 2021. This would allow for states to coordinate their CAVR compliance with other compliance efforts. If this proposed revision is finalized, it would reduce the chances that CAVR would be material for MGE. At this time, however, the BART regulatory obligations, compliance strategies, and costs remain uncertain due to the continued legal uncertainty surrounding CSAPR.

Solid Waste

EPA's Coal Combustion Residuals Rule

In December 2014, the EPA finalized its Disposal of Coal Combustion Residuals from Electric Utilities (CCR) rule. The rule became effective in October 2015. It provides that coal ash will be regulated as a solid waste, and defines what ash use activities would be considered generally exempt beneficial reuse of coal ash. The rule also regulates landfills, ash ponds, and other surface impoundments for coal combustion residuals by regulating their design, location, monitoring, and operation. This portion of the rule is accomplished in phases to allow for sites with onsite storage and/or disposal to evaluate their compliance with the rule's design criteria. Landfills and impoundments that cannot meet design criteria will need to close formally within defined timeframes.

The Columbia and Elm Road Units co-owners and plant operators are working through the phased requirements to determine what changes may be necessary at those facilities to meet design criteria. We anticipate that some design and operational changes may need to be made at these facilities. Review of our Elm Road facility has indicated that the costs to comply with this rule are not expected to be significant. Columbia's operator has developed a preliminary implementation schedule for meeting the various deadlines spelled out in the rule. Costs at Columbia will be dependent on what is determined during the evaluation stage. Management believes compliance costs will be recovered in future rates based on previous treatment of environmental compliance projects.

b. Legal Matters.

MGE is involved in various legal matters that are being defended and handled in the normal course of business. MGE maintains accruals for such costs that are probable of being incurred and subject to reasonable estimation. The accrued amount for these matters is not material to the financial statements. MGE does not expect the resolution of these matters to have a material adverse effect on its consolidated results of operations, financial condition, or cash flows.

c. Purchase Contracts.

MGE Energy and MGE have entered into various commodity supply, transportation, and storage contracts to meet their obligations to deliver natural gas to customers. As of June 30, 2016, the future commitments related to these purchase contracts were as follows:

| <i>(In thousands)</i> | <u>2016</u> | <u>2017</u> | <u>2018</u> | <u>2019</u> | <u>2020</u> | <u>Thereafter</u> |
|--|------------------|------------------|------------------|------------------|------------------|-------------------|
| Natural gas | | | | | | |
| Transportation & storage ^(a) \$ | 10,621 | \$ 25,044 | \$ 24,833 | \$ 23,048 | \$ 16,274 | \$ 32,595 |
| Supply ^(b) | 11,035 | 13,092 | - | - | - | - |
| | <u>\$ 21,656</u> | <u>\$ 38,136</u> | <u>\$ 24,833</u> | <u>\$ 23,048</u> | <u>\$ 16,274</u> | <u>\$ 32,595</u> |

(a) MGE's natural gas transportation and storage contracts require fixed monthly payments for firm supply pipeline transportation and storage capacity. The pricing components of the fixed monthly payments for the transportation and storage contracts are established by FERC but may be subject to change. Management expects to recover these costs in future customer rates.

(b) These commitments include market-based pricing. Management expects to recover these costs in future customer rates.

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

a. Purpose.

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

b. Notional Amounts.

The gross notional volume of open derivatives is as follows:

| | <u>June 30, 2016</u> | <u>December 31, 2015</u> |
|-------------------------------------|----------------------|--------------------------|
| Commodity derivative contracts..... | 479,725 MWh | 355,580 MWh |
| Commodity derivative contracts..... | 1,887,500 Dth | 5,037,500 Dth |
| FTRs..... | 5,653 MW | 2,000 MW |

c. Financial Statement Presentation.

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

instrument. At June 30, 2016, the fair value of exchange traded derivatives and FTRs exceeded their cost basis by \$1.7 million. At December 31, 2015, the cost basis of exchange traded derivatives and FTRs exceeded their fair value by \$0.8 million.

MGE is a party to a purchased power agreement that provides MGE with firm capacity and energy during a base term from June 1, 2012, through May 31, 2022. The agreement also allows MGE an option to extend the contract after the base term. The agreement is accounted for as a derivative contract and is recognized at its fair value on the consolidated balance sheets. However, the derivative qualifies for regulatory deferral and is recognized with a corresponding regulatory asset or liability depending on whether the fair value is in a loss or gain position. The fair value of the contract at June 30, 2016, and December 31, 2015, reflects a loss position of \$52.2 million and \$53.3 million, respectively. The actual cost will be recognized in purchased power expense in the month of purchase.

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

| <i>(In thousands)</i> | Asset Derivatives | | Liability Derivatives | |
|--------------------------------------|------------------------|------------|----------------------------------|------------|
| | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| June 30, 2016 | | | | |
| Commodity derivative contracts | Other current assets | \$ 1,814 | Derivative liability (current) | \$ 212 |
| Commodity derivative contracts | Other deferred charges | 143 | Derivative liability (long-term) | 60 |
| FTRs | Other current assets | 34 | Derivative liability (current) | - |
| PPA..... | N/A | N/A | Derivative liability (current) | 8,650 |
| PPA..... | N/A | N/A | Derivative liability (long-term) | 43,590 |
| December 31, 2015 | | | | |
| Commodity derivative contracts | Other current assets | \$ 146 | Derivative liability (current) | \$ 1,266 |
| Commodity derivative contracts | Other deferred charges | 144 | Derivative liability (long-term) | 70 |
| FTRs | Other current assets | 234 | Derivative liability (current) | - |
| PPA..... | N/A | N/A | Derivative liability (current) | 8,340 |
| PPA..... | N/A | N/A | Derivative liability (long-term) | 44,930 |

The following tables show the effect of netting arrangements for recognized derivative assets and liabilities that are subject to a master netting arrangement or similar arrangement on the consolidated balance sheets.

Offsetting of Derivative Assets

| <i>(In thousands)</i> | Gross Amounts | Gross Amounts Offset in Balance Sheets | Collateral Posted Against Derivative Positions | Net Amount Presented in Balance Sheets |
|--|---------------|--|--|--|
| June 30, 2016 | | | | |
| Commodity derivative contracts..... \$ | 1,957 | \$ (272) | \$ - | \$ 1,685 |
| FTRs | 34 | - | - | 34 |
| December 31, 2015 | | | | |
| Commodity derivative contracts..... \$ | 290 | \$ (290) | \$ - | \$ - |
| FTRs | 234 | - | - | 234 |

Offsetting of Derivative Liabilities

| <i>(In thousands)</i> | Gross Amounts | Gross Amounts Offset in Balance Sheets | Collateral Posted Against Derivative Positions | Net Amount Presented in Balance Sheets |
|--|---------------|--|--|--|
| June 30, 2016 | | | | |
| Commodity derivative contracts..... \$ | 272 | \$ (272) | \$ - | \$ - |
| PPA | 52,240 | - | - | 52,240 |
| December 31, 2015 | | | | |
| Commodity derivative contracts..... \$ | 1,336 | \$ (290) | \$ (1,038) | \$ 8 |
| PPA | 53,270 | - | - | 53,270 |

The following tables summarize the unrealized and realized gains (losses) related to the derivative instruments on the consolidated balance sheets at June 30, 2016 and 2015, and the consolidated income statements for the three and six months ended June 30, 2016 and 2015.

| | 2016 | | 2015 | |
|---|--|----------------------|--|----------------------|
| | Current and Long-Term Regulatory Asset | Other Current Assets | Current and Long-Term Regulatory Asset | Other Current Assets |
| <i>(In thousands)</i> | | | | |
| Three Months Ended June 30: | | | | |
| Balance at April 1, | \$ 56,884 | \$ 655 | \$ 53,966 | \$ 268 |
| Unrealized (gain) loss | (4,580) | - | 3,160 | - |
| Realized gain (loss) reclassified to a deferred account . | 17 | (17) | (231) | 231 |
| Realized (loss) gain reclassified to income statement... | (1,800) | 21 | (847) | (44) |
| Balance at June 30, | <u>\$ 50,521</u> | <u>\$ 659</u> | <u>\$ 56,048</u> | <u>\$ 455</u> |
| Six Months Ended June 30: | | | | |
| Balance at January 1, | \$ 54,082 | \$ 1,208 | \$ 54,998 | \$ 1,001 |
| Unrealized loss | 1,791 | - | 4,478 | - |
| Realized (loss) gain reclassified to a deferred account . | (1,434) | 1,434 | (1,292) | 1,292 |
| Realized (loss) gain reclassified to income statement... | (3,918) | (1,983) | (2,136) | (1,838) |
| Balance at June 30, | <u>\$ 50,521</u> | <u>\$ 659</u> | <u>\$ 56,048</u> | <u>\$ 455</u> |

| | Realized Losses (Gains) | | | |
|--------------------------------------|--|------------------|--|------------------|
| | 2016 | | 2015 | |
| | Fuel for Electric Generation/ Purchased Power | Cost of Gas Sold | Fuel for Electric Generation/ Purchased Power | Cost of Gas Sold |
| | <i>(In thousands)</i> | | | |
| Three Months Ended June 30: | | | | |
| Commodity derivative contracts | \$ 417 | \$ - | \$ 578 | \$ (2) |
| FTRs | 136 | - | (255) | - |
| PPA | 1,226 | - | 570 | - |
| Six Months Ended June 30: | | | | |
| Commodity derivative contracts | \$ 1,424 | \$ 1,814 | \$ 998 | \$ 1,759 |
| FTRs | 68 | - | (374) | - |
| PPA | 2,595 | - | 1,591 | - |

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

The PPA has a provision that may require MGE to post collateral if MGE's debt rating falls below investment grade (i.e., below BBB-). The amount of collateral that it may be required to post varies from \$20.0 million to \$40.0 million, depending on MGE's nominated capacity amount. As of June 30, 2016, no collateral is required to be, or has been, posted. Certain counterparties extend MGE a credit limit. If MGE exceeds these limits, the counterparties may require collateral to be posted. As of June 30, 2016, no counterparties were in a net liability position. As of December 31, 2015, certain counterparties were in a net liability position of less than \$0.1 million.

Nonperformance of counterparties to the non-exchange traded derivatives could expose MGE to credit loss. However, MGE enters into transactions only with companies that meet or exceed strict credit guidelines, and it monitors these counterparties on an ongoing basis to mitigate nonperformance risk in its portfolio. As of June 30, 2016, no counterparties have defaulted.

9. Rate Matters - MGE Energy and MGE.

a. Rate Proceedings.

In April 2016, MGE filed an application with the PSCW requesting a 1.7% increase to electric rates and a 3.7% increase to gas rates for 2017. The proposed electric and gas rate increases cover costs primarily associated with the state's electric transmission and MGE's natural gas system infrastructure improvements. In its application, MGE has also proposed mechanisms to address potential 2018 electric and gas rate changes, including a rate adjustment for limited issues and escrow accounting on certain costs.

In July 2015, the PSCW approved MGE's request to extend the current accounting treatment for transmission related costs through 2016, conditioned upon MGE not filing a base rate case for 2016. This accounting treatment will allow MGE to reflect any differential between transmission costs reflected in rates and actual costs incurred in its next rate case filing, which occurred in the April 2016 filing.

On December 23, 2014, the PSCW authorized MGE to increase 2015 rates for retail electric customers by 3.8% or \$15.4 million and to decrease gas rates by 2.0% or \$3.8 million. The increase in retail electric rates cover costs associated with the construction of emission-reduction equipment at Columbia, improvements and reliability of the state's electric transmission system, fuel and purchased power related to coal delivery costs, partially offset by lower cost as a result of market conditions for pension and postretirement benefit costs. The authorized return on common stock equity is 10.2%.

The PSCW also approved changes to customer rates and rate design for gas service that became effective January 1, 2015. Gas rate design consists of a fixed monthly customer charge and a variable charge tied to actual usage, in addition to the separate charge through the PGA for natural gas commodity costs. The change shifted more of the rate recovery to the monthly charge, reflecting the related fixed costs of providing gas services, and reduced the variable usage-based charge. Thus, gas net income is expected to be more evenly distributed during the year and less sensitive to weather.

b. Fuel Rules.

Fuel rules require the PSCW and Wisconsin utilities to defer electric fuel-related costs that fall outside a symmetrical cost tolerance band around the amount approved for a utility in its annual fuel proceedings. Any over/under recovery of the actual costs is determined on an annual basis and is adjusted in future billings to electric retail customers. The fuel rules bandwidth is currently set at plus or minus 2%. Under fuel rules, MGE would defer costs, less any excess revenues, if its actual electric fuel costs exceeded 102% of the electric fuel costs allowed in its latest rate order. Excess revenues are defined as revenues in the year in question that provide MGE with a greater return on common equity than authorized by the PSCW in MGE's latest rate order. Conversely, MGE is required to defer the benefit of lower costs if actual electric fuel costs were less than 98% of the electric fuel costs allowed in that order.

In August 2015, the PSCW approved a \$0.00256/kWh fuel credit that began on September 1, 2015, and will continue throughout 2016. The fuel credit established a mechanism to return \$10.9 million of fuel savings to electric customers as a bill credit. MGE returned \$2.6 million of electric fuel-related savings in customer bill credits during the period from September 1, 2015, through December 31, 2015. MGE returned \$3.9 million of electric fuel-related savings during the six months ended June 30, 2016.

In January 2016, the PSCW lowered MGE's 2016 fuel rules monitored costs by \$14.8 million as a result of continued lower projected fuel costs in 2016. Also, in March 2016, MGE filed its 2015 fuel plan reconciliation application with an overcollection of 2015 fuel rules monitored costs. The return of the additional 2015 and 2016 fuel savings to customers was addressed during the PSCW's annual review during 2016 of 2015 fuel costs. In July 2016, the PSCW issued a final order stating that MGE shall refund the additional fuel savings incurred during 2015 and 2016 for a total of \$15.7 million to its retail electric customers over a one-month period expected to occur by the end of the third quarter of 2016. This one-time fuel credit will be in addition to the fuel credit approved in August 2015, which is currently being returned to customers throughout the remainder of 2016.

As of June 30, 2016, MGE had a deferred balance of \$14.8 million of electric fuel-related savings that are outside the range authorized by the PSCW. Within this amount, MGE has deferred \$2.3 million of 2016 fuel savings that were in excess of the fuel savings included within the fuel credits referenced above. These costs will be subject to the PSCW's annual review of 2016 fuel costs, expected to be completed in 2017.

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

Fair value is defined as the price that would be received to sell an asset or would be paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants at the measurement date. The accounting standard clarifies that fair value should be based on the assumptions market participants would use when pricing the asset or liability including assumptions about risk. The standard also establishes a three level fair value hierarchy based upon the observability of the assumptions used and requires the use of observable market data when available. The levels are:

Level 1 - Pricing inputs are quoted prices within active markets for identical assets or liabilities.

Level 2 - Pricing inputs are quoted prices within active markets for similar assets or liabilities; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations that are correlated with or otherwise verifiable by observable market data.

Level 3 - Pricing inputs are unobservable and reflect management's best estimate of what market participants would use in pricing the asset or liability.

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

At June 30, 2016, and December 31, 2015, the carrying amount of cash, cash equivalents, and outstanding commercial paper approximates fair market value due to the short maturity of those investments and obligations. The estimated fair market value of MGE Energy's and MGE's long-term debt is based on quoted market prices for similar financial instruments at June 30, 2016, and December 31, 2015. Since long-term debt is not traded in an active market, it is classified as Level 2. The estimated fair market value of MGE Energy's and MGE's financial instruments are as follows:

| <i>(In thousands)</i> | June 30, 2016 | | December 31, 2015 | |
|---------------------------------|-----------------|------------|-------------------|------------|
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| MGE Energy | | | | |
| Assets: | | | | |
| Cash and cash equivalents | \$ 110,308 | \$ 110,308 | \$ 81,384 | \$ 81,384 |
| Liabilities: | | | | |
| Long-term debt* | 393,386 | 472,696 | 395,508 | 435,767 |
| MGE | | | | |
| Assets: | | | | |
| Cash and cash equivalents | \$ 40,947 | \$ 40,947 | \$ 26,760 | \$ 26,760 |
| Liabilities: | | | | |
| Long-term debt* | 393,386 | 472,696 | 395,508 | 435,767 |

*Includes long-term debt due within one year.

b. Recurring Fair Value Measurements.

The following table presents the balances of assets and liabilities measured at fair value on a recurring basis for MGE Energy and MGE.

| <i>(In thousands)</i> | Fair Value as of June 30, 2016 | | | |
|-----------------------------------|--------------------------------|-----------------|-----------------|------------------|
| | Total | Level 1 | Level 2 | Level 3 |
| MGE Energy | | | | |
| Assets: | | | | |
| Derivatives, net | \$ 1,719 | \$ 1,362 | \$ - | \$ 357 |
| Exchange-traded investments | 501 | 501 | - | - |
| Total Assets | <u>\$ 2,220</u> | <u>\$ 1,863</u> | <u>\$ -</u> | <u>\$ 357</u> |
| Liabilities: | | | | |
| Derivatives, net | \$ 52,240 | \$ - | \$ - | \$ 52,240 |
| Deferred compensation | 3,250 | - | 3,250 | - |
| Total Liabilities | <u>\$ 55,490</u> | <u>\$ -</u> | <u>\$ 3,250</u> | <u>\$ 52,240</u> |

MGE

| | | | | |
|-----------------------------------|------------------|-----------------|-----------------|------------------|
| Assets: | | | | |
| Derivatives, net | \$ 1,719 | \$ 1,362 | \$ - | \$ 357 |
| Exchange-traded investments | 84 | 84 | - | - |
| Total Assets | <u>\$ 1,803</u> | <u>\$ 1,446</u> | <u>\$ -</u> | <u>\$ 357</u> |
| Liabilities: | | | | |
| Derivatives, net | \$ 52,240 | \$ - | \$ - | \$ 52,240 |
| Deferred compensation | 3,250 | - | 3,250 | - |
| Total Liabilities | <u>\$ 55,490</u> | <u>\$ -</u> | <u>\$ 3,250</u> | <u>\$ 52,240</u> |

| <i>(In thousands)</i> | Fair Value as of December 31, 2015 | | | |
|---------------------------------------|------------------------------------|---------------|-----------------|------------------|
| | Total | Level 1 | Level 2 | Level 3 |
| MGE Energy | | | | |
| Assets: | | | | |
| Derivatives, net | \$ 234 | \$ - | \$ - | \$ 234 |
| Exchange-traded investments | 759 | 759 | - | - |
| Total Assets | <u>\$ 993</u> | <u>\$ 759</u> | <u>\$ -</u> | <u>\$ 234</u> |
| Liabilities: | | | | |
| Derivatives, net ^(a) | \$ 54,316 | \$ 581 | \$ - | \$ 53,735 |
| Deferred compensation | 3,145 | - | 3,145 | - |
| Total Liabilities | <u>\$ 57,461</u> | <u>\$ 581</u> | <u>\$ 3,145</u> | <u>\$ 53,735</u> |

MGE

| | | | | |
|---------------------------------------|------------------|---------------|-----------------|------------------|
| Assets: | | | | |
| Derivatives, net | \$ 234 | \$ - | \$ - | \$ 234 |
| Exchange-traded investments | 148 | 148 | - | - |
| Total Assets | <u>\$ 382</u> | <u>\$ 148</u> | <u>\$ -</u> | <u>\$ 234</u> |
| Liabilities: | | | | |
| Derivatives, net ^(a) | \$ 54,316 | \$ 581 | \$ - | \$ 53,735 |
| Deferred compensation | 3,145 | - | 3,145 | - |
| Total Liabilities | <u>\$ 57,461</u> | <u>\$ 581</u> | <u>\$ 3,145</u> | <u>\$ 53,735</u> |

(a) These amounts are shown gross and exclude \$1.0 million of collateral that was posted against derivative positions with counterparties as of December 31, 2015.

No transfers were made in or out of Level 1 or Level 2 for the six months ended June 30, 2016.

Investments include exchange-traded investment securities valued using quoted prices on active exchanges and are therefore classified as Level 1.

Derivatives include exchange-traded derivative contracts, over-the-counter transactions, a purchased power agreement, and FTRs. Most exchange-traded derivative contracts are valued based on unadjusted quoted prices in active markets and are therefore classified as Level 1. A small number of exchange-traded derivative contracts are valued using quoted market pricing in markets with insufficient volumes

and are therefore considered unobservable and classified as Level 3. Transactions done with an over-the-counter party are on inactive markets and are therefore classified as Level 3. These transactions are valued based on quoted prices from markets with similar exchange traded transactions. FTRs are priced based upon monthly auction results for identical or similar instruments in a closed market with limited data available and are therefore classified as Level 3.

The purchased power agreement (see Footnote 8) was valued using an internally-developed pricing model and therefore is classified as Level 3. The model projects future market energy prices and compares those prices to the projected power costs to be incurred under the contract. Inputs to the model require significant management judgment and estimation. Future energy prices are based on a forward power pricing curve using exchange-traded contracts in the electric futures market, where such exchange-traded contracts exist, and upon calculations based on forward gas prices, where such exchange-traded contracts do not exist. A basis adjustment is applied to the market energy price to reflect the price differential between the market price delivery point and the counterparty delivery point. The historical relationship between the delivery points is reviewed and a discount (below 100%) or premium (above 100%) is derived. This comparison is done for both peak times when demand is high and off peak times when demand is low. If the basis adjustment is lowered, the fair value measurement will decrease, and if the basis adjustment is increased, the fair value measurement will increase.

The projected power costs anticipated to be incurred under the purchased power agreement are determined using many factors, including historical generating costs, future prices, and expected fuel mix of the counterparty. An increase in the projected fuel costs would result in a decrease in the fair value measurement of the purchased power agreement. A significant input that MGE estimates is the counterparty's fuel mix in determining the projected power cost. MGE also considers the assumptions that market participants would use in valuing the asset or liability. This consideration includes assumptions about market risk such as liquidity, volatility, and contract duration. The fair value model uses a discount rate that incorporates discounting, credit, and model risks.

The following table presents the significant unobservable inputs used in the pricing model.

| Significant Unobservable Inputs | Model Input | |
|---------------------------------|---------------|-------------------|
| | June 30, 2016 | December 31, 2015 |
| Basis adjustment: | | |
| On peak..... | 94.9% | 96.9% |
| Off peak..... | 94.7% | 95.1% |
| Counterparty fuel mix: | | |
| Internal generation..... | 55% - 75% | 60% - 75% |
| Purchased power..... | 45% - 25% | 40% - 25% |

The deferred compensation plan allows participants to defer certain cash compensation into a notional investment account. These amounts are included within other deferred liabilities in the consolidated balance sheets of MGE Energy and MGE. The notional investments earn interest based upon the semiannual rate of U.S. Treasury Bills having a 26 week maturity increased by 1% compounded monthly with a minimum annual rate of 7%, compounded monthly. The notional investments are based upon observable market data, however, since the deferred compensation obligations themselves are not exchanged in an active market, they are classified as Level 2.

The following table summarizes the changes in Level 3 assets and liabilities measured at fair value on a recurring basis for both MGE Energy and MGE.

| <i>(In thousands)</i> | Three Months Ended | | Six Months Ended | |
|---|--------------------|--------------------|--------------------|--------------------|
| | June 30, | | June 30, | |
| | 2016 | 2015 | 2016 | 2015 |
| Beginning balance | \$ (57,101) | \$ (53,866) | \$ (53,501) | \$ (53,986) |
| Realized and unrealized gains (losses): | | | | |
| Included in regulatory liabilities (assets)..... | 5,218 | (2,327) | 1,618 | (2,208) |
| Included in other comprehensive income | - | - | - | - |
| Included in earnings | (1,809) | (883) | (3,972) | (2,211) |
| Included in current assets | - | - | - | - |
| Purchases..... | 5,636 | 4,953 | 10,937 | 11,115 |
| Sales | - | - | - | - |
| Issuances | - | - | - | - |
| Settlements | (3,827) | (4,071) | (6,965) | (8,904) |
| Transfers in and/or out of Level 3..... | - | - | - | - |
| Balance as of June 30,..... | <u>\$ (51,883)</u> | <u>\$ (56,194)</u> | <u>\$ (51,883)</u> | <u>\$ (56,194)</u> |
| Total gains (losses) included in earnings attributed to the change in unrealized gains (losses) related to assets and liabilities held at June 30, ^(b) | <u>\$ -</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ -</u> |

The following table presents total realized and unrealized gains (losses) included in income for Level 3 assets and liabilities measured at fair value on a recurring basis for both MGE Energy and MGE (b).

| <i>(In thousands)</i> | Three Months Ended | | Six Months Ended | |
|-------------------------------|--------------------|-----------------|-------------------|-------------------|
| | June 30, | | June 30, | |
| | 2016 | 2015 | 2016 | 2015 |
| Purchased Power Expense | \$ (1,809) | \$ (885) | \$ (3,972) | \$ (2,213) |
| Cost of Gas Sold Expense..... | - | 2 | - | 2 |
| Total | <u>\$ (1,809)</u> | <u>\$ (883)</u> | <u>\$ (3,972)</u> | <u>\$ (2,211)</u> |

(b) MGE's exchange-traded derivative contracts, over-the-counter party transactions, purchased power agreement, and FTRs are subject to regulatory deferral. These derivatives are therefore marked to fair value and are offset in the financial statements with a corresponding regulatory asset or liability.

11. New Accounting Pronouncements - MGE Energy and MGE.

a. Revenue from Contracts with Customers.

In May 2014, the FASB issued authoritative guidance within the Codification's Revenue Recognition topic that provides guidance on the recognition, measurement, and disclosure of revenue from contracts with customers. This authoritative guidance will become effective January 1, 2018. MGE Energy and MGE are currently assessing the impact this pronouncement will have on their financial statements.

b. Consolidation.

In February 2015, the FASB issued authoritative guidance within the Codification's Consolidation topic that provides guidance on the evaluation of certain legal entities for consolidation purposes. This authoritative guidance became effective January 1, 2016. This guidance had no impact on our financial statements.

c. Debt Issuance Costs.

In April 2015, the FASB issued authoritative guidance within the Codification's Interest topic that provides guidance on the presentation of debt issuance costs in financial statements. This authoritative guidance became effective January 1, 2016, and changed the presentation of debt issuance costs on the balance sheet. Prior to the authoritative guidance, debt issuance costs were treated as a deferred asset, and beginning January 1, 2016, these costs are included as a direct deduction to the related debt liability on the consolidated balance sheet. As of June 30, 2016, assets (other deferred assets and other) and liabilities (long-term debt) decreased approximately \$4.1 million as a cumulative result of the guidance. In addition, this guidance was applied retrospectively to all prior periods presented, resulting in a decrease to assets and liabilities of \$4.3 million for the year ended December 31, 2015.

d. Financial Instruments.

In January 2016, the FASB issued authoritative guidance within the Codification's Financial Instruments topic that provides guidance on the recognition and measurement of financial instruments. This authoritative guidance will become effective January 1, 2018, and will require equity investments to be measured at fair value with changes in fair value recognized in net income rather than in other comprehensive income. The impact of this guidance on our financial statements is not expected to be material.

e. Leases.

In February 2016, the FASB issued authoritative guidance within the Leases topic that provides guidance on the classification, recognition, measurement, and disclosure of leases. This authoritative guidance will become effective January 1, 2019. MGE Energy and MGE are currently assessing the impact this pronouncement will have on their financial statements.

12. Segment Information - MGE Energy and MGE.

MGE Energy operates in the following business segments: electric utility, gas utility, nonregulated energy, transmission investment, and all other. See MGE Energy's and MGE's 2015 Annual Report on Form 10-K for additional discussion of each of these segments.

The following tables show segment information for MGE Energy's operations for the indicated periods:

(In thousands)

| MGE Energy | Electric | Gas | Nonregulated Energy | Transmission Investment | All Others | Consolidation/ Elimination Entries | Consolidated Total |
|---|------------------|-----------------|----------------------------|--------------------------------|-------------------|---|---------------------------|
| Three Months Ended June 30, 2016 | | | | | | | |
| Operating revenues | \$ 100,329 | \$ 20,961 | \$ 286 | \$ - | \$ - | \$ - | \$ 121,576 |
| Interdepartmental revenues..... | 567 | 6,141 | 10,919 | - | - | (17,627) | - |
| Total operating revenues | <u>100,896</u> | <u>27,102</u> | <u>11,205</u> | <u>-</u> | <u>-</u> | <u>(17,627)</u> | <u>121,576</u> |
| Depreciation and amortization | (7,259) | (2,015) | (1,828) | - | (12) | - | (11,114) |
| Other operating expenses..... | (78,291) | (21,295) | (35) | (3) | (253) | 17,627 | (82,250) |
| Operating income (loss) | 15,346 | 3,792 | 9,342 | (3) | (265) | - | 28,212 |
| Other income (deductions), net | 118 | (18) | - | 1,767 | 312 | - | 2,179 |
| Interest (expense) income, net | (2,776) | (799) | (1,449) | - | 67 | - | (4,957) |
| Income before taxes | 12,688 | 2,975 | 7,893 | 1,764 | 114 | - | 25,434 |
| Income tax provision | (4,158) | (1,195) | (3,168) | (709) | (54) | - | (9,284) |
| Net income | <u>\$ 8,530</u> | <u>\$ 1,780</u> | <u>\$ 4,725</u> | <u>\$ 1,055</u> | <u>\$ 60</u> | <u>\$ -</u> | <u>\$ 16,150</u> |
| Three Months Ended June 30, 2015 | | | | | | | |
| Operating revenues | \$ 99,481 | \$ 20,669 | \$ 1,976 | \$ - | \$ - | \$ - | \$ 122,126 |
| Interdepartmental revenues..... | 122 | 2,291 | 9,853 | - | - | (12,266) | - |
| Total operating revenues | <u>99,603</u> | <u>22,960</u> | <u>11,829</u> | <u>-</u> | <u>-</u> | <u>(12,266)</u> | <u>122,126</u> |
| Depreciation and amortization | (7,456) | (1,662) | (1,866) | - | (11) | - | (10,995) |
| Other operating expenses..... | (79,961) | (19,089) | (36) | - | (262) | 12,266 | (87,082) |
| Operating income (loss) | 12,186 | 2,209 | 9,927 | - | (273) | - | 24,049 |
| Other income (deductions), net | 16 | (25) | - | 2,290 | 165 | - | 2,446 |
| Interest (expense) income, net | (2,768) | (790) | (1,507) | - | 57 | - | (5,008) |
| Income (loss) before taxes..... | 9,434 | 1,394 | 8,420 | 2,290 | (51) | - | 21,487 |
| Income tax (provision) benefit | (3,164) | (557) | (3,380) | (919) | 12 | - | (8,008) |
| Net income (loss) | <u>\$ 6,270</u> | <u>\$ 837</u> | <u>\$ 5,040</u> | <u>\$ 1,371</u> | <u>\$ (39)</u> | <u>\$ -</u> | <u>\$ 13,479</u> |
| Six Months Ended June 30, 2016 | | | | | | | |
| Operating revenues | \$ 193,537 | \$ 74,798 | \$ 768 | \$ - | \$ - | \$ - | \$ 269,103 |
| Interdepartmental revenues..... | 1,023 | 11,238 | 21,896 | - | - | (34,157) | - |
| Total operating revenues | <u>194,560</u> | <u>86,036</u> | <u>22,664</u> | <u>-</u> | <u>-</u> | <u>(34,157)</u> | <u>269,103</u> |
| Depreciation and amortization | (14,422) | (3,996) | (3,704) | - | (24) | - | (22,146) |
| Other operating expenses..... | (153,670) | (69,036) | (82) | (4) | (579) | 34,157 | (189,214) |
| Operating income (loss) | 26,468 | 13,004 | 18,878 | (4) | (603) | - | 57,743 |
| Other income (deductions), net | 314 | (26) | - | 4,000 | 333 | - | 4,621 |
| Interest (expense) income, net | (5,566) | (1,607) | (2,912) | - | 128 | - | (9,957) |
| Income (loss) before taxes..... | 21,216 | 11,371 | 15,966 | 3,996 | (142) | - | 52,407 |
| Income tax (provision) benefit | (6,694) | (4,554) | (6,408) | (1,606) | 33 | - | (19,229) |
| Net income (loss) | <u>\$ 14,522</u> | <u>\$ 6,817</u> | <u>\$ 9,558</u> | <u>\$ 2,390</u> | <u>\$ (109)</u> | <u>\$ -</u> | <u>\$ 33,178</u> |
| Six Months Ended June 30, 2015 | | | | | | | |
| Operating revenues | \$ 197,721 | \$ 90,597 | \$ 3,942 | \$ - | \$ - | \$ - | \$ 292,260 |
| Interdepartmental revenues..... | 237 | 5,016 | 19,700 | - | - | (24,953) | - |
| Total operating revenues | <u>197,958</u> | <u>95,613</u> | <u>23,642</u> | <u>-</u> | <u>-</u> | <u>(24,953)</u> | <u>292,260</u> |
| Depreciation and amortization | (14,788) | (3,304) | (3,729) | - | (23) | - | (21,844) |
| Other operating expenses..... | (159,761) | (79,157) | (86) | - | (465) | 24,953 | (214,516) |
| Operating income (loss) | 23,409 | 13,152 | 19,827 | - | (488) | - | 55,900 |
| Other income (deductions), net | 106 | (26) | - | 4,171 | 300 | - | 4,551 |
| Interest (expense) income, net | (5,587) | (1,594) | (3,025) | - | 107 | - | (10,099) |
| Income (loss) before taxes..... | 17,928 | 11,532 | 16,802 | 4,171 | (81) | - | 50,352 |
| Income tax (provision) benefit | (5,547) | (4,638) | (6,744) | (1,675) | 9 | - | (18,595) |
| Net income (loss) | <u>\$ 12,381</u> | <u>\$ 6,894</u> | <u>\$ 10,058</u> | <u>\$ 2,496</u> | <u>\$ (72)</u> | <u>\$ -</u> | <u>\$ 31,757</u> |

The following tables show segment information for MGE's operations for the indicated periods:

(In thousands)

| MGE | Electric | Gas | Nonregulated Energy | Transmission Investment | Consolidation/ Elimination Entries | Consolidated Total |
|--|------------------|-----------------|---------------------|-------------------------|---------------------------------------|--------------------|
| Three Months Ended June 30, 2016 | | | | | | |
| Operating revenues | \$ 100,336 | \$ 20,967 | \$ 286 | \$ - | \$ - | \$ 121,589 |
| Interdepartmental revenues..... | 560 | 6,135 | 10,919 | - | (17,614) | - |
| Total operating revenues | <u>100,896</u> | <u>27,102</u> | <u>11,205</u> | <u>-</u> | <u>(17,614)</u> | <u>121,589</u> |
| Depreciation and amortization | (7,259) | (2,015) | (1,828) | - | - | (11,102) |
| Other operating expenses* | <u>(82,405)</u> | <u>(22,476)</u> | <u>(3,203)</u> | <u>(3)</u> | <u>17,614</u> | <u>(90,473)</u> |
| Operating income (loss)*..... | 11,232 | 2,611 | 6,174 | (3) | - | 20,014 |
| Other income (deductions), net* | 74 | (32) | - | 1,058 | - | 1,100 |
| Interest expense, net | <u>(2,776)</u> | <u>(799)</u> | <u>(1,449)</u> | <u>-</u> | <u>-</u> | <u>(5,024)</u> |
| Net income | 8,530 | 1,780 | 4,725 | 1,055 | - | 16,090 |
| Less: Net income attributable to noncontrolling interest, net of tax | - | - | - | - | (5,952) | (5,952) |
| Net income attributable to MGE | <u>\$ 8,530</u> | <u>\$ 1,780</u> | <u>\$ 4,725</u> | <u>\$ 1,055</u> | <u>\$ (5,952)</u> | <u>\$ 10,138</u> |
| Three Months Ended June 30, 2015 | | | | | | |
| Operating revenues | \$ 99,486 | \$ 20,671 | \$ 1,976 | \$ - | \$ - | \$ 122,133 |
| Interdepartmental revenues..... | 117 | 2,289 | 9,853 | - | (12,259) | - |
| Total operating revenues | <u>99,603</u> | <u>22,960</u> | <u>11,829</u> | <u>-</u> | <u>(12,259)</u> | <u>122,133</u> |
| Depreciation and amortization | (7,456) | (1,662) | (1,866) | - | - | (10,984) |
| Other operating expenses* | <u>(83,079)</u> | <u>(19,632)</u> | <u>(3,416)</u> | <u>-</u> | <u>12,259</u> | <u>(93,868)</u> |
| Operating income*..... | 9,068 | 1,666 | 6,547 | - | - | 17,281 |
| Other (deductions) income, net* | (30) | (39) | - | 1,371 | - | 1,302 |
| Interest expense, net | <u>(2,768)</u> | <u>(790)</u> | <u>(1,507)</u> | <u>-</u> | <u>-</u> | <u>(5,065)</u> |
| Net income | 6,270 | 837 | 5,040 | 1,371 | - | 13,518 |
| Less: Net income attributable to noncontrolling interest, net of tax | - | - | - | - | (6,626) | (6,626) |
| Net income attributable to MGE | <u>\$ 6,270</u> | <u>\$ 837</u> | <u>\$ 5,040</u> | <u>\$ 1,371</u> | <u>\$ (6,626)</u> | <u>\$ 6,892</u> |
| Six Months Ended June 30, 2016 | | | | | | |
| Operating revenues | \$ 193,550 | \$ 74,814 | \$ 768 | \$ - | \$ - | \$ 269,132 |
| Interdepartmental revenues..... | 1,010 | 11,222 | 21,896 | - | (34,128) | - |
| Total operating revenues | <u>194,560</u> | <u>86,036</u> | <u>22,664</u> | <u>-</u> | <u>(34,128)</u> | <u>269,132</u> |
| Depreciation and amortization | (14,422) | (3,996) | (3,704) | - | - | (22,122) |
| Other operating expenses* | <u>(160,284)</u> | <u>(73,567)</u> | <u>(6,490)</u> | <u>(4)</u> | <u>34,128</u> | <u>(206,217)</u> |
| Operating income (loss)*..... | 19,854 | 8,473 | 12,470 | (4) | - | 40,793 |
| Other income (deductions), net* | 234 | (49) | - | 2,394 | - | 2,579 |
| Interest expense, net | <u>(5,566)</u> | <u>(1,607)</u> | <u>(2,912)</u> | <u>-</u> | <u>-</u> | <u>(10,085)</u> |
| Net income | 14,522 | 6,817 | 9,558 | 2,390 | - | 33,287 |
| Less: Net income attributable to noncontrolling interest, net of tax | - | - | - | - | (12,204) | (12,204) |
| Net income attributable to MGE | <u>\$ 14,522</u> | <u>\$ 6,817</u> | <u>\$ 9,558</u> | <u>\$ 2,390</u> | <u>\$ (12,204)</u> | <u>\$ 21,083</u> |
| Six Months Ended June 30, 2015 | | | | | | |
| Operating revenues | \$ 197,731 | \$ 90,604 | \$ 3,942 | \$ - | \$ - | \$ 292,277 |
| Interdepartmental revenues..... | 227 | 5,009 | 19,700 | - | (24,936) | - |
| Total operating revenues | <u>197,958</u> | <u>95,613</u> | <u>23,642</u> | <u>-</u> | <u>(24,936)</u> | <u>292,277</u> |
| Depreciation and amortization | (14,788) | (3,304) | (3,729) | - | - | (21,821) |
| Other operating expenses* | <u>(165,221)</u> | <u>(83,770)</u> | <u>(6,830)</u> | <u>-</u> | <u>24,936</u> | <u>(230,885)</u> |
| Operating income*..... | 17,949 | 8,539 | 13,083 | - | - | 39,571 |
| Other income (deductions), net* | 19 | (51) | - | 2,496 | - | 2,464 |
| Interest expense, net | <u>(5,587)</u> | <u>(1,594)</u> | <u>(3,025)</u> | <u>-</u> | <u>-</u> | <u>(10,206)</u> |
| Net income | 12,381 | 6,894 | 10,058 | 2,496 | - | 31,829 |
| Less: Net income attributable to noncontrolling interest, net of tax | - | - | - | - | (13,179) | (13,179) |
| Net income attributable to MGE | <u>\$ 12,381</u> | <u>\$ 6,894</u> | <u>\$ 10,058</u> | <u>\$ 2,496</u> | <u>\$ (13,179)</u> | <u>\$ 18,650</u> |

*Amounts are shown net of the related tax expense, consistent with the presentation on the MGE Consolidated Statement of Income.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

General

MGE Energy is an investor-owned public utility holding company operating through subsidiaries in five business segments:

- Regulated electric utility operations, conducted through MGE,
- Regulated gas utility operations, conducted through MGE,
- Nonregulated energy operations, conducted through MGE Power and its subsidiaries,
- Transmission investments, representing our equity investment in ATC, and
- All other, which includes corporate operations and services.

Our principal subsidiary is MGE, which generates and distributes electric energy, distributes natural gas, and represents a majority portion of our assets, liabilities, revenues, and expenses. MGE generates and distributes electricity to approximately 146,000 customers in Dane County, Wisconsin, including the city of Madison, and purchases and distributes natural gas to approximately 152,000 customers in the Wisconsin counties of Columbia, Crawford, Dane, Iowa, Juneau, Monroe, and Vernon.

Our nonregulated energy operations own interests in electric generating capacity that is leased to MGE. The ownership/leasing structure was adopted under applicable state regulatory guidelines for MGE's participation in these generation facilities, consisting principally of a stable return on the equity investment in the new generation facilities over the term of the related leases. The nonregulated energy operations include an ownership interest in two coal-fired generating units in Oak Creek, Wisconsin and a partial ownership of a cogeneration project on the UW-Madison campus. A third party operates the units in Oak Creek, and MGE operates the cogeneration project. Due to the nature of MGE's participation in these facilities, the results of our nonregulated operations are also consolidated into MGE's consolidated financial position and results of operations under applicable accounting standards.

Executive Overview

Our primary focus today and for the foreseeable future is our core utility customers at MGE as well as creating long-term value for our shareholders. MGE continues to face the challenge of providing its customers with reliable power at competitive prices. MGE meets this challenge by investing in more efficient generation projects, including renewable energy sources. MGE will continue to focus on growing earnings while controlling operating and fuel costs. MGE maintains safe and efficient operations in addition to providing customer value. We believe it is critical to maintain a strong credit standing consistent with financial strength in MGE as well as the parent company in order to accomplish these goals.

We earn our revenue and generate cash from operations by providing electric and natural gas utility services, including electric power generation and electric power and gas distribution. The earnings and cash flows from the utility business are sensitive to various external factors, including:

- Weather, and its impact on customer sales,
- Economic conditions, including current business activity and employment and their impact on customer demand,
- Regulation and regulatory issues, and their impact on the timing and recovery of costs,
- Energy commodity prices, including natural gas prices,
- Equity price risk pertaining to pension related assets,
- Credit market conditions, including interest rates and our debt credit rating,
- Environmental laws and regulations, including adopted and pending environmental rule changes,

and other factors listed in "Item 1A. Risk Factors" in our 2015 Annual Report on Form 10-K.

For the three months ended June 30, 2016, MGE Energy's earnings were \$16.2 million or \$0.47 per share compared to \$13.5 million or \$0.39 per share for the same period in the prior year. MGE's earnings for the three months ended June 30, 2016, were \$10.1 million compared to \$6.9 million for the same period in the prior year.

For the six months ended June 30, 2016, MGE Energy's earnings were \$33.2 million or \$0.96 per share compared to \$31.8 million or \$0.92 per share for the same period in the prior year. MGE's earnings for the six months ended June 30, 2016, were \$21.1 million compared to \$18.7 million for the same period in the prior year.

MGE Energy's net income was derived from our business segments as follows:

| <i>(In thousands)</i> | Three Months Ended | | Six Months Ended | |
|--------------------------------|--------------------|------------------|------------------|------------------|
| | June 30, | | June 30, | |
| Business Segment: | 2016 | 2015 | 2016 | 2015 |
| Electric Utility | \$ 8,530 | \$ 6,270 | \$ 14,522 | \$ 12,381 |
| Gas Utility | 1,780 | 837 | 6,817 | 6,894 |
| Nonregulated Energy | 4,725 | 5,040 | 9,558 | 10,058 |
| Transmission Investments | 1,055 | 1,371 | 2,390 | 2,496 |
| All Other | 60 | (39) | (109) | (72) |
| Net Income | <u>\$ 16,150</u> | <u>\$ 13,479</u> | <u>\$ 33,178</u> | <u>\$ 31,757</u> |

Our net income during the three months ended June 30, 2016, compared to the same period in the prior year primarily reflects the effects of the following factors:

- Electric net income increased due to an 8.4% increase in residential electric retail sales as the result of warmer weather during the second quarter of 2016 compared to the same period in the prior year.
- Gas net income increased due to a 12.6% increase in gas retail sales.
- Carrying costs incurred during construction of the Elm Road Units and WCCF were recognized by MGE Power Elm Road and MGE Power West Campus over the period allowed for recovery in rates. The recovery period ended in 2015, contributing to a reduction in nonregulated earnings in 2016. The reduction in earnings was offset by an increase in lease revenue.

Our net income during the six months ended June 30, 2016, primarily reflects the effects of the following factors:

- Electric net income increased due to a 2.2% increase in residential electric retail sales as the result of warmer weather during the second quarter of 2016 compared to the same period in the prior year.
- Carrying costs incurred during construction of the Elm Road Units and WCCF were recognized by MGE Power Elm Road and MGE Power West Campus over the period allowed for recovery in rates. The recovery period ended in 2015, contributing to a reduction in nonregulated earnings in 2016. The reduction in earnings was offset by an increase in lease revenue.

During the first six months of 2016, the following events occurred:

2016 Rates: In July 2015, the PSCW approved MGE's request to extend the current accounting treatment for transmission related costs through 2016, conditioned upon MGE not filing a base rate case for 2016. This accounting treatment allows MGE to reflect any differential between transmission costs reflected in rates and actual costs incurred in its next rate case filing, which occurred in April 2016.

2016 Annual Fuel Proceeding: In August 2015, the PSCW approved a \$0.00256/kWh fuel credit that began on September 1, 2015, and will continue throughout 2016. The fuel credit established a mechanism to return \$10.9 million of fuel savings to electric customers as a bill credit. MGE returned \$3.9 million of electric fuel-related savings in customer bill credits during the six months ended June 30, 2016.

In January 2016, the PSCW lowered MGE's 2016 fuel rules monitored costs by \$14.8 million as a result of continued lower projected fuel costs in 2016. Also, in March 2016, MGE filed its 2015 fuel plan reconciliation application with an overcollection of 2015 fuel rules monitored costs. The return of the additional 2015 and 2016 fuel savings to customers was addressed during the PSCW's annual review during 2016. In July 2016, the PSCW issued a final order stating that MGE shall refund the additional fuel savings incurred during 2015 and 2016 for a total of \$15.7 million to its retail electric customers over a one-month period expected to occur by the end of the third quarter of 2016. This one-time fuel credit will be in addition to the fuel credit approved in August 2015, which is currently being returned to customers throughout the remainder of 2016.

As of June 30, 2016, MGE had a deferred balance of \$14.8 million of electric fuel-related savings that are outside the range authorized by the PSCW. Within this amount, MGE has deferred \$2.3 million of 2016 fuel savings that were in excess of the fuel savings included within the fuel credits referenced above. These costs will be subject to the PSCW's annual review of 2016 fuel costs, expected to be completed in 2017.

In the near term, several items may affect us, including:

2017 Rate Case Filing: In April 2016, MGE filed an application with the PSCW requesting a 1.7% increase to electric rates and a 3.7% increase to gas rates for 2017. The proposed electric and gas rate increases cover costs primarily associated with the state's electric transmission and MGE's natural gas system infrastructure improvements. In its application, MGE has also proposed mechanisms to address potential 2018 electric and gas rate changes, including a rate adjustment for limited issues and escrow accounting on certain costs.

ATC Return on Equity: Several parties have filed complaints with the FERC seeking to reduce the base return on equity (ROE) used by MISO transmission owners, including ATC. In June 2016, an administrative law judge issued an initial decision that would reduce the transmission owners' base ROE to 9.7% related to one of the complaints. Any change to ATC's ROE could result in lower equity earnings and distributions from ATC in the future. We derived approximately 7.1% and 7.7% of our net income for the six months ended June 30, 2016 and 2015, respectively, from our investment in ATC. See "Other Matters" below for additional information concerning ATC.

Loss of Industrial Customer: In November 2015, a large industrial customer announced its intention to relocate its operations out of state and to close its manufacturing facilities within our service territory. That closure is expected to occur in early 2017. This customer contributed approximately \$1.7 million of pre-tax earnings for the six months ended June 30, 2016 and 2015. Our rate case filing for 2017 addresses the effects of the closure. There could be some impact on our electric revenues during 2016 if the customer's operations are curtailed as a result of the impending closure.

Environmental Initiatives: There are proposed legislation, rules, and initiatives involving matters related to air emissions, water effluent, hazardous materials, and greenhouse gases, all of which affect generation plant capital expenditures and operating costs as well as future operational planning. Such legislation and rulemaking could significantly affect the costs of owning and operating fossil-fueled generating plants, such as Columbia and the Elm Road Units, from which we derive approximately 44% of our electric generating capacity. We would expect to seek and receive recovery of any such costs in rates; however, it is difficult to estimate the amount of such costs due to the uncertainty as to the timing and form of the legislation and rules, and the scope and time of the recovery of costs in rates, which may lag the incurrence of those costs.

EPA's Clean Power Plan: In 2015, the EPA published its Clean Power Plan rule setting guidelines and approval criteria for states to use in developing plans to control GHG emissions from existing fossil fuel-fired EGUs and systems. Implementation of the rule is expected to have a direct impact on coal and natural gas fired generating units, including possible changes in dispatch and additional operating costs. MGE is currently evaluating the rule and its requirements. Although the implementation of the rule is presently stayed as a result of a February 9, 2016, U.S. Supreme Court ruling, compliance with the rule's requirements, including the yet-to-be-developed state implementation plan, could have a material impact on MGE if the rule is upheld and becomes effective.

Pension and Other Postretirement Benefit Costs: Costs for pension and other postretirement benefits are affected by actual investment returns on the assets held for those benefits and by the discount rate, which is sensitive to interest rates, used to calculate those benefits. Interest rates and investment returns have experienced volatility since the end of the year that could affect the value of the pension and postretirement benefit obligations. The changes in the discount rates and value of plan assets are not expected to have an impact on the income statements for 2016. However, these changes may affect benefit costs in future years. MGE expects changes in the cost for employee benefit plans will be factored into future rate actions.

Future Generation: During the first quarter of 2016, MGE entered into an agreement with WPL under which MGE may acquire up to 50 MW of capacity in a gas-fired generating plant to be constructed by WPL at its Riverside Energy Center in Beloit, Wisconsin, during the five-year period following the in-service date of the plant. The plant is expected to be completed by early 2020. MGE and WPL have negotiated a second agreement under which, subject to the approval of the PSCW, MGE will reduce its obligation to pay certain capital expenditures (other than SCR-related expenditures) at Columbia prior to the expected in-service date of the Riverside gas-fired generating plant in exchange for a proportional reduction in MGE's ownership in Columbia. MGE has accrued \$10.3 million of 2016 capital expenditures in total property, plant, and equipment (of which \$5.8 million is included in construction

work in progress) related to Columbia, that MGE would forgo as part of this second agreement with WPL, if approved by the PSCW. MGE currently owns 22% of Columbia.

General Economic Conditions: Economic conditions both inside and outside our service area are expected to continue to affect the level of demand for our utility services and may affect the collection of our accounts receivable and the creditworthiness of counterparties with whom we do business. We have in place lines of credit aggregating \$150 million for MGE Energy (including MGE) and \$100 million for MGE to address our liquidity needs. As of June 30, 2016, there were no borrowings outstanding under MGE Energy's or MGE's lines of credit.

Financing Plans: MGE has a \$30 million medium-term note maturing in 2017 and expects to refinance this debt with new long-term debt in 2016.

The following discussion is based on the business segments as discussed in Footnote 12 of the Notes to Consolidated Financial Statements.

Three Months Ended June 30, 2016 and 2015

Electric Utility Operations - MGE Energy and MGE

Electric sales and revenues

The following table compares MGE's electric revenues and electric kWh sales by customer class for each of the periods indicated:

| <i>(In thousands, except cooling degree days)</i> | Revenues | | | Sales (kWh) | | |
|---|-----------------------------|------------------|----------|-----------------------------|----------------|----------|
| | Three Months Ended June 30, | | | Three Months Ended June 30, | | |
| | 2016 | 2015 | % Change | 2016 | 2015 | % Change |
| Residential..... | \$ 31,493 | \$ 29,902 | 5.3 % | 180,932 | 166,970 | 8.4 % |
| Commercial | 55,327 | 55,252 | 0.1 % | 461,166 | 451,890 | 2.1 % |
| Industrial..... | 4,855 | 5,181 | (6.3)% | 59,951 | 62,620 | (4.3)% |
| Other-retail/municipal..... | 9,169 | 9,638 | (4.9)% | 97,047 | 106,730 | (9.1)% |
| Total retail..... | 100,844 | 99,973 | 0.9 % | 799,096 | 788,210 | 1.4 % |
| Sales to the market..... | 3,019 | 604 | N/A% | 98,320 | 16,615 | N/A% |
| Deferral of fuel savings | (3,488) | - | - % | - | - | - % |
| Adjustments to revenues..... | (46) | (1,096) | 95.8 % | - | - | - % |
| Total | <u>\$ 100,329</u> | <u>\$ 99,481</u> | 0.9 % | <u>897,416</u> | <u>804,825</u> | 11.5 % |
| Cooling degree days (normal 176) | | | | 201 | 161 | 24.8 % |

Electric operating revenues increased \$0.8 million or 0.9% for the three months ended June 30, 2016, compared to the same period in 2015, due to the following:

| <i>(In millions)</i> | |
|--|---------------|
| Volume | \$ 2.6 |
| Sales to the market..... | 2.4 |
| Adjustments to revenues..... | 1.1 |
| Other..... | 0.2 |
| Deferral of fuel savings/fuel credit | (5.5) |
| Total | <u>\$ 0.8</u> |

In July 2015, the PSCW authorized MGE to freeze 2016 rates at 2015 levels for retail electric customers.

- *Deferral of fuel savings/fuel credit.* In January 2016, the PSCW lowered MGE's 2016 fuel rules monitored costs by \$14.8 million as a result of continued lower projected fuel costs in 2016. During the three months ended June 30, 2016, MGE deferred \$3.5 million of these 2016 fuel rules monitored costs. During the three months ended June 30, 2016, customers received a fuel credit on their bill related to the fuel savings of \$2.0 million, which decreased electric revenues when compared to the same period in the prior year.
- *Volume.* During the three months ended June 30, 2016, there was a 1.4% increase in total retail sales volumes compared to the same period in the prior year driven by increased customer demand due, at least in part, to more favorable weather conditions, as evidenced by the higher number of cooling degree days.

- *Sales to the market.* Sales to the market represent wholesale sales made to third parties who are not ultimate users of the electricity. These sales may include spot market transactions on the markets operated by MISO and PJM. These sales may also include bilateral sales to other utilities or power marketers. Generating units are dispatched by MISO based on cost considerations as well as reliability of the system. Sales to the market typically occur when MGE has more generation and purchases online than are needed for its own system demand. The excess electricity is then sold to others in the market. For the three months ended June 30, 2016, market volumes increased compared to the same period in the prior year, reflecting increased opportunities for sales and those sales were made at higher market prices. The revenue generated from these sales is included in fuel rules monitored costs. See fuel rules discussion in Footnote 9.b.
- *Adjustments to revenue.* The adjustments to revenues amount includes the elimination of carrying costs for the Elm Road Units and the WCCF that were collected in electric rates ending in 2015, which were recognized as operating revenues in our Nonregulated Energy Operations segment.

MGE leases electric generating capacity from MGE Power Elm Road. MGE collects in rates the lease payments associated with the electric generating capacity as authorized by the PSCW. Any differential between estimated lease payments collected in rates and actual lease payments paid to MGE Power Elm Road are included in adjustments to revenues.

Electric fuel and purchased power

Electric fuel and purchased power costs reflect an increase in internal generation volumes offset by a decrease in the volume of purchased power when compared to the prior period. Adjustments related to the regulatory recovery for fuel costs, known as fuel rules, decreased purchased power expense. These items are explained below.

Fuel for electric generation

The expense for fuel for internal electric generation increased \$2.4 million during the three months ended June 30, 2016, compared to the same period in the prior year, due to the following:

| | |
|---------------------------------|---------------|
| <i>(In millions)</i> | |
| Increase in volume..... | \$ 5.1 |
| Decrease in per-unit cost | <u>(2.7)</u> |
| Total | <u>\$ 2.4</u> |

This increase in expense reflects a 40.0% increase in internal generation volume delivered to the system primarily as a result of increased generation at WCCF based on market prices, partially offset by a 15.2% decrease in per-unit cost of internal electric generation, reflective of lower natural gas prices.

Purchased power

Purchased power expense decreased \$6.4 million during the three months ended June 30, 2016, compared to the same period in the prior year, due to the following:

| | |
|--|-----------------|
| <i>(In millions)</i> | |
| Decrease in volume..... | \$ (5.1) |
| Increase in per-unit cost..... | 1.7 |
| Change in fuel rule adjustments, net of recoveries | <u>(3.0)</u> |
| Total | <u>\$ (6.4)</u> |

The decrease in expense (before fuel rules adjustments) reflects a 28.4% decrease in the volume of power purchased from third parties primarily as a result of the increased internal generation, partially offset by a 12.9% increase in the per-unit cost of purchased power.

Under fuel rules, MGE is required to defer electric fuel-related costs that fall outside a 2% cost tolerance band around the amount used in the most recent rate proceeding. Any fuel rules adjustments are reflected in purchased power expense.

Electric operating and maintenance expenses

Electric operating and maintenance expenses decreased \$0.1 million during the three months ended June 30, 2016, compared to the same period in 2015. The following changes contributed to the net change:

(In millions)

| | | |
|---|----|--------------|
| Decreased customer accounts costs | \$ | (0.3) |
| Decreased distribution expenses | | (0.1) |
| Decreased administrative and general costs..... | | (0.1) |
| Increased production expenses | | 0.4 |
| Total..... | \$ | <u>(0.1)</u> |

Gas Utility Operations - MGE Energy and MGE

Gas deliveries and revenues

The following table compares MGE's gas revenues and gas therms delivered by customer class during each of the periods indicated:

| <i>(In thousands, except HDD and average rate per therm of retail customer)</i> | Revenues | | | Therms Delivered | | |
|---|-----------------------------|------------------|----------|-----------------------------|---------------|----------|
| | Three Months Ended June 30, | | | Three Months Ended June 30, | | |
| | 2016 | 2015 | % Change | 2016 | 2015 | % Change |
| Residential..... | \$ 13,654 | \$ 13,214 | 3.3 % | 13,144 | 11,178 | 17.6 % |
| Commercial/Industrial | 6,173 | 6,338 | (2.6)% | 12,969 | 12,009 | 8.0 % |
| Total retail | 19,827 | 19,552 | 1.4 % | 26,113 | 23,187 | 12.6 % |
| Gas transportation..... | 1,049 | 1,003 | 4.6 % | 16,521 | 16,013 | 3.2 % |
| Other revenues..... | 85 | 114 | (25.4)% | - | - | - % |
| Total | \$ <u>20,961</u> | \$ <u>20,669</u> | 1.4 % | <u>42,634</u> | <u>39,200</u> | 8.8 % |
| Heating degree days (normal 831)..... | | | | 828 | 721 | 14.8 % |
| Average rate per therm of retail customer | \$ 0.759 | \$ 0.843 | (10.0)% | | | |

Gas revenues increased \$0.3 million or 1.4% for the three months ended June 30, 2016, compared to the same period in 2015. These changes are related to the following factors:

(In millions)

| | | |
|-----------------------|----|------------|
| Volume | \$ | 1.2 |
| Rate/PGA changes..... | | (0.9) |
| Total | \$ | <u>0.3</u> |

In July 2015, the PSCW authorized MGE to freeze 2016 rates at 2015 levels for retail gas customers.

- *Volume.* For the three months ended June 30, 2016, retail gas deliveries increased 12.6% compared to the same period in the prior year.
- *Rate/PGA changes.* MGE recovers the cost of natural gas in its gas segment through the purchased gas adjustment clause (PGA). Under the PGA, MGE is able to pass through to its gas customers the cost of gas. Changes in PGA recoveries affect revenues, but do not impact net income.

The average retail rate per therm for the three months ended June 30, 2016, decreased 10.0% compared to the same period in 2015, reflecting a \$1.1 million decrease in natural gas commodity costs (PGA), offset by an increase in fixed rate charges.

Cost of gas sold

For the three months ended June 30, 2016, cost of gas sold decreased by \$0.2 million, compared to the same period in the prior year. The cost per therm of natural gas decreased 11.4%, which resulted in \$0.8 million of decreased expense. The volume of gas purchased increased 8.8%, which resulted in \$0.6 million of increased expense.

Gas operating and maintenance expenses

Gas operating and maintenance expenses decreased by \$0.4 million for the three months ended June 30, 2016, compared to the same period in 2015. The following changes contributed to the net change:

| | |
|---|-----------------|
| <i>(In millions)</i> | |
| Decreased customer accounts costs | \$ (0.2) |
| Decreased administrative and general costs..... | (0.1) |
| Decreased distribution expenses | (0.1) |
| Total..... | <u>\$ (0.4)</u> |

Nonregulated Energy Operations - MGE Energy and MGE

The nonregulated energy operations are conducted through MGE Energy's subsidiaries: MGE Power Elm Road (the Elm Road Units) and MGE Power West Campus (WCCF), which have been formed to own and lease electric generating capacity to assist MGE. For the three months ended June 30, 2016 and 2015, net income at the nonregulated energy operations segment was \$4.7 million and \$5.0 million, respectively. Carrying costs incurred during construction of the Elm Road Units and WCCF were recognized by MGE Power Elm Road and MGE Power West Campus over the period allowed for recovery in rates. The recovery period ended in 2015, contributing to a reduction in nonregulated earnings in 2016. The reduction in earnings was offset by an increase in lease revenue.

Transmission Investment Operations - MGE Energy and MGE

Transmission investment other income

For the three months ended June 30, 2016 and 2015, other income at the transmission investment segment was \$1.8 million and \$2.3 million, respectively. The transmission investment segment holds our interest in ATC, and its income reflects our equity in the earnings of ATC. See Footnote 3 of the Notes to Consolidated Financial Statements and "Other Matters" below for additional information concerning ATC and summarized financial information regarding ATC.

Consolidated Income Taxes - MGE Energy and MGE

MGE Energy's effective income tax rate for the three months ended June 30, 2016 and 2015, was 36.5% and 37.3%, respectively. MGE's effective income tax rate for the three months ended June 30, 2016 and 2015, was 36.5% and 37.2%, respectively. The decrease in the effective tax rate is due in part to higher estimated AFUDC equity earnings offset by a lower estimated domestic manufacturing deduction in 2016.

Noncontrolling Interest, Net of Tax - MGE

The noncontrolling interest, net of tax, reflects the accounting required for MGE Energy's interest in MGE Power Elm Road (the Elm Road Units) and MGE Power West Campus (WCCF). MGE Energy owns 100% of MGE Power Elm Road and MGE Power West Campus; however, due to the contractual agreements for these projects with MGE, the entities are considered VIEs with respect to MGE and their results are consolidated with those of MGE, the primary beneficiary of the VIEs. Also included in noncontrolling interest, net of tax, is MGE Energy's interest in MGE Transco, which holds our investment in ATC. The following table shows MGE Energy's noncontrolling interest, net of tax, reflected on MGE's consolidated statement of income:

| <i>(In millions)</i> | Three Months Ended | |
|----------------------------------|--------------------|--------|
| | June 30, | |
| | 2016 | 2015 |
| MGE Power Elm Road | \$ 3.6 | \$ 4.2 |
| MGE Power West Campus | 1.8 | 1.8 |
| MGE Transco ^(a) | 0.5 | 0.6 |

- (a) MGE's ownership interest declined below a majority in July 2016 as a result of continued funding of ATC capital contributions by MGE Energy. As a result of the change in majority ownership in MGE Transco in July 2016, MGE will deconsolidate the noncontrolling interest within MGE's financial statements for MGE Energy's proportionate share of the equity in MGE Transco. As of June 30, 2016, the noncontrolling interest attributable to MGE Transco on MGE's consolidated balance sheet was \$24.9 million. No gain or loss was recognized in July 2016 due to MGE ceasing to have a controlling financial interest.

Six Months Ended June 30, 2016 and 2015

Electric Utility Operations - MGE Energy and MGE

Electric sales and revenues

The following table compares MGE's electric revenues and electric kWh sales by customer class for each of the periods indicated:

| (In thousands, except cooling degree days) | Revenues | | | Sales (kWh) | | |
|--|---------------------------|-------------------|----------|---------------------------|------------------|----------|
| | Six Months Ended June 30, | | | Six Months Ended June 30, | | |
| | 2016 | 2015 | % Change | 2016 | 2015 | % Change |
| Residential..... | \$ 64,797 | \$ 64,149 | 1.0 % | 382,022 | 373,783 | 2.2 % |
| Commercial | 105,824 | 106,430 | (0.6)% | 903,485 | 893,325 | 1.1 % |
| Industrial..... | 9,259 | 9,873 | (6.2)% | 117,173 | 121,343 | (3.4)% |
| Other-retail/municipal..... | 17,407 | 18,799 | (7.4)% | 181,996 | 208,153 | (12.6)% |
| Total retail..... | 197,287 | 199,251 | (1.0)% | 1,584,676 | 1,596,604 | (0.7)% |
| Sales to the market..... | 3,161 | 900 | N/A% | 108,939 | 24,548 | N/A% |
| Deferral of fuel savings..... | (7,070) | - | - % | - | - | - % |
| Adjustments to revenues..... | 159 | (2,430) | (106.5)% | - | - | - % |
| Total | <u>\$ 193,537</u> | <u>\$ 197,721</u> | (2.1)% | <u>1,693,615</u> | <u>1,621,152</u> | 4.5 % |
| Cooling degree days (normal 176) | | | | 201 | 161 | 24.8 % |

Electric operating revenues decreased \$4.2 million or 2.1% for the six months ended June 30, 2016, compared to the same period in 2015, due to the following:

| (In millions) | |
|--|-----------------|
| Deferral of fuel savings/fuel credit | \$ (11.0) |
| Adjustments to revenue | 2.6 |
| Sales to the market..... | 2.3 |
| Volume | 1.2 |
| Other..... | 0.7 |
| Total | <u>\$ (4.2)</u> |

In July 2015, the PSCW authorized MGE to freeze 2016 rates at 2015 levels for retail electric customers.

- *Deferral of fuel savings/fuel credit.* In January 2016, the PSCW lowered MGE's 2016 fuel rules monitored costs by \$14.8 million as a result of continued lower projected fuel costs in 2016. During the six months ended June 30, 2016, MGE deferred \$7.1 million of these 2016 fuel rules monitored costs. During the six months ended June 30, 2016, customers received a fuel credit on their bill related to the fuel savings of \$3.9 million, which decreased electric revenues when compared to the same period in the prior year.
- *Adjustments to revenue.* The adjustments to revenues amount includes the elimination of carrying costs for the Elm Road Units and the WCCF that were collected in electric rates ending in 2015, which were recognized as operating revenues in our Nonregulated Energy Operations segment.

MGE leases electric generating capacity from MGE Power Elm Road. MGE collects in rates the lease payments associated with the electric generating capacity as authorized by the PSCW. Any differential between estimated lease payments collected in rates and actual lease payments paid to MGE Power Elm Road are included in adjustments to revenues.

- *Sales to the market.* Sales to the market represent wholesale sales made to third parties who are not ultimate users of the electricity. These sales may include spot market transactions on the markets operated by MISO and PJM. These sales may also include bilateral sales to other utilities or power marketers. Generating units are dispatched by MISO based on cost considerations as well as reliability of the system. Sales to the market typically occur when MGE has purchases and generation online exceeding its own system demand. The excess electricity is then sold to others in the market. For the six months ended June 30, 2016, market volumes increased compared to the same period in the prior year, reflecting increased opportunities for sales; however,

those sales were made at lower market prices. The revenue generated from these sales is included in fuel rules monitored costs. See fuel rules discussion in Footnote 9.b.

- *Volume.* During the six months ended June 30, 2016, there was a 2.2% increase in residential sales volumes compared to the same period in the prior year driven by increased customer demand due, at least in part, to more favorable weather conditions, as evidenced by the higher number of cooling degree days.

Electric fuel and purchased power

Electric fuel and purchased power costs reflect an increase in internal generation volumes offset by a decrease in the volume of purchased power when compared to the prior period. Adjustments related to the regulatory recovery for fuel costs, known as fuel rules, decreased purchased power expense. These items are explained below.

Fuel for electric generation

The expense for fuel for internal electric generation increased \$2.5 million during the six months ended June 30, 2016, compared to the same period in the prior year, due to the following:

| | |
|---------------------------------|---------------|
| <i>(In millions)</i> | |
| Increase in volume..... | \$ 5.8 |
| Decrease in per-unit cost | (3.3) |
| Total | <u>\$ 2.5</u> |

This increase in expense reflects a 27.1% increase in internal generation volume delivered to the system primarily as a result of increased generation at WCCF based on market prices, partially offset by a 13.3% decrease in per-unit cost of internal electric generation, reflective of lower natural gas prices.

Purchased power

Purchased power expense decreased \$14.6 million during the six months ended June 30, 2016, compared to the same period in the prior year, due to the following:

| | |
|--|------------------|
| <i>(In millions)</i> | |
| Decrease in volume | \$ (9.8) |
| Increase in per-unit cost | 2.5 |
| Change in fuel rule adjustments, net of recoveries | (7.3) |
| Total..... | <u>\$ (14.6)</u> |

The decrease in expense (before fuel rules adjustments) reflects a 25.5% decrease in the volume of power purchased from third parties primarily as a result of the increased internal generation, partially offset by an 8.6% increase in the per-unit cost of purchased power.

Under fuel rules, MGE is required to defer electric fuel-related costs that fall outside a 2% cost tolerance band around the amount used in the most recent rate proceeding. Any fuel rules adjustments are reflected in purchased power expense.

Electric operating and maintenance expenses

Electric operating and maintenance expenses increased \$1.4 million during the six months ended June 30, 2016, compared to the same period in 2015. The following changes contributed to the net change:

| | |
|---------------------------------------|---------------|
| <i>(In millions)</i> | |
| Increased production expenses | \$ 1.0 |
| Increased distribution expenses | 0.2 |
| Increased transmission costs..... | 0.2 |
| Total..... | <u>\$ 1.4</u> |

For the six months ended June 30, 2016, increased production expenses are primarily related to increased maintenance costs at Columbia and WCCF compared to the prior year.

Gas Utility Operations - MGE Energy and MGE

Gas deliveries and revenues

The following table compares MGE's gas revenues and gas therms delivered by customer class during each of the periods indicated:

| <i>(In thousands, except HDD and average rate per therm of retail customer)</i> | Revenues | | | Therms Delivered | | |
|---|---------------------------|------------------|----------|---------------------------|----------------|----------|
| | Six Months Ended June 30, | | | Six Months Ended June 30, | | |
| | 2016 | 2015 | % Change | 2016 | 2015 | % Change |
| Residential..... | \$ 44,904 | \$ 52,902 | (15.1)% | 56,720 | 62,038 | (8.6)% |
| Commercial/Industrial | 27,281 | 34,933 | (21.9)% | 50,325 | 55,836 | (9.9)% |
| Total retail | 72,185 | 87,835 | (17.8)% | 107,045 | 117,874 | (9.2)% |
| Gas transportation..... | 2,405 | 2,472 | (2.7)% | 37,974 | 41,007 | (7.4)% |
| Other revenues..... | 208 | 290 | (28.3)% | - | - | - % |
| Total | <u>\$ 74,798</u> | <u>\$ 90,597</u> | (17.4)% | <u>145,019</u> | <u>158,881</u> | (8.7)% |
| Heating degree days (normal 4,405) | | | | 4,086 | 4,555 | (10.3)% |
| Average rate per therm of retail customer | \$ 0.674 | \$ 0.745 | (9.5)% | | | |

Gas revenues decreased \$15.8 million or 17.4% for the six months ended June 30, 2016, compared to the same period in 2015. These changes are related to the following factors:

(In millions)

| | |
|--|------------------|
| Rate/PGA changes..... | \$ (8.4) |
| Volume | (7.3) |
| Transportation and other effects | (0.1) |
| Total | <u>\$ (15.8)</u> |

In July 2015, the PSCW authorized MGE to freeze 2016 rates at 2015 levels for retail gas customers.

- *Rate/PGA changes.* MGE recovers the cost of natural gas in its gas segment through the purchased gas adjustment clause (PGA). Under the PGA, MGE is able to pass through to its gas customers the cost of gas. Changes in PGA recoveries affect revenues, but do not impact net income.

The average retail rate per therm for the six months ended June 30, 2016, decreased 9.5% compared to the same period in 2015, reflecting an \$8.8 million decrease in natural gas commodity costs (PGA), offset by an increase in fixed rate charges.

- *Volume.* For the six months ended June 30, 2016, retail gas deliveries decreased 9.2% due, at least in part, to warmer weather in the first quarter of 2016 compared to the same period in the prior year.

Cost of gas sold

For the six months ended June 30, 2016, cost of gas sold decreased by \$14.6 million, compared to the same period in the prior year. The cost per therm of natural gas decreased 19.2%, which resulted in \$9.3 million of decreased expense. The volume of purchased gas decreased 10.1%, which resulted in \$5.4 million of decreased expense.

Gas operating and maintenance expenses

Gas operating and maintenance expenses increased by \$0.1 million for the six months ended June 30, 2016, compared to the same period in 2015.

Nonregulated Energy Operations - MGE Energy and MGE

The nonregulated energy operations are conducted through MGE Energy's subsidiaries: MGE Power Elm Road (the Elm Road Units) and MGE Power West Campus (WCCF), which have been formed to own and lease electric generating capacity to assist MGE. For the six months ended June 30, 2016 and 2015, net income at the nonregulated energy operations segment was \$9.6 million and \$10.1 million, respectively. Carrying costs incurred

during construction of the Elm Road Units and WCCF were recognized by MGE Power Elm Road and MGE Power West Campus over the period allowed for recovery in rates. The recovery period ended in 2015, contributing to a reduction in nonregulated earnings in 2016. The reduction in earnings was offset by an increase in lease revenue.

Transmission Investment Operations - MGE Energy and MGE

Transmission investment other income

For the six months ended June 30, 2016 and 2015, other income at the transmission investment segment was \$4.0 million and \$4.2 million, respectively. The transmission investment segment holds our interest in ATC, and its income reflects our equity in the earnings of ATC. See Footnote 3 of the Notes to Consolidated Financial Statements and "Other Matters" below for additional information concerning ATC and summarized financial information regarding ATC.

Consolidated Income Taxes - MGE Energy and MGE

Both MGE Energy's and MGE's effective income tax rate for the six months ended June 30, 2016 and 2015, was 36.7% and 36.9%, respectively. The decrease in the effective tax rates is due in part to higher estimated AFUDC equity earnings offset by a lower estimated domestic manufacturing deduction in 2016.

Noncontrolling Interest, Net of Tax - MGE

The noncontrolling interest, net of tax, reflects the accounting required for MGE Energy's interest in MGE Power Elm Road (the Elm Road Units) and MGE Power West Campus (WCCF). MGE Energy owns 100% of MGE Power Elm Road and MGE Power West Campus; however, due to the contractual agreements for these projects with MGE, the entities are considered VIEs with respect to MGE and their results are consolidated with those of MGE, the primary beneficiary of the VIEs. Also included in noncontrolling interest, net of tax, is MGE Energy's interest in MGE Transco, which holds our investment in ATC. The following table shows MGE Energy's noncontrolling interest, net of tax, reflected on MGE's consolidated statement of income:

| <i>(In millions)</i> | Six Months Ended | |
|----------------------------------|------------------|--------|
| | June 30, | |
| | 2016 | 2015 |
| MGE Power Elm Road | \$ 7.4 | \$ 8.3 |
| MGE Power West Campus | 3.6 | 3.7 |
| MGE Transco ^(a) | 1.2 | 1.2 |

- (a) MGE's ownership interest declined below a majority in July 2016 as a result of continued funding of ATC capital contributions by MGE Energy. As a result of the change in majority ownership in MGE Transco in July 2016, MGE will deconsolidate the noncontrolling interest within MGE's financial statements for MGE Energy's proportionate share of the equity in MGE Transco. As of June 30, 2016, the noncontrolling interest attributable to MGE Transco on MGE's consolidated balance sheet was \$24.9 million. No gain or loss was recognized in July 2016 due to MGE ceasing to have a controlling financial interest.

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 six months ended June 30, 2016, except as noted below. Further discussion of the contractual obligations and commercial commitments is included in Footnote 18 of Notes to Consolidated Financial Statements, and "Contractual Obligations and Commercial Commitments for MGE Energy and MGE" under "Management's Discussion and Analysis of Financial Condition and Results of Operations" in MGE Energy's and MGE's 2015 Annual Report on Form 10-K.

Purchase Contracts - MGE Energy and MGE

See Footnote 7.c. of Notes to Consolidated Financial Statements for a description of commitments at June 30, 2016, that MGE Energy and MGE have entered with respect to various commodity supply, transportation, and storage contracts to meet their obligations to deliver natural gas to customers.

Liquidity and Capital Resources

MGE Energy and MGE have adequate liquidity to fund future operations and capital expenditures over the next twelve months. Available resources include cash and cash equivalents, operating cash flows, liquid assets, borrowing capacity under revolving credit facilities, and access to equity and debt capital markets.

Cash Flows

The following summarizes cash flows for MGE Energy and MGE during the six months ended June 30, 2016 and 2015:

| <i>(In thousands)</i> | <u>MGE Energy</u> | | <u>MGE</u> | |
|------------------------------|-------------------|-------------|-------------|-------------|
| | <u>2016</u> | <u>2015</u> | <u>2016</u> | <u>2015</u> |
| Cash provided by/(used for): | | | | |
| Operating activities..... | \$ 93,514 | \$ 72,993 | \$ 93,209 | \$ 78,992 |
| Investing activities..... | (41,973) | (33,801) | (42,028) | (33,628) |
| Financing activities..... | (22,617) | (29,156) | (36,994) | (26,603) |

Cash Provided by Operating Activities

MGE Energy

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

Cash provided by operating activities for the six months ended June 30, 2016, was \$93.5 million, an increase of \$20.5 million when compared to the same period in the prior year.

MGE Energy's net income increased \$1.4 million for the six months ended June 30, 2016, when compared to the same period in the prior year.

In both 2016 and 2015, MGE received a \$10.0 million refund from the IRS for the 2015 and 2014 tax years, respectively. Excluding the 2016 and 2015 refund, MGE Energy's federal and state taxes paid decreased \$1.1 million during the six months ended June 30, 2016, when compared to the same period in the prior year.

Working capital accounts (excluding prepaid and accrued taxes) resulted in \$24.6 million in cash provided by operating activities for the six months ended June 30, 2016, primarily due to decreased gas inventories, decreased receivables, increased accounts payable, and increased other current liabilities. The increase in current liabilities includes a fuel credit, that was approved in August 2015, of \$3.9 million that customers received on their bill January through June 2016 and \$9.2 million of deferred fuel related cost savings to be returned to customers.

Working capital accounts (excluding prepaid and accrued taxes) resulted in \$0.7 million in cash provided by operating activities for the six months ended June 30, 2015, primarily due to decreased receivables and decreased unbilled revenues, partially offset by decreased accounts payable and decreased other current liabilities.

For the six months ended June 30, 2015, MGE deferred \$5.7 million in fuel related cost savings to be returned to customers.

MGE

Cash provided by operating activities for the six months ended June 30, 2016, was \$93.2 million, an increase of \$14.2 million when compared to the same period in the prior year.

Net income increased \$1.5 million for the six months ended June 30, 2016, when compared to the same period in the prior year.

In both 2016 and 2015, MGE received a \$10.0 million refund from the IRS for the 2015 and 2014 tax years, respectively. Excluding the 2016 and 2015 refund, MGE's federal and state taxes paid to MGE Energy increased \$2.9 million during the six months ended June 30, 2016, when compared to the same period in the prior year.

Working capital accounts (excluding prepaid and accrued taxes) resulted in \$24.4 million in cash provided by operating activities for the six months ended June 30, 2016, primarily due to decreased gas inventories, decreased receivables, increased accounts payable, and increased other current liabilities. The increase in current liabilities includes a fuel credit, that was approved in August 2015, of \$3.9 million that customers received on their bill January through June 2016 and \$9.2 million of deferred fuel related cost savings to be returned to customers.

Working capital accounts (excluding prepaid taxes and accrued taxes) resulted in \$9.6 million in cash provided by operating activities for the six months ended June 30, 2015, primarily due to decreased receivables and decreased unbilled revenues, partially offset by decreased accounts payable.

For the six months ended June 30, 2015, MGE deferred \$5.7 million in fuel related cost savings to be returned to customers.

Cash Used for Investing Activities

MGE Energy

MGE Energy's cash used for investing activities increased \$8.2 million for the six months ended June 30, 2016, when compared to the same period in the prior year.

Capital expenditures for the six months ended June 30, 2016, were \$40.8 million. This amount represents an increase of \$7.6 million from the expenditures made in the same period in the prior year. This increase primarily reflects increased expenditures on electric and gas distribution assets.

MGE

MGE's cash used for investing activities increased \$8.4 million for the six months ended June 30, 2016, when compared to the same period in the prior year.

Capital expenditures for the six months ended June 30, 2016, were \$40.8 million. This amount represents an increase of \$7.6 million from the expenditures made in the same period in the prior year. This increase primarily reflects increased expenditures on electric and gas distribution assets.

Cash Used for Financing Activities

MGE Energy

Cash used for MGE Energy's financing activities was \$22.6 million for the six months ended June 30, 2016, compared to \$29.2 million of cash used for MGE Energy's financing activities in the six months ended June 30, 2015.

For the six months ended June 30, 2016, dividends paid were \$20.5 million compared to \$19.6 million in the prior year. This increase was a result of a higher dividend per share (\$0.590 vs. \$0.565).

For the six months ended June 30, 2015, net short term debt repayments were \$7.0 million. There were no short term debt repayments in the current year.

MGE

During the six months ended June 30, 2016, cash used for MGE's financing activities was \$37.0 million compared to \$26.6 million of cash used for MGE's financing activities in the prior year.

Dividends paid from MGE to MGE Energy were \$25.0 million for the six months ended June 30, 2016. For the six months ended June 30, 2015, cash dividends paid from MGE to MGE Energy were \$10.0 million.

Distributions to parent from noncontrolling interest, which represent distributions from MGE Power Elm Road and MGE Power West Campus, were \$10.6 million for the six months ended June 30, 2016, compared to \$10.1 million in the prior year.

For the six months ended June 30, 2016, equity contributions received from MGE Power West Campus and MGE Transco were \$0.7 million compared to \$2.9 million in the prior year.

For the six months ended June 30, 2015, net short term debt repayments were \$7.0 million. There were no short term debt repayments in the current year.

Capitalization Ratios^(a)

MGE Energy's capitalization ratios were as follows:

| | MGE Energy | |
|-------------------------------------|---------------|-------------------|
| | June 30, 2016 | December 31, 2015 |
| Common shareholders' equity..... | 64.4 % | 63.8 % |
| Long-term debt ^(b) | 35.6 % | 36.2 % |

(a) Reflects application of new accounting pronouncement. See Footnote 11.c. of the Notes to Consolidated Financial Statements for additional information regarding the treatment of debt issuance costs.

(b) Includes the current portion of long-term debt.

MGE Energy's and MGE's Capital Requirements

MGE Energy's and MGE's liquidity are primarily affected by their capital requirements. During the six months ended June 30, 2016, capital expenditures for MGE Energy and MGE totaled \$40.8 million, which included \$39.1 million of capital expenditures for utility operations.

Credit Ratings

MGE Energy's and MGE's access to the capital markets, including, in the case of MGE, the commercial paper market, and their respective financing costs in those markets, may depend on the credit ratings of the entity that is accessing the capital markets.

None of MGE Energy's or MGE's borrowings are subject to default or prepayment as a result of a downgrading of credit ratings, although a downgrading of MGE's credit ratings could increase fees and interest charges under both MGE Energy's and MGE's credit agreements.

Environmental Matters

The following discussion is limited to updates or developments in environmental matters that occurred during the six months ended June 30, 2016. Further discussion of environmental matters is included in MGE Energy's and MGE's 2015 Annual Report on Form 10-K and Footnote 7.a. of Notes to Consolidated Financial Statements in this Report.

Sulfur Dioxide (SO₂) NAAQS

In March 2015, the EPA identified MGE's Columbia Plant in Columbia County as a large stationary source of SO₂ that may exceed the one hour SO₂ NAAQS standard and was subject to a State of Wisconsin proposed county attainment/nonattainment determination. In September 2015, Wisconsin sent a letter to the EPA proposing that Columbia County be designated as being in attainment for SO₂ NAAQS based on recent modeling demonstrating that SO₂ pollution controls on the Columbia Plant had brought the county into attainment. In June 2016, the EPA issued a final rule classifying Columbia County as an unclassified/ attainment area. In addition to the EPA's actions on SO₂ NAAQS, the WDNR is revising its state rules to incorporate the one hour SO₂ standard with a proposed final rule date of August 2016. MGE does not anticipate any material costs from this rule.

Clean Air Visibility Rule (CAVR)

Columbia may be subject to the best available retrofit technology (BART) regulations, a subsection of the EPA's Clean Air Visibility Rule (CAVR), which may require pollution control retrofits. Columbia's pollution control upgrades and the EPA's stance that compliance with the CSAPR equals compliance with BART should mean that Columbia will not need to do additional work to meet BART requirements. In February 2016, the EPA submitted a proposed revision to the rule. The proposed revision would move state plan due dates from July 2018 to July 2021. This would allow for states to coordinate their CAVR compliance with other compliance efforts. If this proposed revision is finalized, it would reduce the chances that CAVR will be material for MGE. At this time, however, the BART regulatory obligations, compliance strategies, and costs remain uncertain due to the continued legal uncertainty surrounding CSAPR.

Other Matters

ATC

In 2013, several parties filed a complaint with the FERC seeking to reduce the base return on equity (ROE) used by MISO transmission owners, including ATC, "due to changes in the capital markets." The complaint alleges that the MISO ROE should not exceed 9.15%, the equity components of hypothetical capital structures should be restricted to 50%, and the relevant incentive ROE adders should be discontinued. MISO's base ROE is 12.38% and ATC's base ROE is 12.2%. In December 2015, an administrative law judge issued an initial decision that would reduce the transmission owners' base ROE to 10.32%. That initial decision will be reviewed by FERC and it is anticipated FERC will issue an order on this issue by October 2016. In February 2015, a second complaint was filed with the FERC requesting a reduction in the base ROE used by MISO transmission owners, including ATC, to 8.67%, with a refund effective date retroactive to the filing date of the complaint. In June 2016, an administrative law judge issued an initial decision that would reduce the transmission owner's base ROE to 9.7%. The initial decision will be reviewed by FERC and it is anticipated FERC will issue an order on this issue by mid-2017.

In January 2015, FERC accepted the transmission owner's request for a 50 basis-point incentive ROE adder for participating in MISO. The adder became effective January 6, 2015, subject to refund, and FERC accepted the transmission owner's request to defer collection of the adder pending the outcome of the first ROE complaint proceeding.

Any change to ATC's ROE could result in lower equity earnings and distributions from ATC in the future. Our share of ATC's earnings reflects a pre-tax charge of \$0.8 million and \$0.2 million for the three months ended June 30, 2016 and 2015, respectively, and a pre-tax charge of \$1.1 million and \$0.8 million for the six months ended June 30, 2016 and 2015, respectively, recorded by ATC for this matter representing its estimate of its refund liability. We derived approximately 7.1% and 7.7% of our net income for the six months ended June 30, 2016 and 2015, respectively, from our investment in ATC.

New Accounting Principles

See Footnote 11 of Notes to Consolidated Financial Statements for discussion of new accounting pronouncements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

MGE Energy and MGE are potentially exposed to market risk associated with interest rates, commodity prices, and equity returns. MGE currently has no exposure to foreign currency risk. MGE manages some risk exposure through risk management policies and the use of derivative instruments. MGE's risk management policy prohibits speculative trading transactions.

Commodity Price Risk

MGE has commodity price risk exposure with respect to the price of natural gas, electricity, coal, emission credits, and oil. MGE's electric operations burn natural gas in several of its peaking power plants and, in many cases, the cost of purchased power is tied to the cost of natural gas. MGE employs established policies and procedures to reduce the market risks associated with changing commodity prices. MGE's commodity risks are somewhat mitigated by the current ratemaking process in place for recovering electric fuel cost, purchased energy costs, and the cost of natural gas.

MGE's electric fuel costs are subject to fuel rules established by the PSCW. The fuel rules require the PSCW and Wisconsin utilities to defer electric fuel-related costs that fall outside a symmetrical cost tolerance band. Any over/under recovery of the actual costs is determined on an annual basis and is adjusted in future billings to electric retail customers. Under the electric fuel rules, MGE is required to defer the benefit of lower costs if the actual electric fuel costs fall outside the lower end of the range and is required to defer costs, less any excess revenues, if the actual electric fuel costs exceed the upper end of the range. Excess revenues are defined as revenues in the year in question that provide MGE with a greater return on common equity than authorized by the PSCW in MGE's latest rate order. The range is defined by the PSCW and has been modified throughout the years based on market conditions and other relevant factors. Currently, MGE is subject to a plus or minus 2% range. MGE assumes the risks and benefits of variances that are within the cost tolerance band. For 2016, fuel and purchased power costs included in MGE's base fuel rates are \$108.2 million. See Footnote 9.b. of the Notes to Consolidated Financial Statements for additional information.

MGE recovers the cost of natural gas in its gas utility segment through the purchased gas adjustment clause (PGA). Under the PGA, MGE is able to pass through to its gas customers the cost of gas.

MGE also reduces price risk caused by market fluctuations via physical contracts and financial derivative contracts, including futures, swaps, options, forwards, and other contractual commitments. The maximum length of time over which cash flows related to energy commodities can be hedged under applicable PSCW approvals is four years.

MGE has financial gas and electric commodity contracts to hedge commodity price risk in the gas and electric utility segments. These contracts are primarily comprised of exchange-traded option and future contracts. MGE also holds FTRs, which are used to hedge the risk of increased transmission congestion charges. At June 30, 2016, the fair value of these instruments exceeded their cost basis by \$1.7 million. Under the PGA clause and electric fuel rules, MGE may include in the costs of fuel (natural gas or power) the costs and benefits of the aforementioned fuel price risk management tools. Because these costs/benefits are recoverable, the related unrealized loss/gain has been deferred on the consolidated balance sheets as a regulatory asset/liability.

MGE has also entered into a purchased power agreement that provides MGE with firm capacity and energy that began on June 1, 2012, and ends on May 31, 2022 (the "base term"). The agreement also allows MGE an option to extend the contract after the base term. The agreement is considered a derivative contract and is recognized at its fair value on the consolidated balance sheet. However, the derivative qualifies for regulatory deferral and is recognized with a corresponding regulatory asset or liability depending on whether the fair value is in a loss or gain position. The fair value of the contract at June 30, 2016, reflects a loss position of \$52.2 million.

Interest Rate Risk

Both MGE Energy and MGE may have short term borrowings at varying interest rates. MGE issues commercial paper for its short-term borrowings, while MGE Energy draws from its current credit facility to meet its short-term borrowing needs. Borrowing levels vary from period to period depending upon capital investments and other factors. Future short-term interest expense and payments will reflect both future short-term interest rates and borrowing levels. MGE Energy and MGE manage interest rate risk by limiting their variable rate exposure and continually monitoring the effects of market changes on interest rates. MGE is not exposed to changes in interest rates on a substantial portion of its long-term debt until that debt matures and is refinanced at market rates.

Equity Price Risk - Pension-Related Assets

MGE currently funds its liabilities related to employee benefits through trust funds. These funds, which include investments in debt and equity securities, are managed by various investment managers. Changes in market value of these investments can have an impact on the future expenses related to these liabilities.

Credit Risk - Counterparty

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

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

Additionally, if a counterparty were to default and MGE were to liquidate all contracts with that entity, MGE's credit loss would include the loss in value of mark-to-market contracts; the amount owed for settled transactions; and additional payments, if any, to settle unrealized losses on accrual contracts. As of June 30, 2016, no counterparties have defaulted.

MGE is obligated to provide service to all electric and gas customers within its respective franchised territories. MGE's franchised electric territory includes a 316 square-mile area in Dane County, Wisconsin, and MGE's franchised gas territory includes a service area covering 1,682 square miles in Wisconsin. Based on results for the year ended December 31, 2015, no one customer constituted more than 10% of total operating revenues for MGE Energy and MGE. Credit risk for electric and gas is managed by MGE's credit and collection policies, which are consistent with state regulatory requirements.

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

Item 4. Controls and Procedures.

During the second quarter of 2016, each registrant's management, including the principal executive officer and principal financial officer, evaluated its disclosure controls and procedures related to the recording, processing, summarization, and reporting of information in its periodic reports that it files with the SEC. These disclosure controls and procedures have been designed to ensure that material information relating to that registrant, including its subsidiaries, is accumulated and made known to that registrant's management, including these officers, by other employees of that registrant and its subsidiaries as appropriate to allow timely decisions regarding required disclosure, and that this information is recorded, processed, summarized, evaluated, and reported, as applicable, within the time periods specified in the SEC's rules and forms. Due to the inherent limitations of control systems, not all misstatements may be detected. These inherent limitations include the realities that judgments in decision making can be faulty and breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. Also, the registrants do not control or manage certain of their unconsolidated entities and thus, their access and ability to apply their procedures to those entities is more limited than is the case for their consolidated subsidiaries.

As of June 30, 2016, each registrant's principal executive officer and principal financial officer concluded that its disclosure controls and procedures were effective. Each registrant intends to strive continually to improve its disclosure controls and procedures to enhance the quality of its financial reporting.

During the quarter ended June 30, 2016, there were no changes in either registrant's internal controls over financial reporting that materially affected, or are reasonably likely to affect materially, that registrant's internal control over financial reporting.

PART II. OTHER INFORMATION.

Item 1. Legal Proceedings.

MGE Energy and MGE

MGE Energy and its subsidiaries, including MGE, from time to time are involved in various legal proceedings that are handled and defended in the ordinary course of business.

See Footnote 7.a. and 7.b. of Notes to Consolidated Financial Statements for more information.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

Issuer Purchases of Equity Securities

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs* | Maximum number (or Approximate Dollar Value) of Shares That May Yet Be Purchased Under the Plans or Programs* |
|------------------|--|---------------------------------|--|--|
| April 1-30, 2016 | 19,450 | \$ 50.28 | - | - |
| May 1-31, 2016 | 20,205 | 51.60 | - | - |
| June 1-30, 2016 | 55,900 | 54.86 | - | - |
| Total | 95,555 | \$ 53.24 | - | - |

*Under the Stock Plan, common stock shares deliverable to plan participants may be either newly issued shares or shares purchased on the open market, as determined from time to time by MGE Energy. In June 2009, MGE Energy switched to using open market purchases to provide shares to meet obligations to participants in the Stock Plan. The shares are purchased on the open market through a securities broker-dealer and then are reissued under the Stock Plan as needed to meet share delivery requirements. The volume and timing of share repurchases in the open market depends upon the level of dividend reinvestment and optional share purchases being made from time to time by plan participants. As a result, there is no specified maximum number of shares to be repurchased and no specified termination date for the repurchases. All shares issued through the Stock Plan, whether newly issued or reissued following open market purchases, are issued and sold pursuant to a registration statement that was filed with the SEC and is currently effective.

Item 4. Mine Safety Disclosures.

Not applicable to MGE Energy and MGE.

Item 6. Exhibits.

- 12 Statement regarding computation of ratio of earnings to fixed charges for Madison Gas and Electric Company.

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, 2016, filed by the following officers for the following companies:

- 31.1 Filed by Gary J. Wolter for MGE Energy, Inc.
31.2 Filed by Jeffrey C. Newman for MGE Energy, Inc.
31.3 Filed by Gary J. Wolter for Madison Gas and Electric Company
31.4 Filed by Jeffrey C. Newman 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, 2016, filed by the following officers for the following companies:

- 32.1 Filed by Gary J. Wolter for MGE Energy, Inc.
- 32.2 Filed by Jeffrey C. Newman for MGE Energy, Inc.
- 32.3 Filed by Gary J. Wolter for Madison Gas and Electric Company
- 32.4 Filed by Jeffrey C. Newman for Madison Gas and Electric Company

101 Interactive Data Files:

- 101.INS XBRL Instance
- 101.SCH XBRL Taxonomy Extension Schema
- 101.CAL XBRL Taxonomy Extension Calculation
- 101.DEF XBRL Taxonomy Extension Definition
- 101.LAB XBRL Taxonomy Extension Labels
- 101.PRE XBRL Taxonomy Extension Presentation

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 4, 2016

/s/ Gary J. Wolter

Gary J. Wolter

Chairman, President and Chief Executive Officer

(Duly Authorized Officer)

Date: August 4, 2016

/s/ Jeffrey C. Newman

Jeffrey C. Newman

Senior Vice President, Chief Financial Officer, Secretary and Treasurer

(Chief Financial and Accounting Officer)

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 4, 2016

/s/ Gary J. Wolter

Gary J. Wolter

Chairman, President and Chief Executive Officer

(Duly Authorized Officer)

Date: August 4, 2016

/s/ Jeffrey C. Newman

Jeffrey C. Newman

Senior Vice President, Chief Financial Officer, Secretary and Treasurer

(Chief Financial and Accounting Officer)