

MGE ENERGY INC  
Form 10-Q  
August 04, 2017

**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, 2017**

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

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

| <b>Commission</b>            | <b>Name of Registrant, State of Incorporation, Address</b>  | <b>IRS Employer</b>                     |
|------------------------------|---|---|
| <b>File No.</b><br>000-49965 | <b>of Principal Executive Offices, and Telephone No.</b><br><b>MGE Energy, Inc.</b><br><br>(a Wisconsin Corporation)<br><br>133 South Blair Street<br><br>Madison, Wisconsin 53788<br><br>(608) 252-7000<br><br>mgeenergy.com | <b>Identification No.</b><br>39-2040501 |
| 000-1125                     | <b>Madison Gas and Electric Company</b>   | 39-0444025                              |

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(a Wisconsin Corporation)

133 South Blair Street

Madison, Wisconsin 53788

(608) 252-7000

mge.com

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

Indicate by check mark whether the registrants have submitted electronically and posted on their corporate Web sites, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrants were required to submit and post such files):

Yes  No

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

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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, 2017**

|                                  |  |
|----------------------------------|--|
| 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.). |

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

### **Filing Format**

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

### **Forward-Looking Statements**

This report, and other documents filed by MGE Energy and MGE with the Securities and Exchange Commission (SEC) from time to time, contain forward-looking statements that reflect management's current assumptions and estimates regarding future performance and economic conditions especially as they relate to 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' 2016 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 17, 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](http://sec.gov), MGE Energy's website at [mgeenergy.com](http://mgeenergy.com), and MGE's website at [mge.com](http://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               |
| MGEE Transco              | MGEE Transco, LLC                         |
| NGV Fueling Services      | NGV Fueling Services, LLC                 |

**Other Defined Terms:**

|                     |  |
|---------------------|--|
| AFUDC               | Allowance for Funds Used During Construction   |
| ATC                 | American Transmission Company LLC  |
| ATC Holdco          | ATC Holdco, LLC  |
| 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  |
| 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  |
| GAAP                | Generally Accepted Accounting Principles   |
| 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 <sub>2</sub>           | Nitrogen Dioxide   |
| NO <sub>x</sub>           | 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)  |
| PPA                       | Purchased Power Agreement  |
| PSCW                      | Public Service Commission of Wisconsin   |

|                 |   |
|-----------------|---|
| Riverside       | Riverside Energy Center   |
| ROE             | Return on Equity  |
| SCR             | Selective Catalytic Reduction   |
| SEC             | Securities and Exchange Commission  |
| SO2             | Sulfur Dioxide  |
| Stock Plan      | Direct Stock Purchase and Dividend Reinvestment Plan of MGE Energy            |
| UW              | University of Wisconsin at Madison  |
| VIE             | Variable Interest Entity  |
| WCCF            | West Campus Cogeneration Facility   |
| WEPCO           | Wisconsin Electric Power Company, a subsidiary of WEC Energy Group, Inc.      |
| Working capital | Current assets less current liabilities                                       |
| WPL             | Wisconsin Power and Light Company, a subsidiary of Alliant Energy Corporation |
| XBRL            | eXtensible Business Reporting Language  |

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

|   | <b>Three Months Ended<br/>June 30,</b> |             | <b>Six Months Ended<br/>June 30,</b> |             |
|---|--|-------------|--------------------------------------|-------------|
|   | <b>2017</b>                            | <b>2016</b> | <b>2017</b>                          | <b>2016</b> |
| <b>Operating Revenues:</b>  |  |             |                                      |             |
| Electric revenues   | \$ 102,382                             | \$ 100,615  | \$ 200,779                           | \$ 194,305  |
| Gas revenues  | 24,081                                 | 20,961      | 82,507                               | 74,798      |
| <i>Total Operating Revenues</i>                                       | 126,463                                | 121,576     | 283,286                              | 269,103     |
| <b>Operating Expenses:</b>  |  |             |                                      |             |
| Fuel for electric generation  | 11,910                                 | 15,049      | 24,109                               | 27,062      |
| Purchased power   | 16,720                                 | 14,861      | 32,074                               | 29,531      |
| Cost of gas sold  | 9,231                                  | 6,410       | 45,015                               | 38,933      |
| Other operations and<br>maintenance                                   | 43,924                                 | 40,963      | 86,614                               | 83,693      |
| Depreciation and amortization   | 13,275                                 | 11,114      | 26,234                               | 22,146      |
| Other general taxes   | 4,852                                  | 4,967       | 9,779                                | 9,995       |
| <i>Total Operating Expenses</i>                                       | 99,912                                 | 93,364      | 223,825                              | 211,360     |
| <b>Operating Income</b>   | 26,551                                 | 28,212      | 59,461                               | 57,743      |
| Other income, net   | 2,614                                  | 2,179       | 5,065                                | 4,621       |
| Interest expense, net   | (4,886)                                | (4,957)     | (9,780)                              | (9,957)     |
| Income before income taxes  | 24,279                                 | 25,434      | 54,746                               | 52,407      |
| Income tax provision  | (8,736)                                | (9,284)     | (19,903)                             | (19,229)    |
| <b>Net Income</b>   | \$ 15,543                              | \$ 16,150   | \$ 34,843                            | \$ 33,178   |
| <b>Earnings Per Share of Common<br/>Stock</b><br>(basic and diluted)  | \$ 0.45                                | \$ 0.47     | \$ 1.01                              | \$ 0.96     |
| Dividends per share of common<br>stock                                | \$ 0.308                               | \$ 0.295    | \$ 0.615                             | \$ 0.590    |
| <b>Weighted Average Shares<br/>Outstanding</b><br>(basic and diluted) | 34,668                                 | 34,668      | 34,668                               | 34,668      |

*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)*

|  | <b>Three Months Ended<br/>June 30,</b> |                  | <b>Six Months Ended<br/>June 30,</b> |                  |
|--|--|------------------|--------------------------------------|------------------|
|  | <b>2017</b>                            | <b>2016</b>      | <b>2017</b>                          | <b>2016</b>      |
| Net Income   | \$ 15,543                              | \$ 16,150        | \$ 34,843                            | \$ 33,178        |
| Other comprehensive income, net of tax:  |  |                  |                                      |                  |
| Unrealized gain (loss) on available-for-sale securities, net of tax ((\$21) and (\$7), and (\$86) and \$104, respectively) | 32                                     | 10               | 129                                  | (154)            |
| <b>Comprehensive Income</b>  | <b>\$ 15,575</b>                       | <b>\$ 16,160</b> | <b>\$ 34,972</b>                     | <b>\$ 33,024</b> |

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

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

|   | <b>Six Months Ended<br/>June 30,</b> |                   |
|---|--------------------------------------|-------------------|
|   | <b>2017</b>                          | <b>2016</b>       |
| <b>Operating Activities:</b>                                    |                                      |                   |
| Net income  | \$ 34,843                            | \$ 33,178         |
| Items not affecting cash:                                       |                                      |                   |
| Depreciation and amortization                                   | 26,234                               | 22,146            |
| Deferred income taxes   | 1,037                                | 9,522             |
| Provision for doubtful receivables                              | 367                                  | 483               |
| Employee benefit plan cost                                      | 727                                  | 30                |
| Equity earnings in ATC  | (5,094)                              | (4,000)           |
| Other items   | 780                                  | 392               |
| Changes in working capital items:                               |                                      |                   |
| Decrease in current assets                                      | 21,287                               | 27,585            |
| (Decrease) increase in current liabilities                      | (11,516)                             | 12,230            |
| Dividends from ATC  | 4,072                                | 2,728             |
| Cash contributions to pension and other<br>postretirement plans | (8,284)                              | (12,096)          |
| Other noncurrent items, net                                     | 3,257                                | 1,316             |
| <i>Cash Provided by Operating Activities</i>                    | 67,710                               | 93,514            |
| <b>Investing Activities:</b>                                    |                                      |                   |
| Capital expenditures  | (42,169)                             | (40,791)          |
| Capital contributions to investments                            | (5,557)                              | (998)             |
| Other   | 778                                  | (184)             |
| <i>Cash Used for Investing Activities</i>                       | (46,948)                             | (41,973)          |
| <b>Financing Activities:</b>                                    |                                      |                   |
| Cash dividends paid on common stock                             | (21,321)                             | (20,454)          |
| Repayment of long-term debt                                     | (32,167)                             | (2,123)           |
| Issuance of long-term debt                                      | 40,000                               | -                 |
| Other   | (317)                                | (40)              |
| <i>Cash Used for Financing Activities</i>                       | (13,805)                             | (22,617)          |
| Change in cash and cash equivalents                             | 6,957                                | 28,924            |
| Cash and cash equivalents at beginning of<br>period             | 95,959                               | 81,384            |
| <b>Cash and cash equivalents at end of period</b>               | <b>\$ 102,916</b>                    | <b>\$ 110,308</b> |

**Supplemental disclosures of cash flow  
information:**

Significant noncash investing activities:

|                              |    |       |    |       |
|------------------------------|----|-------|----|-------|
| Accrued capital expenditures | \$ | 8,450 | \$ | 7,091 |
|------------------------------|----|-------|----|-------|

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

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

|   | <b>June 30,<br/>2017</b> | <b>December 31,<br/>2016</b> |
|---|--------------------------|------------------------------|
| <b>ASSETS</b>   |                          |                              |
| <b>Current Assets:</b>  |                          |                              |
| Cash and cash equivalents   | \$ 102,916               | \$ 95,959                    |
| Accounts receivable, less reserves of \$3,030 and \$3,017, respectively   | 35,252                   | 39,887                       |
| Other accounts receivable, less reserves of \$386 and \$426, respectively | 7,024                    | 8,530                        |
| Unbilled revenues   | 23,238                   | 29,846                       |
| Materials and supplies, at average cost                                   | 20,354                   | 18,561                       |
| Fossil fuel, at average cost  | 11,186                   | 9,757                        |
| Stored natural gas, at average cost                                       | 9,607                    | 12,819                       |
| Prepaid taxes   | 15,679                   | 26,636                       |
| Regulatory assets - current   | 7,602                    | 6,414                        |
| Assets held for sale  | 5,117                    | 14,813                       |
| Other current assets  | 11,320                   | 12,293                       |
| <i>Total Current Assets</i>   | 249,295                  | 275,515                      |
| Regulatory assets   | 149,866                  | 158,485                      |
| Pension and other postretirement benefit asset                            | 2,984                    | 2,020                        |
| Other deferred assets and other   | 6,228                    | 6,691                        |
| <b>Property, Plant, and Equipment:</b>                                    |                          |                              |
| Property, plant, and equipment, net                                       | 1,262,674                | 1,245,269                    |
| Construction work in progress   | 36,511                   | 36,790                       |
| <i>Total Property, Plant, and Equipment</i>                               | 1,299,185                | 1,282,059                    |
| <b>Investments</b>  | 84,946                   | 76,290                       |
| <b>Total Assets</b>   | <b>\$ 1,792,504</b>      | <b>\$ 1,801,060</b>          |
| <b>LIABILITIES AND CAPITALIZATION</b>                                     |                          |                              |
| <b>Current Liabilities:</b>   |                          |                              |
| Long-term debt due within one year  | \$ 4,404                 | \$ 4,333                     |
| Accounts payable  | 34,047                   | 47,799                       |
| Accrued interest and taxes  | 5,600                    | 5,495                        |
| Accrued payroll related items   | 9,719                    | 11,892                       |
| Regulatory liabilities - current  | 10,795                   | 6,910                        |
| Derivative liabilities  | 9,000                    | 7,620                        |
| Other current liabilities   | 10,075                   | 19,456                       |
| <i>Total Current Liabilities</i>  | 83,640                   | 103,505                      |
| <b>Other Credits:</b>   |                          |                              |
| Deferred income taxes   | 385,210                  | 383,813                      |
| Investment tax credit - deferred  | 906                      | 947                          |
| Regulatory liabilities  | 23,579                   | 22,173                       |



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|   |              |              |
|---|--------------|--------------|
| Accrued pension and other postretirement benefits | 66,800       | 74,347       |
| Derivative liabilities                            | 37,620       | 42,970       |
| Other deferred liabilities and other              | 66,572       | 66,426       |
| <i>Total Other Credits</i>                        | 580,687      | 590,676      |
| <b>Capitalization:</b>                            |              |              |
| Common shareholders' equity                       | 737,739      | 724,088      |
| Long-term debt                                    | 390,438      | 382,791      |
| <i>Total Capitalization</i>                       | 1,128,177    | 1,106,879    |
| Commitments and contingencies (see Footnote 7)    |              |              |
| <b>Total Liabilities and Capitalization</b>       | \$ 1,792,504 | \$ 1,801,060 |

*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<br>Shares | Common Stock<br>Value | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income/(Loss) | Total      |
|---|------------------------|-----------------------|----------------------------------|----------------------|--|------------|
| <b>2016</b>   |                        |                       |                                  |                      |  |            |
| Beginning balance -<br>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<br>declared<br>(\$0.590 per share) |                        |                       |                                  | (20,454)             |  | (20,454)   |
| Ending balance - June 30,<br>2016                         | 34,668                 | \$ 34,668             | \$ 316,268                       | \$ 351,889           | \$ 203   | \$ 703,028 |
| <b>2017</b>   |                        |                       |                                  |                      |  |            |
| Beginning balance -<br>December 31, 2016                  | 34,668                 | \$ 34,668             | \$ 316,268                       | \$ 372,950           | \$ 202   | \$ 724,088 |
| Net income  |                        |                       |                                  | 34,843               |  | 34,843     |
| Other comprehensive<br>income                             |                        |                       |                                  |                      | 129  | 129        |
| Common stock dividends<br>declared<br>(\$0.615 per share) |                        |                       |                                  | (21,321)             |  | (21,321)   |
| Ending balance - June 30,<br>2017                         | 34,668                 | \$ 34,668             | \$ 316,268                       | \$ 386,472           | \$ 331   | \$ 737,739 |

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

**Madison Gas and Electric Company**

**Consolidated Statements of Income (unaudited)**

(In thousands)

|   | <b>Three Months Ended</b> |                  | <b>Six Months Ended</b> |                  |
|---|---------------------------|------------------|-------------------------|------------------|
|   | <b>June 30,</b>           |                  | <b>June 30,</b>         |                  |
|   | <b>2017</b>               | <b>2016</b>      | <b>2017</b>             | <b>2016</b>      |
| <b>Operating Revenues:</b>                      |                           |                  |                         |                  |
| Electric revenues                               | \$ 102,382                | \$ 100,622       | \$ 200,783              | \$ 194,318       |
| Gas revenues                                    | 24,080                    | 20,967           | 82,515                  | 74,814           |
| <i>Total Operating Revenues</i>                 | 126,462                   | 121,589          | 283,298                 | 269,132          |
| <b>Operating Expenses:</b>                      |                           |                  |                         |                  |
| Fuel for electric generation                    | 11,910                    | 15,051           | 24,111                  | 27,067           |
| Purchased power                                 | 16,720                    | 14,864           | 32,076                  | 29,538           |
| Cost of gas sold                                | 9,230                     | 6,415            | 45,023                  | 38,949           |
| Other operations and maintenance                | 43,707                    | 40,712           | 86,028                  | 83,114           |
| Depreciation and amortization                   | 13,275                    | 11,102           | 26,234                  | 22,122           |
| Other general taxes                             | 4,852                     | 4,967            | 9,779                   | 9,995            |
| Income tax provision                            | 7,756                     | 8,464            | 18,021                  | 17,554           |
| <i>Total Operating Expenses</i>                 | 107,450                   | 101,575          | 241,272                 | 228,339          |
| <b>Operating Income</b>                         | <b>19,012</b>             | <b>20,014</b>    | <b>42,026</b>           | <b>40,793</b>    |
| <b>Other Income and Deductions:</b>             |                           |                  |                         |                  |
| AFUDC - equity funds                            | 294                       | 263              | 565                     | 524              |
| Equity earnings in MGE Transco                  | -                         | 1,767            | -                       | 4,000            |
| Income tax provision                            | (47)                      | (767)            | (91)                    | (1,709)          |
| Other expense, net                              | (111)                     | (163)            | (187)                   | (236)            |
| <i>Total Other Income and Deductions</i>        | 136                       | 1,100            | 287                     | 2,579            |
| <i>Deductions</i>                               | 136                       | 1,100            | 287                     | 2,579            |
| Income before interest expense                  | 19,148                    | 21,114           | 42,313                  | 43,372           |
| <b>Interest Expense:</b>                        |                           |                  |                         |                  |
| Interest on long-term debt                      | 5,013                     | 5,096            | 10,056                  | 10,205           |
| Other interest, net                             | 65                        | 14               | 96                      | 51               |
| AFUDC - borrowed funds                          | (80)                      | (86)             | (172)                   | (171)            |
| <i>Net Interest Expense</i>                     | 4,998                     | 5,024            | 9,980                   | 10,085           |
| <b>Net Income</b>                               | <b>\$ 14,150</b>          | <b>\$ 16,090</b> | <b>\$ 32,333</b>        | <b>\$ 33,287</b> |
| Less: Net Income Attributable to Noncontrolling |                           |                  |                         |                  |
| Interest, net of tax                            | (5,396)                   | (5,952)          | (10,785)                | (12,204)         |
| <b>Net Income Attributable to MGE</b>           | <b>\$ 8,754</b>           | <b>\$ 10,138</b> | <b>\$ 21,548</b>        | <b>\$ 21,083</b> |

*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)*

|  |    | <b>Three Months Ended</b> |             | <b>Six Months Ended</b> |             |
|--|----|---------------------------|-------------|-------------------------|-------------|
|  |    | <b>June 30,</b>           |             | <b>June 30,</b>         |             |
|  |    | <b>2017</b>               | <b>2016</b> | <b>2017</b>             | <b>2016</b> |
| Net Income   | \$ | 14,150\$                  | 16,090\$    | 32,333\$                | 33,287      |
| Other comprehensive income, net of tax:  |    |                           |             |                         |             |
| Unrealized loss on available-for-sale securities, net of tax (\$17 and \$6, and \$21 and \$26, respectively) |    | (25)                      | (9)         | (31)                    | (39)        |
| <b>Comprehensive Income</b>  | \$ | 14,125\$                  | 16,081\$    | 32,302\$                | 33,248      |
| Less: Comprehensive Income Attributable to Noncontrolling Interest, net of tax                               |    | (5,396)                   | (5,952)     | (10,785)                | (12,204)    |
| <b>Comprehensive Income Attributable to MGE</b>  | \$ | 8,729\$                   | 10,129\$    | 21,517\$                | 21,044      |

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

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

|   | <b>Six Months Ended<br/>June 30,</b> |             |
|---|--------------------------------------|-------------|
|   | <b>2017</b>                          | <b>2016</b> |
| <b>Operating Activities:</b>                                    |                                      |             |
| Net income  | \$ 32,333                            | \$ 33,287   |
| Items not affecting cash:                                       |                                      |             |
| Depreciation and amortization                                   | 26,234                               | 22,122      |
| Deferred income taxes   | (149)                                | 8,894       |
| Provision for doubtful receivables                              | 367                                  | 483         |
| Employee benefit plan cost                                      | 727                                  | 30          |
| Equity earnings in MGE Transco                                  | -                                    | (4,000)     |
| Other items   | 971                                  | 770         |
| Changes in working capital items:                               |                                      |             |
| Decrease in current assets                                      | 20,394                               | 27,628      |
| (Decrease) increase in current liabilities                      | (11,021)                             | 12,123      |
| Dividends from MGE Transco                                      | -                                    | 2,728       |
| Cash contributions to pension and other<br>postretirement plans | (8,284)                              | (12,096)    |
| Other noncurrent items, net                                     | 3,141                                | 1,240       |
| <i>Cash Provided by Operating Activities</i>                    | 64,713                               | 93,209      |
| <b>Investing Activities:</b>                                    |                                      |             |
| Capital expenditures  | (42,169)                             | (40,791)    |
| Capital contributions to investments                            | -                                    | (710)       |
| Other   | (9)                                  | (527)       |
| <i>Cash Used for Investing Activities</i>                       | (42,178)                             | (42,028)    |
| <b>Financing Activities:</b>                                    |                                      |             |
| Cash dividends paid to parent by MGE                            | (25,000)                             | (25,000)    |
| Distributions to parent from noncontrolling<br>interest         | (10,000)                             | (10,552)    |
| Equity contribution received from<br>noncontrolling interest    | -                                    | 710         |
| Repayment of long-term debt                                     | (32,167)                             | (2,123)     |
| Issuance of long-term debt                                      | 40,000                               | -           |
| Other   | (305)                                | (29)        |
| <i>Cash Used for Financing Activities</i>                       | (27,472)                             | (36,994)    |
| Change in cash and cash equivalents                             | (4,937)                              | 14,187      |
| Cash and cash equivalents at beginning of<br>period             | 10,768                               | 26,760      |

|   |    |       |    |        |
|---|----|-------|----|--------|
| <b>Cash and cash equivalents at end of period</b> | \$ | 5,831 | \$ | 40,947 |
|---|----|-------|----|--------|

**Supplemental disclosures of cash flow information:**

Significant noncash investing activities:

|                              |    |       |    |       |
|------------------------------|----|-------|----|-------|
| Accrued capital expenditures | \$ | 8,450 | \$ | 7,091 |
|------------------------------|----|-------|----|-------|

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

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

|   | <b>June 30,<br/>2017</b> | <b>December 31,<br/>2016</b> |
|---|--------------------------|------------------------------|
| <b>ASSETS</b>   |                          |                              |
| <b>Current Assets:</b>  |                          |                              |
| Cash and cash equivalents   | \$ 5,831                 | \$ 10,768                    |
| Accounts receivable, less reserves of \$3,030 and \$3,017, respectively   | 35,252                   | 39,887                       |
| Affiliate receivables   | 802                      | 539                          |
| Other accounts receivable, less reserves of \$386 and \$426, respectively | 6,954                    | 6,363                        |
| Unbilled revenues   | 23,238                   | 29,846                       |
| Materials and supplies, at average cost                                   | 20,354                   | 18,561                       |
| Fossil fuel, at average cost  | 11,186                   | 9,757                        |
| Stored natural gas, at average cost                                       | 9,607                    | 12,819                       |
| Prepaid taxes   | 15,905                   | 25,798                       |
| Regulatory assets - current   | 7,602                    | 6,414                        |
| Assets held for sale  | 5,117                    | 14,813                       |
| Other current assets  | 11,312                   | 12,268                       |
| <i>Total Current Assets</i>   | 153,160                  | 187,833                      |
| Affiliate receivable long-term  | 3,971                    | 4,236                        |
| Regulatory assets   | 149,866                  | 158,485                      |
| Pension and other postretirement benefit asset                            | 2,984                    | 2,020                        |
| Other deferred assets and other   | 3,997                    | 4,353                        |
| <b>Property, Plant, and Equipment:</b>                                    |                          |                              |
| Property, plant, and equipment, net                                       | 1,262,702                | 1,244,648                    |
| Construction work in progress   | 36,511                   | 36,790                       |
| <i>Total Property, Plant, and Equipment</i>                               | 1,299,213                | 1,281,438                    |
| <b>Investments</b>  | 434                      | 487                          |
| <b>Total Assets</b>   | \$ 1,613,625             | \$ 1,638,852                 |
| <b>LIABILITIES AND CAPITALIZATION</b>                                     |                          |                              |
| <b>Current Liabilities:</b>   |                          |                              |
| Long-term debt due within one year  | \$ 4,404                 | \$ 4,333                     |
| Accounts payable  | 34,044                   | 47,790                       |
| Accrued interest and taxes  | 6,298                    | 5,440                        |
| Accrued payroll related items   | 9,719                    | 11,892                       |
| Regulatory liabilities - current  | 10,795                   | 6,910                        |
| Derivative liabilities  | 9,000                    | 7,620                        |
| Other current liabilities   | 9,702                    | 19,347                       |
| <i>Total Current Liabilities</i>  | 83,962                   | 103,332                      |
| <b>Other Credits:</b>   |                          |                              |
| Deferred income taxes   | 343,697                  | 343,117                      |

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|   |              |              |
|---|--------------|--------------|
| Investment tax credit - deferred                  | 906          | 947          |
| Regulatory liabilities                            | 23,579       | 22,173       |
| Accrued pension and other postretirement benefits | 66,800       | 74,347       |
| Derivative liabilities                            | 37,620       | 42,970       |
| Other deferred liabilities and other              | 66,572       | 66,426       |
| <i>Total Other Credits</i>                        | 539,174      | 549,980      |
| <b>Capitalization:</b>                            |              |              |
| Common shareholder's equity                       | 483,601      | 487,084      |
| Noncontrolling interest                           | 116,450      | 115,665      |
| <i>Total Equity</i>                               | 600,051      | 602,749      |
| Long-term debt                                    | 390,438      | 382,791      |
| <i>Total Capitalization</i>                       | 990,489      | 985,540      |
| Commitments and contingencies (see Footnote 7)    |              |              |
| <b>Total Liabilities and Capitalization</b>       | \$ 1,613,625 | \$ 1,638,852 |

*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<br>Shares | Common Stock<br>Value | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income/(Loss) | Non-<br>Controlling<br>Interest | Total    |
|---|------------------------|-----------------------|----------------------------------|----------------------|--|---------------------------------|----------|
| <b>2016</b>   |                        |                       |                                  |                      |  |                                 |          |
| Beginning balance - Dec.<br>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<br>loss                                     |                        |                       |                                  |                      | (39)   |                                 | (39)     |
| Cash dividends paid to<br>parent<br>by MGE                      |                        |                       |                                  | (25,000)             |  |                                 | (25,000) |
| Equity contribution<br>received from<br>noncontrolling interest |                        |                       |                                  |                      |  | 710                             | 710      |
| Distributions to parent<br>from<br>noncontrolling interest      |                        |                       |                                  |                      |  | (10,552)                        | (10,552) |
| Ending balance -<br>June 30, 2016                               | 17,348\$               | 17,348\$              | 192,417\$                        | 287,971\$            | (16)\$   | 142,670\$                       | 640,390  |
| <b>2017</b>   |                        |                       |                                  |                      |  |                                 |          |
| Beginning balance - Dec.<br>31, 2016                            | 17,348\$               | 17,348\$              | 192,417\$                        | 277,300\$            | 19\$   | 115,665\$                       | 602,749  |
| Net income  |                        |                       |                                  | 21,548               |  | 10,785                          | 32,333   |
| Other comprehensive<br>loss                                     |                        |                       |                                  |                      | (31)   |                                 | (31)     |
| Cash dividends paid to<br>parent<br>by MGE                      |                        |                       |                                  | (25,000)             |  |                                 | (25,000) |
| Distributions to parent<br>from<br>noncontrolling interest      |                        |                       |                                  |                      |  | (10,000)                        | (10,000) |
| Ending balance -<br>June 30, 2017                               | 17,348\$               | 17,348\$              | 192,417\$                        | 273,848\$            | (12)\$   | 116,450\$                       | 600,051  |

*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, 2017**

**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 2016 Annual Report on Form 10-K.

Prior to December 1, 2016, MGE Transco was jointly owned by MGE Energy and MGE. MGE's ownership interest in MGE Transco declined below a majority in July 2016. As a result of the change in majority ownership in MGE Transco in July 2016, MGE deconsolidated MGE Energy's proportionate share of the equity in MGE Transco. The change in consolidation was applied prospectively by reducing its investment and noncontrolling interest on MGE's consolidated financial statements. On December 1, 2016, MGE's ownership interest in MGE Transco was transferred to MGE Energy. See Footnote 3 for further discussion.

The accompanying consolidated financial statements as of June 30, 2017, 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 2016 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 54 through 104 of the 2016 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 three and six months ended June 30, 2017 and 2016, 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 stock option or stock award programs or any dilutive securities.

**c.**

**Long-term Debt - MGE Energy and MGE.**

On January 13, 2017, MGE issued \$40 million of 3.76% senior unsecured notes due January 15, 2052. MGE used the net proceeds from the sale of senior notes to refinance \$30 million of medium-term notes, which matured in January 2017, and assist with the financing of additional capital expenditures. The new, unsecured long-term debt carries an interest rate of 3.76% per annum over its 35-year term. The covenants of this debt are substantially consistent with MGE's existing unsecured long-term debt.



## 3.

**Investment in ATC and ATC Holdco - 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, as of December 1, 2016, is owned solely by MGE Energy. ATC Holdco was formed by several members of ATC, including MGE Energy, to pursue electric transmission development and investments outside of Wisconsin. The ownership interest in ATC Holdco is held by MGEE Transco, a wholly-owned subsidiary of MGE Energy.

MGE Transco and MGEE Transco have accounted for their investment in ATC and ATC Holdco, respectively, under the equity method of accounting. Equity earnings from investments are recorded as "Other income" on MGE Energy's consolidated statements of income. For the three and six months ended June 30, 2017 and 2016, MGE Transco recorded the following:

| <i>(In thousands)</i>                  | Three Months Ended |          | Six Months Ended |          |
|--|--------------------|----------|------------------|----------|
|  | June 30,           |          | June 30,         |          |
|  | 2017               | 2016     | 2017             | 2016     |
| Equity earnings from investment in ATC | \$ 2,486           | \$ 1,767 | \$ 5,094         | \$ 4,000 |
| Dividends from ATC <sup>(a)</sup>      | 2,000              | 1,863    | 2,000            | 2,728    |
| Capital contributions to ATC           | 888                | 177      | 2,308            | 710      |

(a)

As of December 31, 2016, MGE Transco recorded a \$2.1 million receivable from ATC for a cash dividend received in January 2017.

ATC Holdco's activities commenced in late December 2016 and had an immaterial impact on results of operations, cash flows, and financial condition.

At June 30, 2017, and December 31, 2016, MGE Transco held a 3.6% ownership interest in ATC. At June 30, 2017, and December 31, 2016, MGEE Transco held a 4.3% and 4.0% ownership interest in ATC Holdco, respectively.

In June 2016, the PSCW required MGE to transfer its interest in ATC to MGE Energy, which was to be completed by December 31, 2022. The requirement arose in the context of requests for regulatory approvals by several owners of ATC in connection with a reorganization of ATC. MGE's ownership interest in ATC, held through MGE Transco, was transferred net of deferred tax liabilities to MGE Energy by way of a dividend in kind of \$15.8 million as of December 1, 2016. As a result of the transfer, MGE's ownership interest in MGE Transco was completely eliminated in favor of MGE Energy. The change had no effect on MGE Energy's consolidated financial statements.

ATC's summarized financial data for the three and six months ended June 30, 2017 and 2016, is as follows:

| <i>(In thousands)</i>                 | Three Months Ended |            | Six Months Ended |            |
|---------------------------------------|--------------------|------------|------------------|------------|
|                                       | June 30,           |            | June 30,         |            |
|                                       | 2017               | 2016       | 2017             | 2016       |
| Operating revenues                    | \$ 176,610         | \$ 154,225 | \$ 351,279       | \$ 318,465 |
| Operating expenses                    | (82,665)           | (81,698)   | (165,053)        | (160,763)  |
| Other income, net                     | 612                | 1,308      | 819              | 1,435      |
| Interest expense, net                 | (26,299)           | (24,882)   | (52,915)         | (49,090)   |
| Earnings before members' income taxes | \$ 68,258          | \$ 48,953  | \$ 134,130       | \$ 110,047 |

MGE receives transmission and other related services from ATC. During the three and six months ended June 30, 2017, MGE recorded \$7.3 million and \$14.6 million, respectively, for transmission services received compared to \$7.4 million and \$14.7 million for the comparable periods in 2016. MGE also provides a variety of operational, maintenance, and project management services for ATC, which is reimbursed by ATC. As of June 30, 2017, and December 31, 2016, MGE had a receivable due from ATC of \$0.1 million.

## 4.

**Taxes - MGE Energy and MGE.**

MGE Energy's effective income tax rates for the three and six months ended June 30, 2017, were 36.0% and 36.4%, respectively, compared to 36.5% and 36.7% for the same periods in 2016. MGE's effective income tax rates for the three and six months ended June 30, 2017, were 35.5% and 35.9%, respectively, compared to 36.5% and 36.7% for the same periods in 2016. For both MGE Energy and MGE, the decrease in the effective tax rate is due in part to a higher estimated domestic manufacturing deduction in 2017. In addition, MGE's effective income tax rate decreased as a result of the transfer in December 2016 of its ownership interest in MGE Transco to MGE Energy.

## 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.

The following table presents the components of net periodic benefit costs recognized for the three and six months ended June 30, 2017 and 2016. A portion of the net periodic benefit cost is capitalized within the consolidated balance sheets.

| <i>(In thousands)</i>                    | Three Months Ended<br>June 30, |          | Six Months Ended<br>June 30, |          |
|--|--------------------------------|----------|------------------------------|----------|
|  | 2017                           | 2016     | 2017                         | 2016     |
| <b>Pension Benefits</b>                  |                                |          |                              |          |
| Components of net periodic benefit cost: |                                |          |                              |          |
| Service cost                             | \$ 1,360                       | \$ 1,564 | \$ 2,692                     | \$ 2,945 |
| Interest cost                            | 3,194                          | 3,494    | 6,313                        | 6,583    |
| Expected return on assets                | (5,740)                        | (6,329)  | (11,482)                     | (11,922) |
| Amortization of:                         |                                |          |                              |          |
| Prior service (credit) cost              | (4)                            | 3        | (8)                          | 5        |
| Actuarial loss                           | 1,711                          | 1,534    | 3,175                        | 2,890    |
| Net periodic benefit cost                | \$ 521                         | \$ 266   | \$ 690                       | \$ 501   |
| <b>Postretirement Benefits</b>           |                                |          |                              |          |
| Components of net periodic benefit cost: |                                |          |                              |          |
| Service cost                             | \$ 423                         | \$ 399   | \$ 629                       | \$ 723   |
| Interest cost                            | 912                            | 831      | 1,356                        | 1,505    |
| Expected return on assets                | (971)                          | (868)    | (1,443)                      | (1,573)  |



|                             |          |          |          |          |
|-----------------------------|----------|----------|----------|----------|
| Amortization of:            |          |          |          |          |
| Transition obligation       | 1        | 1        | 1        | 2        |
| Prior service credit        | (898)    | (822)    | (1,334)  | (1,489)  |
| Actuarial loss              | 251      | 196      | 380      | 355      |
| Net periodic benefit credit | \$ (282) | \$ (263) | \$ (411) | \$ (477) |

## 6.

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

Under MGE Energy's Director Incentive Plan and its Performance Unit Plan, non-employee directors and eligible employees 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 2017, 4,032 units were granted under the Director Incentive Plan and are subject to a three-year graded vesting schedule. In March 2017, 14,704 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 director or 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, 2017, 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 three and six months ended June 30, 2017, MGE recorded \$0.2 million and \$0.7 million, respectively, in compensation expense as a result of awards under the plans compared to \$0.5 million and \$1.8 million for the comparable periods in 2016. In January 2017, cash payments of \$2.0 million were distributed according to the terms of the awards granted earlier under the plans that had reached their payment dates. No forfeitures of units occurred during the three and six months ended June 30, 2017 and 2016. At June 30, 2017, \$5.4 million of outstanding awards are vested, and of this amount, no cash settlements have occurred.

7.

**Commitments and Contingencies.**

a.

**Environmental - MGE Energy and MGE.**

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 they conduct their operations, the costs of those operations, as well as capital and operating expenditures. Several of these environmental rules are subject to legal challenges, reconsideration and/or other uncertainties. 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. Management believes compliance costs will be recovered in future rates based on previous treatment of environmental compliance projects. These initiatives, proposed rules, and court challenges include:

•

The EPA's published water effluent limitations guidelines and standards for steam electric power plants, which focus on the reduction of metals and other pollutants in wastewater from new and existing power plants, such as the coal-burning plants at Columbia and the Elm Road Units.

•

The EPA's cooling water intake rules, which require cooling water intake structures at electric power plants, such as our WCCF, Blount, and Columbia 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.

•

Greenhouse Gas (GHG) reduction guidelines and approval criteria established under the Clean Air Act for states to use in developing plans to control GHG emissions from existing fossil fuel-fired electric generating units (EGUs) and systems. 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. In May 2017, the EPA requested the U.S. Court of Appeals for the D.C. Circuit to put on hold, indefinitely, any ongoing challenges to the rules while the EPA reviews the rule and undertakes any potential rulemaking. Given the pending legal proceedings, and the EPA's recent request, 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.

•

Federal and state air quality regulations impose restrictions on various emissions including emissions of sulfur dioxide (SO<sub>2</sub>), nitrogen dioxides (NO<sub>2</sub>), and other pollutants, and may require permits for operation of emission sources.

•

The EPA's rule to regulate ambient levels of a pollutant through the Ozone National Ambient Air Quality Standards (NAAQS). 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. Oral arguments in this case were delayed following a request by the EPA. In June 2017, the EPA gave notice that it will delay decisions on area designations until October 2018, an action that is being challenged in the U.S. Court of Appeals for the D.C. Circuit by several environmental groups. MGE will continue to monitor the EPA's progress on attainment designations and related litigation to assess potential impacts at our facilities, particularly our Elm Road Units.

- Rules regulating nitrogen oxide (NO<sub>x</sub>) and SO<sub>2</sub> emissions including the Cross State Air Pollution Rule (CSAPR) and Clean Air Visibility Rule (CAVR). At this time, regulatory obligations, compliance strategies, and costs remain uncertain due to uncertainties surrounding the pending implementation of Phase II of CSAPR and the continued legal challenges surrounding CSAPR and CAVR.

- The EPA's Coal Combustion Residuals Rule, which regulates coal ash 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. Review of our Elm Road Units 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.

The matters in the bullet points above are discussed further in Footnote 17.c. in the Financial Statements of MGE Energy's and MGE's 2016 Annual Report on Form 10-K.

**b.**

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

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.**

MGE has entered into various commodity supply, transportation, and storage contracts to meet its obligation to deliver electricity and natural gas to customers. Management expects to recover these costs in future customer rates. As of June 30, 2017, the future commitments related to these purchase contracts were as follows:

| <i>(In thousands)</i>             | <b>2017</b> | <b>2018</b> | <b>2019</b> | <b>2020</b> | <b>2021</b> | <b>Thereafter</b> |
|-----------------------------------|-------------|-------------|-------------|-------------|-------------|-------------------|
| Coal <sup>(a)</sup>               | \$ 13,656   | \$ 18,333   | \$ 10,851   | \$ -        | \$ -        | \$ -              |
| Natural gas supply <sup>(b)</sup> | 10,393      | 11,984      | -           | -           | -           | -                 |
|                                   | \$ 24,049   | \$ 30,317   | \$ 10,851   | \$ -        | \$ -        | \$ -              |

(a)

Total coal commitments for the Columbia and Elm Road Units, including transportation. Fuel procurement for MGE's jointly owned Columbia and Elm Road Units is handled by WPL and WEPCO, respectively, who are the operators of those facilities.

(b)

These commitments include market-based pricing.

**d.**

#### **Other Commitments - MGE Energy.**

In May 2017, MGE Energy entered a subscription agreement to invest in a nonpublic venture capital fund. From time to time, this entity will require capital infusions from its investors. MGE Energy has committed to contribute \$5 million in capital for such infusions. The timing of these infusions is dependent on the needs of the investee and is therefore uncertain at this time.

**8.**

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

**a.**

#### **Rate Proceedings.**

In December 2016, the PSCW authorized MGE, effective January 1, 2017, to decrease 2017 rates for retail electric customers by 0.8% or \$3.3 million and to increase rates for retail gas customers by 1.9% or \$3.1 million. The decrease

in retail electric rates is attributable to declining fuel and purchased power costs. The increase in retail gas rates covers costs associated with MGE's natural gas system infrastructure improvements. The authorized return on common stock equity for 2017 is 9.8% based on a capital structure consisting of 57.2% common equity. The PSCW also approved MGE's request to extend the current accounting treatment for transmission related costs through 2018. 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.

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.

**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 in the following year and is then reflected 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 continued throughout 2016. MGE returned \$2.6 million of electric fuel-related savings to customers through bill credits during the period from September 1, 2015, through December 31, 2015. MGE returned \$8.3 million of electric fuel-related savings during the year ended December 31, 2016.

In July 2016, the PSCW issued a final order in the fuel rules proceedings requiring MGE to refund additional fuel savings realized during 2015 and 2016 to its retail electric customers over a one-month period. In September 2016, MGE returned \$15.5 million to customers through bill credits.

In July 2017, the PSCW issued a final order in the fuel rules proceedings requiring MGE to refund \$6.0 million of additional fuel savings realized during 2015 and 2016 to its retail electric customers over a one-month period in October 2017.

As of June 30, 2017, MGE has deferred \$1.8 million of 2017 fuel savings. The 2017 fuel savings will be subject to the PSCW's annual review of 2017 fuel costs, expected to be completed in 2018.

9.

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

a.

**Purpose.**

As part of its regular operations, MGE enters into contracts, including options, swaps, futures, forwards, and other contractual commitments, to manage its exposure to commodity prices. 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, the derivatives are recognized in the consolidated balance sheets at fair value. MGE's financial 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 depending on whether the derivative is in a net loss or net gain position, respectively. 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:

|                                | June 30, 2017 | December 31, 2016 |
|--------------------------------|---------------|-------------------|
| Commodity derivative contracts | 461,165 MWh   | 393,395 MWh       |
| Commodity derivative contracts | 4,781,500 Dth | 4,195,000 Dth     |
| FTRs                           | 5,091 MW      | 2,251 MW          |
| PPA                            | 2,950 MW      | 3,250 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, 2017, and December 31, 2016, the fair value of exchange traded derivatives and FTRs exceeded their cost basis by \$1.3 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, 2017, and December 31, 2016, reflects a loss position of \$46.6 million and \$50.6 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, instruments are netted with the same counterparty under a master netting agreement as well as the netting of collateral. As of June 30, 2017, and December 31, 2016, the receivable margin account balance of \$1.6 million and \$1.3 million, respectively, is shown net of any collateral posted against derivative positions.

| <i>(In thousands)</i>                         | Derivative<br>Assets | Derivative<br>Liabilities | Balance Sheet Location              |
|---|----------------------|---------------------------|-------------------------------------|
| <b>June 30, 2017</b>                          |                      |                           |                                     |
| Commodity derivative contracts <sup>(a)</sup> | \$ 807               | \$ 459                    | Other current assets <sup>(b)</sup> |
| Commodity derivative contracts <sup>(a)</sup> | 10                   | 105                       | Other deferred charges              |
| FTRs  | 1,001                | -                         | Other current assets                |
| PPA   | N/A                  | 8,950                     | Derivative liability (current)      |
|   |                      |                           | Derivative liability                |
| PPA   | N/A                  | 37,620                    | (long-term)                         |

**December 31, 2016**

|   |    |       |    |        |                                |
|---|----|-------|----|--------|--------------------------------|
| Commodity derivative contracts <sup>(a)</sup> | \$ | 1,227 | \$ | 164    | Other current assets           |
| Commodity derivative contracts <sup>(a)</sup> |    | 157   |    | 54     | Other deferred charges         |
| FTRs  |    | 143   |    | -      | Other current assets           |
| PPA   |    | N/A   |    | 7,620  | Derivative liability (current) |
|   |    |       |    |        | Derivative liability           |
| PPA   |    | N/A   |    | 42,970 | (long-term)                    |

(a)

As of June 30, 2017, and December 31, 2016, no collateral was posted against and netted with derivative liability positions on the consolidated balance sheets.

(b)

As of June 30, 2017, \$0.1 million was presented as current derivative liabilities on the consolidated balance sheets.

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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<br>Amounts | Gross<br>Amounts<br>Offset in<br>Balance<br>Sheets | Collateral<br>Posted<br>Against<br>Derivative<br>Positions | Net Amount<br>Presented in<br>Balance<br>Sheets |
|--------------------------------|------------------|--|--|---|
| <b>June 30, 2017</b>           |                  |  |  |   |
| Commodity derivative contracts | \$ 817           | \$ (514)   | \$ -   | \$ 303  |
| FTRs                           | 1,001            | -  | -  | 1,001   |
| <b>December 31, 2016</b>       |                  |  |  |   |
| Commodity derivative contracts | \$ 1,384         | \$ (218)   | \$ -   | \$ 1,166  |
| FTRs                           | 143              | -  | -  | 143   |

**Offsetting of Derivative Liabilities**

| <i>(In thousands)</i>          | Gross<br>Amounts | Gross<br>Amounts<br>Offset in<br>Balance<br>Sheets | Collateral<br>Posted<br>Against<br>Derivative<br>Positions | Net Amount<br>Presented in<br>Balance<br>Sheets |
|--------------------------------|------------------|--|--|---|
| <b>June 30, 2017</b>           |                  |  |  |   |
| Commodity derivative contracts | \$ 564           | \$ (514)   | \$ -   | \$ 50   |
| PPA                            | 46,570           | -  | -  | 46,570  |
| <b>December 31, 2016</b>       |                  |  |  |   |
| Commodity derivative contracts | \$ 218           | \$ (218)   | \$ -   | \$ -  |
| PPA                            | 50,590           | -  | -  | 50,590  |

The following tables summarize the unrealized and realized gains (losses) related to the derivative instruments on the consolidated balance sheets at June 30, 2017 and 2016, and the consolidated income statements for the three and six months ended June 30, 2017 and 2016.

| <i>(In thousands)</i> | 2017  |                            | 2016  |                            |
|-----------------------|---|----------------------------|---|----------------------------|
|                       | Current and<br>Long-Term<br>Regulatory<br>Asset | Other<br>Current<br>Assets | Current and<br>Long-Term<br>Regulatory<br>Asset | Other<br>Current<br>Assets |

**Three Months Ended June 30:**

|   |    |         |    |      |    |         |    |      |
|---|----|---------|----|------|----|---------|----|------|
| Balance at April 1,                                     | \$ | 48,073  | \$ | 142  | \$ | 56,884  | \$ | 655  |
| Unrealized gain   |    | (1,731) |    | -    |    | (4,580) |    | -    |
| Realized (loss) gain reclassified to a deferred account |    | (544)   |    | 544  |    | 17      |    | (17) |
| Realized (loss) gain reclassified to income statement   |    | (482)   |    | (68) |    | (1,800) |    | 21   |
| Balance at June 30,                                     | \$ | 45,316  | \$ | 618  | \$ | 50,521  | \$ | 659  |

**Six Months Ended June 30:**

|   |    |         |    |       |    |         |    |         |
|---|----|---------|----|-------|----|---------|----|---------|
| Balance at January 1,                                   | \$ | 49,281  | \$ | 230   | \$ | 54,082  | \$ | 1,208   |
| Unrealized (gain) loss                                  |    | (2,420) |    | -     |    | 1,791   |    | -       |
| Realized (loss) gain reclassified to a deferred account |    | (622)   |    | 622   |    | (1,434) |    | 1,434   |
| Realized loss reclassified to income statement          |    | (923)   |    | (234) |    | (3,918) |    | (1,983) |
| Balance at June 30,                                     | \$ | 45,316  | \$ | 618   | \$ | 50,521  | \$ | 659     |

## Realized Losses (Gains)

|                                    | 2017   |                  | 2016   |                  |
|------------------------------------|--|------------------|--|------------------|
|                                    | Fuel for Electric Generation/<br>Purchased Power | Cost of Gas Sold | Fuel for Electric Generation/<br>Purchased Power | Cost of Gas Sold |
| <i>(In thousands)</i>              |  |                  |  |                  |
| <b>Three Months Ended June 30:</b> |  |                  |  |                  |
| Commodity derivative contracts     | \$   | 17               | \$   | 63               |
| FTRs                               |  | (439)            |  | -                |
| PPA                                |  | 909              |  | -                |
|                                    |  |                  | \$   | 417              |
|                                    |  |                  |  | 136              |
|                                    |  |                  |  | 1,226            |
|                                    |  |                  | \$   | 1,814            |
| <b>Six Months Ended June 30:</b>   |  |                  |  |                  |
| Commodity derivative contracts     | \$   | 402              | \$   | 209              |
| FTRs                               |  | (1,124)          |  | -                |
| PPA                                |  | 1,670            |  | -                |
|                                    |  |                  | \$   | 1,424            |
|                                    |  |                  |  | 68               |
|                                    |  |                  |  | 2,595            |

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, 2017, 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, 2017, certain counterparties were in a net liability position of less than \$0.1 million. As of December 31, 2016, no counterparties were in a net liability position.

Nonperformance of counterparties to the non-exchange traded derivatives could expose MGE to credit loss. However, MGE enters into transactions only with companies that meet or exceed strict credit guidelines, and it monitors these counterparties on an ongoing basis to mitigate nonperformance risk in its portfolio. As of June 30, 2017, no counterparties have defaulted.

## 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, 2017, and December 31, 2016, 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 long-term debt is based on quoted market prices for similar financial instruments at June 30, 2017, and December 31, 2016. Since long-term debt is not traded in an active market, it is classified as Level 2. The estimated fair market values of financial instruments are as follows:

| <i>(In thousands)</i>         | June 30, 2017   |            | December 31, 2016 |            |
|-------------------------------|-----------------|------------|-------------------|------------|
|                               | Carrying Amount | Fair Value | Carrying Amount   | Fair Value |
| <b>MGE Energy</b>             |                 |            |                   |            |
| Assets:                       |                 |            |                   |            |
| Cash and cash equivalents     | \$ 102,916      | \$ 102,916 | \$ 95,959         | \$ 95,959  |
| Liabilities:                  |                 |            |                   |            |
| Long-term debt <sup>(a)</sup> | 399,074         | 450,497    | 391,242           | 430,122    |

**MGE**

## Assets:

|                           |          |          |           |           |
|---------------------------|----------|----------|-----------|-----------|
| Cash and cash equivalents | \$ 5,831 | \$ 5,831 | \$ 10,768 | \$ 10,768 |
|---------------------------|----------|----------|-----------|-----------|

## Liabilities:

|                               |         |         |         |         |
|-------------------------------|---------|---------|---------|---------|
| Long-term debt <sup>(a)</sup> | 399,074 | 450,497 | 391,242 | 430,122 |
|-------------------------------|---------|---------|---------|---------|

(a) Includes long-term debt due within one year. Excludes debt issuance costs and unamortized discount of \$4.0 million and \$4.1 million at June 30, 2017, and December 31, 2016, respectively.

b.

**Recurring Fair Value Measurements.**

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

| <i>(In thousands)</i>       | Total     | Fair Value as of June 30, 2017 |          |           |
|-----------------------------|-----------|--------------------------------|----------|-----------|
|                             |           | Level 1                        | Level 2  | Level 3   |
| <b>MGE Energy</b>           |           |                                |          |           |
| Assets:                     |           |                                |          |           |
| Derivatives                 | \$ 1,818  | \$ 455                         | \$ -     | \$ 1,363  |
| Exchange-traded investments | 715       | 715                            | -        | -         |
| Total Assets                | \$ 2,533  | \$ 1,170                       | \$ -     | \$ 1,363  |
| Liabilities:                |           |                                |          |           |
| Derivatives                 | \$ 47,134 | \$ 166                         | \$ -     | \$ 46,968 |
| Deferred compensation       | 3,103     | -                              | 3,103    | -         |
| Total Liabilities           | \$ 50,237 | \$ 166                         | \$ 3,103 | \$ 46,968 |

**MGE**

## Assets:

|             |          |        |      |          |
|-------------|----------|--------|------|----------|
| Derivatives | \$ 1,818 | \$ 455 | \$ - | \$ 1,363 |
|-------------|----------|--------|------|----------|

|                             |    |    |   |   |
|-----------------------------|----|----|---|---|
| Exchange-traded investments | 90 | 90 | - | - |
|-----------------------------|----|----|---|---|

|              |          |        |      |          |
|--------------|----------|--------|------|----------|
| Total Assets | \$ 1,908 | \$ 545 | \$ - | \$ 1,363 |
|--------------|----------|--------|------|----------|

## Liabilities:

|             |           |        |      |           |
|-------------|-----------|--------|------|-----------|
| Derivatives | \$ 47,134 | \$ 166 | \$ - | \$ 46,968 |
|-------------|-----------|--------|------|-----------|

|                       |       |   |       |   |
|-----------------------|-------|---|-------|---|
| Deferred compensation | 3,103 | - | 3,103 | - |
|-----------------------|-------|---|-------|---|

|                   |           |        |          |           |
|-------------------|-----------|--------|----------|-----------|
| Total Liabilities | \$ 50,237 | \$ 166 | \$ 3,103 | \$ 46,968 |
|-------------------|-----------|--------|----------|-----------|

| <i>(In thousands)</i> | Total | Fair Value as of December 31, 2016 |         |         |
|-----------------------|-------|------------------------------------|---------|---------|
|                       |       | Level 1                            | Level 2 | Level 3 |

**MGE Energy**

## Assets:

|             |          |          |      |        |
|-------------|----------|----------|------|--------|
| Derivatives | \$ 1,527 | \$ 1,041 | \$ - | \$ 486 |
|-------------|----------|----------|------|--------|



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|                             |           |          |          |           |
|-----------------------------|-----------|----------|----------|-----------|
| Exchange-traded investments | 500       | 500      | -        | -         |
| Total Assets                | \$ 2,027  | \$ 1,541 | \$ -     | \$ 486    |
| Liabilities:                |           |          |          |           |
| Derivatives                 | \$ 50,808 | \$ 16    | \$ -     | \$ 50,792 |
| Deferred compensation       | 3,039     | -        | 3,039    | -         |
| Total Liabilities           | \$ 53,847 | \$ 16    | \$ 3,039 | \$ 50,792 |

**MGE**

Assets:

|                             |          |          |      |        |
|-----------------------------|----------|----------|------|--------|
| Derivatives                 | \$ 1,527 | \$ 1,041 | \$ - | \$ 486 |
| Exchange-traded investments | 143      | 143      | -    | -      |
| Total Assets                | \$ 1,670 | \$ 1,184 | \$ - | \$ 486 |

Liabilities:

|                       |           |       |          |           |
|-----------------------|-----------|-------|----------|-----------|
| Derivatives           | \$ 50,808 | \$ 16 | \$ -     | \$ 50,792 |
| Deferred compensation | 3,039     | -     | 3,039    | -         |
| Total Liabilities     | \$ 53,847 | \$ 16 | \$ 3,039 | \$ 50,792 |

No transfers were made in or out of Level 1 or Level 2 for the six months ended June 30, 2017.

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 9) 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. 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, 2017 | December 31, 2016 |
| Basis adjustment:               |               |                   |
| On peak                         | 92.8%         | 91.9%             |
| Off peak                        | 94.7%         | 93.4%             |
| Counterparty fuel mix:          |               |                   |
| Internal generation             | 55% - 75%     | 55% - 75%         |
| Purchased power                 | 45% - 25%     | 45% - 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. 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.

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The following table summarizes the changes in Level 3 commodity derivative assets and liabilities measured at fair value on a recurring basis.

| <i>(In thousands)</i>   | Three Months Ended<br>June 30, |             | Six Months Ended<br>June 30, |             |
|---|--------------------------------|-------------|------------------------------|-------------|
|   | 2017                           | 2016        | 2017                         | 2016        |
| Beginning balance   | \$ (48,354)                    | \$ (57,101) | \$ (50,305)                  | \$ (53,501) |
| Realized and unrealized gains (losses):   |                                |             |                              |             |
| Included in regulatory liabilities  | 2,748                          | 5,218       | 4,701                        | 1,618       |
| Included in other comprehensive income  | -                              | -           | -                            | -           |
| Included in earnings  | (550)                          | (1,809)     | (1,136)                      | (3,972)     |
| Included in current assets  | (222)                          | -           | (97)                         | -           |
| Purchases   | 6,186                          | 5,636       | 12,182                       | 10,937      |
| Sales   | -                              | -           | -                            | -           |
| Issuances   | -                              | -           | -                            | -           |
| Settlements   | (5,413)                        | (3,827)     | (10,950)                     | (6,965)     |
| Transfers in and/or out of Level 3  | -                              | -           | -                            | -           |
| Balance as of June 30,  | \$ (45,605)                    | \$ (51,883) | \$ (45,605)                  | \$ (51,883) |
| Total gains (losses) included in earnings attributed to the change in unrealized gains (losses) related to assets and liabilities held at June 30, <sup>(b)</sup> | \$ -                           | \$ -        | \$ -                         | \$ -        |

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 *(b)*.

| <i>(In thousands)</i>    | Three Months Ended<br>June 30, |            | Six Months Ended<br>June 30, |            |
|--------------------------|--------------------------------|------------|------------------------------|------------|
|                          | 2017                           | 2016       | 2017                         | 2016       |
| Purchased Power Expense  | \$ (487)                       | \$ (1,809) | \$ (918)                     | \$ (3,972) |
| Cost of Gas Sold Expense | (63)                           | -          | (218)                        | -          |
| Total                    | \$ (550)                       | \$ (1,809) | \$ (1,136)                   | \$ (3,972) |

(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.

**Joint Plant Ownership - MGE Energy and MGE.**

**Columbia.**

In 2016, MGE and WPL negotiated an amendment to the existing Columbia joint operating agreement, that has been approved by the PSCW, under which MGE will have the option to reduce its obligation to pay certain capital expenditures (other than SCR-related expenditures) at Columbia in exchange for a proportional reduction in MGE's ownership in Columbia. On January 1 of each year, beginning in 2017 and ending June 1, 2020, the ownership percentage will be adjusted, through a partial sale, based on the amount of capital expenditures foregone. In June 2017, the FERC approved the ownership transfer in Columbia, effective January 1, 2017.

During 2016, MGE accrued \$14.8 million of 2016 capital expenditures that MGE has forgone as part of the ownership transfer agreement with WPL. As of December 31, 2016, MGE classified \$14.8 million of Columbia assets as held-for-sale on the consolidated balance sheets. In January 2017, MGE reduced its ownership interest in Columbia from 22.0% to 20.4% through the partial sale of plant assets to WPL.

During three and six months ended June 30, 2017, MGE accrued \$2.8 million and \$5.1 million, respectively, of 2017 capital expenditures that MGE has forgone subject to the ownership transfer agreement. As of June 30, 2017, MGE classified \$5.1 million of Columbia assets as held-for-sale on the consolidated balance sheets. The assets recognized as held-for-sale are subject to a partial sale of plant assets to WPL, expected to occur in January 2018.

12.

**Adoption of Accounting Principles and Recently Issued 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. The new standard establishes a five step model for recognizing and measuring revenue from contracts with customers and replaces existing guidance on revenue recognition. The objective of the new standard is to provide a single, comprehensive revenue recognition model for all contracts with customers to improve comparability within industries, across industries and across capital markets. The underlying principle is that an entity will recognize revenue to depict the transfer of goods or services to customers at an amount that the entity expects to be entitled to in exchange for those goods or services.

MGE Energy and MGE have been assessing the impact of this guidance on revenue streams within the scope of the new standard. All retail electric and gas revenues are tariff rates approved by the PSCW. Based on our evaluation of the new standard, retail revenues will be recognized within the period in which utility service is provided to the customer and the performance obligation is fulfilled, consistent with our current revenue recognition model. Electric revenues for sales to the market represent wholesale sales made to third parties who are not ultimate users of the electricity. These sales may also include bilateral sales to other utilities or power marketers. Revenues for sales to the market will be recognized when the sale is completed within the market operated by MISO, similar to the recognition under our current revenue recognition model. In addition, revenues from the transportation of gas will continue to be recognized upon the performance of services for the respective customer. Based on our assessment of the new standard, revenue recognition for retail revenues, sales to the market, and transportation of gas will be materially consistent with our current revenue recognition model. However, additional disclosures regarding the nature, amount, timing, and uncertainty of these revenue streams and related cash flows arising from contracts with customers will be required as a result of the new standard. Management continues to analyze newly-released interpretative guidance and assess the related impacts to the current revenue recognition model.

This authoritative guidance will become effective January 1, 2018, and MGE Energy and MGE anticipate adopting the standard upon the effective date. Adoption of this standard is permitted under one of two methods: the full retrospective method or the modified retrospective method. MGE Energy and MGE are continuing to assess the permitted implementation methods and the impact on our financial statements.

**b.**

**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. As a result of this guidance, MGE Energy and MGE will no longer have any other comprehensive income related to equity investments. This standard will be applied using a modified retrospective approach, with a cumulative effect adjustment recorded to opening retained earnings as of the beginning of all prior periods presented.

**c.**

**Leases.**

In February 2016, the FASB issued authoritative guidance within the Codification's Leases topic that provides guidance on the classification, recognition, measurement, and disclosure of leases. The new leasing standard establishes that a lease conveys the right to control the use of identified property, plant, or equipment for a period of time in exchange for consideration. Under the new guidance, lessees will be required to recognize all leases with terms greater than one year, including operating leases, on the consolidated balance sheet by recording a right-of-use asset and lease liability. Prior to the authoritative guidance, only capital leases were recognized on the balance sheet by lessees. The new accounting guidance as applied by lessors is materially consistent from that applied under current GAAP.

Management has begun utilizing a bottoms-up approach to analyze the impact of the standard on our lease portfolio. MGE Energy and MGE have been reviewing current accounting policies and procedures to identify potential differences in accounting treatment that would result from applying the requirements of the new standard to our existing lease portfolio. In addition, we are identifying appropriate changes to our business processes, systems, and controls to support recognition and disclosure requirements under the new standard. This authoritative guidance will become effective January 1, 2019, with early adoption permitted. MGE Energy and MGE anticipate adopting the standard upon the effective date. The new leasing standard requires entities to recognize and measure leases at the beginning of the earliest comparative period presented using a modified retrospective approach. MGE Energy and MGE are currently assessing the impact this pronouncement will have on our financial statements.

**d.**

**Restricted Cash.**

In November 2016, the FASB issued authoritative guidance within the Codification's Statement of Cash Flows topic that provides guidance on the classification and presentation of changes in restricted cash within the statement of cash flows. The new standard was issued to eliminate a current diversity in practice for the accounting treatment of restricted cash. Under the new guidance, reporting entities will be required to explain the changes in the total of restricted and unrestricted cash and cash equivalents when reconciling the beginning and ending balances on the statement of cash flows. Prior to the authoritative guidance, changes in restricted cash were presented as either cash flows from operating, investing, or financing activities within the statement of cash flows, as appropriate based on the nature of the restriction. Also under the new standard, reporting entities will be required to provide a reconciliation from the balance sheet to the statement of cash flows and disclose the nature of the restrictions of cash. This authoritative guidance will become effective January 1, 2018. Upon the effective date, MGE Energy and MGE will change the presentation of restricted cash to reflect this change in accounting guidance. MGE Energy and MGE will also retrospectively apply the guidance to all prior periods presented. As of June 30, 2017, and December 31, 2016, MGE Energy and MGE had \$5.1 million of restricted cash classified within other current assets on the consolidated balance sheets.

**e.**

**Pension and Other Postretirement Benefits.**

In March 2017, the FASB issued authoritative guidance within the Compensation – Retirement Benefits topic that provides guidance on the presentation of net periodic pension cost and net periodic postretirement benefit cost. Under the new guidance, the service cost component of net benefit cost is required to be recorded in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net benefit cost are required to be presented in the income statement separately from the service cost component and outside of income from operations. The standard also only allows the service cost component to be eligible for capitalization when applicable. 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.



13.

**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 2016 Annual Report on Form 10-K for additional discussion of each of these segments.

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

(In thousands)

| <b>MGE Energy</b>                       | Electric   | Gas       | Nonregulated<br>Energy | Transmission<br>Investment | All<br>Others | Consolidation/<br>Elimination/<br>Entries | Consolidated<br>Total |
|---|------------|-----------|------------------------|----------------------------|---------------|---|-----------------------|
| <b>Three Months Ended June 30, 2017</b> |            |           |                        |                            |               |   |                       |
| Operating revenues                      | \$ 102,306 | \$ 24,081 | \$ 76                  | \$ -                       | \$ -          | \$ -                                      | 126,463               |
| Interdepartmental revenues              | (119)      | 3,422     | 11,107                 | -                          | -             | (14,410)                                  | -                     |
| Total operating revenues                | 102,187    | 27,503    | 11,183                 | -                          | -             | (14,410)                                  | 126,463               |
| Depreciation and amortization           | (9,185)    | (2,232)   | (1,858)                | -                          | -             | -   | (13,275)              |
| Other operating expenses                | (77,615)   | (23,153)  | (62)                   | -                          | (217)         | 14,410                                    | (86,637)              |
| Operating income (loss)                 | 15,387     | 2,118     | 9,263                  | -                          | (217)         | -   | 26,551                |
| Other income (deductions), net          | 191        | (8)       | -                      | 2,506                      | (75)          | -   | 2,614                 |
| Interest (expense) income, net          | (2,801)    | (805)     | (1,392)                | -                          | 112           | -   | (4,886)               |
| Income (loss) before taxes              | 12,777     | 1,305     | 7,871                  | 2,506                      | (180)         | -   | 24,279                |
| Income tax (provision) benefit          | (4,124)    | (521)     | (3,158)                | (1,006)                    | 73            | -   | (8,736)               |
| Net income (loss)                       | \$ 8,653   | \$ 784    | \$ 4,713               | \$ 1,500                   | \$ (107)      | \$ -                                      | 15,543                |
| <b>Three Months Ended June 30, 2016</b> |            |           |                        |                            |               |   |                       |
| Operating revenues                      | \$ 100,329 | \$ 20,961 | \$ 286                 | \$ -                       | \$ -          | \$ -                                      | 121,576               |
| Interdepartmental revenues              | 567        | 6,141     | 10,919                 | -                          | -             | (17,627)                                  | -                     |
| Total operating revenues                | 100,896    | 27,102    | 11,205                 | -                          | -             | (17,627)                                  | 121,576               |
| 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                              | \$ 8,530   | \$ 1,780  | \$ 4,725               | \$ 1,055                   | \$ 60         | \$ -                                      | 16,150                |

**Six Months Ended June 30, 2017**

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|                                |            |           |          |          |          |          |           |
|--------------------------------|------------|-----------|----------|----------|----------|----------|-----------|
| Operating revenues             | \$ 200,630 | \$ 82,507 | \$ 149   | -\$      | -\$      | -\$      | 283,286   |
| Interdepartmental revenues     | (224)      | 7,816     | 22,177   | -        | -        | (29,769) | -         |
| Total operating revenues       | 200,406    | 90,323    | 22,326   | -        | -        | (29,769) | 283,286   |
| Depreciation and amortization  | (18,085)   | (4,445)   | (3,704)  | -        | -        | -        | (26,234)  |
| Other operating expenses       | (152,941)  | (73,730)  | (103)    | -        | (586)    | 29,769   | (197,591) |
| Operating income (loss)        | 29,380     | 12,148    | 18,519   | -        | (586)    | -        | 59,461    |
| Other income (deductions), net | 381        | (3)       | -        | 4,984    | (297)    | -        | 5,065     |
| Interest (expense) income, net | (5,577)    | (1,604)   | (2,799)  | -        | 200      | -        | (9,780)   |
| Income (loss) before taxes     | 24,184     | 10,541    | 15,720   | 4,984    | (683)    | -        | 54,746    |
| Income tax (provision) benefit | (7,578)    | (4,225)   | (6,309)  | (2,003)  | 212      | -        | (19,903)  |
| Net income (loss)              | \$ 16,606  | \$ 6,316  | \$ 9,411 | \$ 2,981 | \$ (471) | -\$      | 34,843    |

**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       | 194,560    | 86,036    | 22,664   | -        | -        | (34,157) | 269,103   |
| 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)              | \$ 14,522  | \$ 6,817  | \$ 9,558 | \$ 2,390 | \$ (109) | -\$      | 33,178    |



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

| <i>(In thousands)</i>  |            |           |                        |   |  |                       |  |  |
|--|------------|-----------|------------------------|---|--|-----------------------|--|--|
| <b>MGE</b>   | Electric   | Gas       | Nonregulated<br>Energy | Transmission<br>Investment <sup>(b)</sup> | Consolidation/<br>Elimination<br>Entries | Consolidated<br>Total |  |  |
| <b>Three Months Ended</b>  |            |           |                        |   |  |                       |  |  |
| <b>June 30, 2017</b>   |            |           |                        |   |  |                       |  |  |
| Operating revenues   | \$ 102,306 | \$ 24,080 | \$ 76                  | \$ -                                      | \$ -                                     | \$ 126,462            |  |  |
| Interdepartmental revenues   | (119)      | 3,423     | 11,107                 | -   | (14,411)                                 | -                     |  |  |
| Total operating revenues   | 102,187    | 27,503    | 11,183                 | -   | (14,411)                                 | 126,462               |  |  |
| Depreciation and amortization  | (9,185)    | (2,232)   | (1,858)                | -   | -  | (13,275)              |  |  |
| Other operating expenses <sup>(a)</sup>                              | (81,702)   | (23,664)  | (3,220)                | -   | 14,411                                   | (94,175)              |  |  |
| Operating income <sup>(a)</sup>                                      | 11,300     | 1,607     | 6,105                  | -   | -  | 19,012                |  |  |
| Other income (deductions), net <sup>(a)</sup>                        | 154        | (18)      | -                      | -   | -  | 136                   |  |  |
| Interest expense, net  | (2,801)    | (805)     | (1,392)                | -   | -  | (4,998)               |  |  |
| Net income   | 8,653      | 784       | 4,713                  | -   | -  | 14,150                |  |  |
| Less: Net income attributable to noncontrolling interest, net of tax | -          | -         | -                      | -   | (5,396)                                  | (5,396)               |  |  |
| Net income attributable to MGE                                       | \$ 8,653   | \$ 784    | \$ 4,713               | \$ -                                      | \$ (5,396)                               | \$ 8,754              |  |  |
| <b>Three Months Ended</b>  |            |           |                        |   |  |                       |  |  |
| <b>June 30, 2016</b>   |            |           |                        |   |  |                       |  |  |
| Operating revenues   | \$ 100,336 | \$ 20,967 | \$ 286                 | \$ -                                      | \$ -                                     | \$ 121,589            |  |  |
| Interdepartmental revenues   | 560        | 6,135     | 10,919                 | -   | (17,614)                                 | -                     |  |  |
| Total operating revenues   | 100,896    | 27,102    | 11,205                 | -   | (17,614)                                 | 121,589               |  |  |
| Depreciation and amortization  | (7,259)    | (2,015)   | (1,828)                | -   | -  | (11,102)              |  |  |
| Other operating expenses <sup>(a)</sup>                              | (82,405)   | (22,476)  | (3,203)                | (3)                                       | 17,614                                   | (90,473)              |  |  |
| Operating income (loss) <sup>(a)</sup>                               | 11,232     | 2,611     | 6,174                  | (3)                                       | -  | 20,014                |  |  |
| Other income (deductions), net <sup>(a)</sup>                        | 74         | (32)      | -                      | 1,058                                     | -  | 1,100                 |  |  |
| Interest expense, net  | (2,776)    | (799)     | (1,449)                | -   | -  | (5,024)               |  |  |
| 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)               |  |  |

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|                                |    |       |    |       |    |       |    |       |    |         |    |        |
|--------------------------------|----|-------|----|-------|----|-------|----|-------|----|---------|----|--------|
| Net income attributable to MGE | \$ | 8,530 | \$ | 1,780 | \$ | 4,725 | \$ | 1,055 | \$ | (5,952) | \$ | 10,138 |
|--------------------------------|----|-------|----|-------|----|-------|----|-------|----|---------|----|--------|

**Six Months Ended  
June 30, 2017**

|  |    |           |    |          |    |         |    |   |    |          |    |           |
|--|----|-----------|----|----------|----|---------|----|---|----|----------|----|-----------|
| Operating revenues   | \$ | 200,634   | \$ | 82,515   | \$ | 149     | \$ | - | \$ | -        | \$ | 283,298   |
| Interdepartmental revenues   |    | (228)     |    | 7,808    |    | 22,177  |    | - |    | (29,757) |    | -         |
| Total operating revenues   |    | 200,406   |    | 90,323   |    | 22,326  |    | - |    | (29,757) |    | 283,298   |
| Depreciation and amortization  |    | (18,085)  |    | (4,445)  |    | (3,704) |    | - |    | -        |    | (26,234)  |
| Other operating expenses <sup>(a)</sup>                              |    | (160,448) |    | (77,935) |    | (6,412) |    | - |    | 29,757   |    | (215,038) |
| Operating income <sup>(a)</sup>                                      |    | 21,873    |    | 7,943    |    | 12,210  |    | - |    | -        |    | 42,026    |
| Other income (deductions), net <sup>(a)</sup>                        |    | 310       |    | (23)     |    | -       |    | - |    | -        |    | 287       |
| Interest expense, net  |    | (5,577)   |    | (1,604)  |    | (2,799) |    | - |    | -        |    | (9,980)   |
| Net income   |    | 16,606    |    | 6,316    |    | 9,411   |    | - |    | -        |    | 32,333    |
| Less: Net income attributable to noncontrolling interest, net of tax |    | -         |    | -        |    | -       |    | - |    | (10,785) |    | (10,785)  |
| Net income attributable to MGE                                       | \$ | 16,606    | \$ | 6,316    | \$ | 9,411   | \$ | - | \$ | (10,785) | \$ | 21,548    |

**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   |    | 194,560   |    | 86,036   |    | 22,664  |    | -     |    | (34,128) |    | 269,132   |
| Depreciation and amortization  |    | (14,422)  |    | (3,996)  |    | (3,704) |    | -     |    | -        |    | (22,122)  |
| Other operating expenses <sup>(a)</sup>                              |    | (160,284) |    | (73,567) |    | (6,490) |    | (4)   |    | 34,128   |    | (206,217) |
| Operating income (loss) <sup>(a)</sup>                               |    | 19,854    |    | 8,473    |    | 12,470  |    | (4)   |    | -        |    | 40,793    |
| Other income (deductions), net <sup>(a)</sup>                        |    | 234       |    | (49)     |    | -       |    | 2,394 |    | -        |    | 2,579     |
| Interest expense, net  |    | (5,566)   |    | (1,607)  |    | (2,912) |    | -     |    | -        |    | (10,085)  |
| 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                                       | \$ | 14,522    | \$ | 6,817    | \$ | 9,558   | \$ | 2,390 | \$ | (12,204) | \$ | 21,083    |

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

*(b) As of July 31, 2016, MGE no longer consolidates MGE Energy's proportionate share of equity earnings in MGE Transco. See Footnote 3 for further discussion.*

**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 ATC Holdco, 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 149,000 customers in Dane County, Wisconsin, including the city of Madison, and purchases and distributes natural gas to approximately 154,000 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 MGE Energy's 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 continues to examine and pursue opportunities to reduce the proportion that coal generation represents in its generation mix, including the announced reduction in its ownership of Columbia. 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:

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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 2016 Annual Report on Form 10-K.

For the three months ended June 30, 2017, MGE Energy's earnings were \$15.5 million or \$0.45 per share compared to \$16.2 million or \$0.47 per share for the same period in the prior year. MGE's earnings for the three months ended June 30, 2017, were \$8.8 million compared to \$10.1 million for the same period in the prior year.

For the six months ended June 30, 2017, MGE Energy's earnings were \$34.8 million or \$1.01 per share compared to \$33.2 million or \$0.96 per share for the same period in the prior year. MGE's earnings for the six months ended June 30, 2017, were \$21.5 million compared to \$21.1 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:        | 2017               | 2016      | 2017             | 2016      |
| Electric Utility         | \$ 8,653           | \$ 8,530  | \$ 16,606        | \$ 14,522 |
| Gas Utility              | 784                | 1,780     | 6,316            | 6,817     |
| Nonregulated Energy      | 4,713              | 4,725     | 9,411            | 9,558     |
| Transmission Investments | 1,500              | 1,055     | 2,981            | 2,390     |
| All Other                | (107)              | 60        | (471)            | (109)     |
| Net Income               | \$ 15,543          | \$ 16,150 | \$ 34,843        | \$ 33,178 |

Our net income during the three and six months ended June 30, 2017, compared to the same period in the prior year primarily reflects the effects of the following factors:

#### *Electric Utility*

For the three months ended, electric net income was relatively flat. For the six months ended, electric net income increased primarily related to efforts to manage the level of operating and maintenance costs.

#### *Gas Utility*

Gas net income decreased during the three months ended June 30, 2017, primarily due to the timing of 2017 operating and maintenance costs occurring mainly in the second quarter and unfavorable weather conditions. For the six months ended, gas net income decreased primarily resulting from unfavorable weather conditions. Average temperature for April was 50 degrees in 2017 compared to 46 degrees in 2016.

#### *Transmission Investments*

Transmission investment income reflects our share of ATC's earnings and a favorable comparison to 2016, which included a charge representing ATC's estimate of its refund liability associated with the return on equity complaint filed with FERC. See "Other Matters" below for additional information concerning ATC.

During the first six months of 2017, the following events occurred:

**2017 Rate Case Order:** On December 15, 2016, the PSCW authorized MGE, effective January 1, 2017, to decrease 2017 rates for retail electric customers by 0.8% or \$3.3 million and to increase rates for retail gas customers by 1.9% or \$3.1 million. The decrease in retail electric rates reflects declining fuel and purchased power costs. The increase in

retail gas rates covers costs associated with MGE's natural gas system infrastructure improvements. The authorized return on common stock equity for 2017 is 9.8% based on a capital structure consisting of 57.2% common equity. The PSCW also approved MGE's request to extend the current accounting treatment for transmission related costs through 2018.

Deferred Fuel Costs: As of June 30, 2017, MGE has deferred \$1.8 million of 2017 fuel savings. These costs will be subject to the PSCW's annual review of 2017 fuel costs, expected to be completed in 2018.

Debt Issuance: MGE issued \$40 million of new long-term unsecured debt in January 2017. The new debt will carry an interest rate of 3.76% per annum over its 35-year term. The proceeds of this debt financing were used to refinance \$30 million of medium-term notes, which matured in January 2017, and assist with the financing of additional capital expenditures. The covenants of this debt are substantially consistent with MGE's existing unsecured long-term debt.

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

2016 Annual Fuel Proceeding: In July 2017, the PSCW issued a final order in the fuel rules proceedings requiring MGE to refund \$6.0 million of additional fuel savings realized during 2015 and 2016 to its retail electric customers over a one-month period in October 2017.

ATC Return on Equity: Several parties have filed complaints with the FERC seeking to reduce the ROE used by MISO transmission owners, including ATC. Any change to ATC's ROE could result in lower equity earnings and distributions from ATC in the future. We derived approximately 8.7% and 7.1% of our net income for the six months ended June 30, 2017 and 2016, respectively, from our investment in ATC. See "Other Matters" below for additional information concerning ATC.

**Environmental Initiatives:** There are proposed legislative 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. At present, it is unclear how the changes in the Presidential and EPA administrations may affect existing, pending or new legislative or rulemaking proposals or regulatory initiatives. 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 43% of our electric generating capacity as of June 30, 2017. 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 October 2015, the EPA finalized its Clean Power Plan (CPP) rule with an effective date of 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. 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. Given the pending legal proceedings and the change in the Presidential and EPA administrations, 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.

**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 an amendment to the existing Columbia joint operating agreement, effective January 1, 2017, under which 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. On January 1 of each year, beginning in 2017 and ending June 1, 2020, the ownership percentage will be adjusted, through a partial sale, based on the amount of capital expenditures foregone. During three and six months ended June 30, 2017, MGE accrued \$2.8 million and \$5.1 million of 2017 capital expenditures that MGE has forgone as part of the ownership transfer agreement with WPL. During 2016, MGE accrued \$14.8 million of 2016 capital expenditures forgone. As of June 30, 2017, and December 31, 2016, MGE classified \$5.1 million and \$14.8 million, respectively, of Columbia assets as held-for-sale on the consolidated balance sheets. In January 2017, MGE reduced its ownership interest in Columbia from 22.0% to 20.4% through the partial sale of plant assets to WPL. By June 2020, MGE's ownership in Columbia is forecasted to be approximately 19%.

**Saratoga Wind Farm:** In April 2017, MGE filed an application with the PSCW to seek approval to construct, own and operate a 66MW wind farm, consisting of 33 turbines, located near Saratoga, Iowa. If approved by the PSCW, construction of the project is expected to begin in early 2018, with an estimated capital cost of \$107 million.

**Financing Plans:** In July 2017, MGE executed a Note Purchase Agreement for \$30 million of new long-term debt expected to be issued in October 2017 to cover capital expenditures and other corporate obligations. The unsecured notes will carry an interest rate of 3.11% per annum, mature on October 1, 2027, and have provisions generally the same as MGE's other unsecured notes.

The following discussion is based on the business segments as discussed in Footnote 13 of the Notes to Consolidated Financial Statements in this Report.

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*Three Months Ended June 30, 2017 and 2016***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, |         |          |
|   | 2017                        | 2016       | % Change | 2017                        | 2016    | % Change |
| Residential                                       | \$ 31,634                   | \$ 31,493  | 0.4 %    | 177,644                     | 180,932 | (1.8)%   |
| Commercial  | 54,721                      | 55,327     | (1.1)%   | 449,876                     | 461,166 | (2.4)%   |
| Industrial  | 4,516                       | 4,855      | (7.0)%   | 53,098                      | 59,951  | (11.4)%  |
| Other-retail/municipal                            | 9,661                       | 9,169      | 5.4 %    | 103,626                     | 97,047  | 6.8 %    |
| Total retail                                      | 100,532                     | 100,844    | (0.3)%   | 784,244                     | 799,096 | (1.9)%   |
| Sales to the market                               | 1,050                       | 3,019      | (65.2)%  | 16,830                      | 98,320  | (82.9)%  |
| Deferral of fuel savings                          | -                           | (3,488)    | (100.0)% | -                           | -       | - %      |
| Adjustments to revenues                           | 724                         | (46)       | N/A%     | -                           | -       | - %      |
| Total   | \$ 102,306                  | \$ 100,329 | 2.0 %    | 801,074                     | 897,416 | (10.7)%  |
| Cooling degree days<br>(normal 180)               |                             |            |          | 172                         | 201     | (14.4)%  |

Electric operating revenues increased \$2.0 million or 2.0% for the three months ended June 30, 2017, compared to the same period in 2016, due to the following:

| <i>(In millions)</i>                 |        |
|--------------------------------------|--------|
| Deferral of fuel savings/fuel credit | \$ 5.5 |
| Adjustments to revenues              | 0.6    |
| Other                                | 0.5    |
| Sales to the market                  | (2.0)  |
| Volume                               | (1.8)  |
| Rate changes                         | (0.8)  |
| Total                                | \$ 2.0 |

*Deferral of fuel savings/fuel credit.* During the three months ended June 30, 2016, customers received a fuel credit on their bill related to accumulated fuel savings of \$2.0 million, which decreased electric revenues in the prior year. In January 2016, the PSCW lowered MGE's 2016 fuel rules monitored costs, which were deferred in revenue in the prior period, as a result of continued lower projected fuel costs in 2016.

*Adjustments to revenue.* 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 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, 2017, market volumes decreased compared to the same period in the prior year, reflecting decreased opportunities for sales; however, 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 8.b. of the Notes to the Consolidated Financial Statements.

*Volume.* During the three months ended June 30, 2017, there was an 11.4% decrease in industrial retail sales volumes compared to the same period in the prior year as a result of a large industrial customer relocating its operations out of state.



*Rate Changes.* In December 2016, the PSCW authorized MGE to decrease 2017 rates for retail electric customers by 0.8% or \$3.3 million.

Rates charged to retail customers for the three months ended June 30, 2017, were 2.0% or \$0.8 million lower than those charged during the same period in the prior year.

***Electric fuel and purchased power***

Electric fuel and purchased power costs reflect a decrease in internal generation volumes offset by an increase 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, increased purchased power expense. These items are explained below.

Fuel for electric generation

The expense for fuel for internal electric generation decreased \$3.1 million during the three months ended June 30, 2017, compared to the same period in the prior year, due to the following:

|                           |          |
|---------------------------|----------|
| <i>(In millions)</i>      |          |
| Decrease in volume        | \$ (3.5) |
| Increase in per-unit cost | 0.4      |
| Total                     | \$ (3.1) |

This decrease in expense reflects a 23.2% decrease in internal generation volume delivered to the system primarily as a result of decreased generation at WCCF based on market prices, partially offset by a 3.0% increase in per-unit cost of internal electric generation.

Purchased power

Purchased power expense increased \$1.9 million during the three months ended June 30, 2017, compared to the same period in the prior year, due to the following:

|                      |        |
|----------------------|--------|
| <i>(In millions)</i> |        |
| Increase in volume   | \$ 3.4 |
|                      | 0.4    |

|  |        |
|--|--------|
| Change in fuel rule adjustments, net of recoveries |        |
| Decrease in per-unit cost                          | (1.9)  |
| Total  | \$ 1.9 |

The increase in expense (before fuel rules adjustments) reflects a 23.2% increase in the volume of power purchased from third parties partially offset by a 10.5% decrease 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, with potential refunds associated with fuel savings increasing that expense and potential recovery of excess fuel costs decreasing that expense.

*Electric operating and maintenance expenses*

For the three months ended June 30, 2017, electric operating and maintenance expenses increased \$1.8 million, compared to the same period in the prior year. The following contributed to the net change:

|  |        |
|--|--------|
| <i>(In millions)</i>                       |        |
| Increased transmission costs               | \$ 1.3 |
| Increased customer accounts costs          | 0.9    |
| Increased other costs                      | 0.2    |
| Decreased production expenses              | (0.4)  |
| Decreased administrative and general costs | (0.2)  |
| Total                                      | \$ 1.8 |

For the three months ended June 30, 2017, increased transmission costs are primarily due to an increase in transmission reliability enhancements, and increased customer accounts costs are primarily related to technology improvements.

***Electric depreciation expense***

Electric depreciation expense increased \$1.9 million for the three months ended June 30, 2017, compared to the same period in the prior year as a result of new depreciation rates for Columbia, as approved by the PSCW.

**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, |        |          |
|   | 2017                        | 2016      | % Change | 2017                        | 2016   | % Change |
| Residential   | \$ 15,140                   | \$ 13,654 | 10.9 %   | 11,915                      | 13,144 | (9.4)%   |
| Commercial/Industrial   | 7,842                       | 6,173     | 27.0 %   | 12,842                      | 12,969 | (1.0)%   |
| Total retail  | 22,982                      | 19,827    | 15.9 %   | 24,757                      | 26,113 | (5.2)%   |
| Gas transportation  | 991                         | 1,049     | (5.5)%   | 15,186                      | 16,521 | (8.1)%   |
| Other revenues  | 108                         | 85        | 27.1 %   | -                           | -      | - %      |
| Total   | \$ 24,081                   | \$ 20,961 | 14.9 %   | 39,943                      | 42,634 | (6.3)%   |
| Heating degree days (normal 813)  |                             |           |          | 757                         | 828    | (8.6)%   |
| Average rate per therm of retail customer                                       | \$ 0.928                    | \$ 0.759  | 22.3 %   |                             |        |          |

Gas revenues increased \$3.1 million or 14.9% for the three months ended June 30, 2017, compared to the same period in 2016. These changes are related to the following factors:

|                      |        |
|----------------------|--------|
| <i>(In millions)</i> |        |
| Rate/PGA changes     | \$ 3.6 |
| Volume               | (0.5)  |
| Total                | \$ 3.1 |

*Rate/PGA changes.* In December 2016, the PSCW authorized MGE to increase 2017 rates for retail gas customers by 1.9% or \$3.1 million.

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, 2017, increased 22.3% compared to the same period in 2016, reflecting a \$3.1 million increase in natural gas commodity costs (recovered through the PGA) and an increase in fixed rate charges.

*Volume.* For the three months ended June 30, 2017, retail gas deliveries decreased 5.2% compared to the same period in the prior year primarily resulting from unfavorable weather conditions.

#### *Cost of gas sold*

For the three months ended June 30, 2017, cost of gas sold increased \$2.8 million compared to the same period in the prior year. The cost per therm of natural gas increased 48.5%, which resulted in \$3.0 million of increased expense. The volume of gas purchased decreased 3.1%, which resulted in \$0.2 million of decreased expense.

***Gas operating and maintenance expenses***

Gas operating and maintenance expenses increased by \$1.1 million for the three months ended June 30, 2017, compared to the same period in 2016. The following contributed to the net change:

|                                   |        |
|-----------------------------------|--------|
| <i>(In millions)</i>              |        |
| Increased customer accounts costs | \$ 0.9 |
| Increased customer service costs  | 0.3    |
| Decreased other costs             | (0.1)  |
| Total                             | \$ 1.1 |

For the three months ended June 30, 2017, increased customer accounts costs are primarily related to technology improvements.

**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 both the three months ended June 30, 2017 and 2016, net income at the nonregulated energy operations segment was \$4.7 million.

**Transmission Investment Operations - MGE Energy and MGE*****Transmission investment other income***

For the three months ended June 30, 2017 and 2016, other income at the transmission investment segment was \$2.5 million and \$1.8 million, respectively. The transmission investment segment holds our interest in ATC and ATC Holdco, and its income reflects our equity in the earnings of the investments. ATC Holdco was formed in December 2016. In the near term, it is expected that ATC Holdco will be pursuing transmission development opportunities that typically have long development and investment lead times before becoming operational. See Footnote 3 of the Notes to Consolidated Financial Statements in this Report 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, 2017 and 2016, was 36.0% and 36.5%, respectively. MGE's effective income tax rate for the three months ended June 30, 2017 and 2016, was 35.5% and 36.5%, respectively. For both MGE Energy and MGE, the decrease in the effective tax rate is due in part to a higher estimated domestic manufacturing deduction in 2017. In addition, MGE's effective income tax rate decreased as a result of the transfer in December 2016 of its ownership interest in MGE Transco to MGE Energy.

#### **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, for the three months ended June 30, 2016, was 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,           |        |
|                            | 2017               | 2016   |
| MGE Power Elm Road         | \$ 3.6             | \$ 3.6 |
| MGE Power West Campus      | 1.8                | 1.8    |
| MGE Transco <sup>(a)</sup> | -                  | 0.5    |

(a)

MGE Transco holds an ownership interest in ATC. In July 2016, MGE's ownership interest in MGE Transco declined below a majority, resulting in MGE Energy's investment in MGE Transco being deconsolidated from MGE's consolidated financial statements. In December 2016, MGE's ownership interest in MGE Transco was transferred to MGE Energy. See Footnote 3 of the Notes to Consolidated Financial Statements in this Report for additional information.

***Six Months Ended June 30, 2017 and 2016***

**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)               |           |          |
|---|---------------------------|------------|----------|---------------------------|-----------|----------|
|   | Six Months Ended June 30, |            |          | Six Months Ended June 30, |           |          |
|   | 2017                      | 2016       | % Change | 2017                      | 2016      | % Change |
| Residential                                       | \$ 64,987                 | \$ 64,797  | 0.3%     | 375,318                   | 382,022   | (1.8)%   |
| Commercial  | 104,885                   | 105,824    | (0.9)%   | 883,265                   | 903,485   | (2.2)%   |
| Industrial  | 8,731                     | 9,259      | (5.7)%   | 104,863                   | 117,173   | (10.5)%  |
| Other-retail/municipal                            | 18,682                    | 17,407     | 7.3 %    | 195,713                   | 181,996   | 7.5 %    |
| Total retail                                      | 197,285                   | 197,287    | -%       | 1,559,159                 | 1,584,676 | (1.6)%   |
| Sales to the market                               | 2,022                     | 3,161      | (36.0)%  | 52,692                    | 108,939   | (51.6)%  |
| Deferral of fuel savings                          | -                         | (7,070)    | (100.0)% | -                         | -         | - %      |
| Adjustments to revenues                           | 1,323                     | 159        | N/A%     | -                         | -         | - %      |
| Total   | \$ 200,630                | \$ 193,537 | 3.7 %    | 1,611,851                 | 1,693,615 | (4.8)%   |
| Cooling degree days<br>(normal 180)               |                           |            |          | 172                       | 201       | (14.4)%  |

Electric operating revenues increased \$7.1 million or 3.7% for the six months ended June 30, 2017, compared to the same period in 2016, due to the following:

| <i>(In millions)</i>                 |         |
|--------------------------------------|---------|
| Deferral of fuel savings/fuel credit | \$ 11.0 |

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|                        |        |
|------------------------|--------|
| Adjustments to revenue | 1.2    |
| Other                  | 0.6    |
| Volume                 | (3.0)  |
| Rate changes           | (1.6)  |
| Sales to the market    | (1.1)  |
| Total                  | \$ 7.1 |

*Deferral of fuel savings/fuel credit.* During the six months ended June 30, 2016, customers received a fuel credit on their bill related to accumulated fuel savings of \$3.9 million, which decreased electric revenues in the prior year. In January 2016, the PSCW lowered MGE's 2016 fuel rules monitored costs, which were deferred in revenue in the prior period, as a result of continued lower projected fuel costs in 2016.

*Adjustments to revenue.* 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.

*Volume.* During the six months ended June 30, 2017, there was a 10.5% decrease in industrial retail sales volumes compared to the same period in the prior year as a result of a large industrial customer relocating its operations out of state.

*Rate Changes.* In December 2016, the PSCW authorized MGE to decrease 2017 rates for retail electric customers by 0.8% or \$3.3 million.

Rates charged to retail customers for the six months ended June 30, 2017, were 1.9% or \$1.6 million lower than those charged during the same period in the prior year.





*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 six months ended June 30, 2017, market volumes decreased compared to the same period in the prior year, reflecting decreased opportunities for sales and 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 8.b. of the Notes to the Consolidated Financial Statements.

### *Electric fuel and purchased power*

Electric fuel and purchased power costs reflect a decrease in internal generation volumes offset by an increase 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, increased purchased power expense. These items are explained below.

#### Fuel for electric generation

The expense for fuel for internal electric generation decreased \$3.0 million during the six months ended June 30, 2017, compared to the same period in the prior year, due to the following:

|                           |          |
|---------------------------|----------|
| <i>(In millions)</i>      |          |
| Decrease in volume        | \$ (3.1) |
| Increase in per-unit cost | 0.1      |
| Total                     | \$ (3.0) |

This decrease in expense reflects an 11.2% decrease in internal generation volume delivered to the system primarily as a result of decreased generation at WCCF based on market prices, partially offset by a 0.3% increase in per-unit cost of internal electric generation.

#### Purchased power

Purchased power expense increased \$2.5 million during the six months ended June 30, 2017, compared to the same period in the prior year, due to the following:

*(In millions)*

|  |        |
|--|--------|
| Change in fuel rule adjustments, net of recoveries | \$ 3.4 |
| Increase in volume                                 | 3.1    |
| Decrease in per-unit cost                          | (4.0)  |
| Total  | \$ 2.5 |

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, with potential refunds associated with fuel savings increasing that expense and potential recovery of excess fuel costs decreasing that expense.

The decrease in expense (before fuel rules adjustments) reflects an 11.7% decrease in the per-unit cost of purchased power partially offset by a 10.0% increase in the volume of power purchased from third parties.

***Electric operating and maintenance expenses***

Electric operating and maintenance expenses increased \$1.8 million during the six months ended June 30, 2017, compared to the same period in 2016. The following changes contributed to the net change:

*(In millions)*

|  |        |
|--|--------|
| Increased transmission costs               | \$ 2.5 |
| Increased customer accounts costs          | 1.1    |
| Increased customer service costs           | 0.3    |
| Decreased production expenses              | (1.7)  |
| Decreased administrative and general costs | (0.4)  |
| Total                                      | \$ 1.8 |

For the six months ended June 30, 2017, increased transmission costs are primarily due to an increase in transmission reliability enhancements and increased customer accounts costs are primarily related to technology improvements, partially offset by decreased production costs at Columbia and the Elm Road Units.

### *Electric depreciation expense*

Electric depreciation expense increased \$3.7 million for the six months ended June 30, 2017, compared to the same period in the prior year as a result of new depreciation rates for Columbia, as approved by the PSCW.

### **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, |         |          |
|   | 2017                      | 2016      | % Change | 2017                      | 2016    | % Change |
| Residential   | \$ 49,043                 | \$ 44,904 | 9.2 %    | 54,953                    | 56,720  | (3.1)%   |
| Commercial/Industrial   | 30,890                    | 27,281    | 13.2 %   | 50,018                    | 50,325  | (0.6)%   |
| Total retail  | 79,933                    | 72,185    | 10.7 %   | 104,971                   | 107,045 | (1.9)%   |
| Gas transportation  | 2,341                     | 2,405     | (2.7)%   | 36,222                    | 37,974  | (4.6)%   |
| Other revenues  | 233                       | 208       | 12.0 %   | -                         | -       | - %      |
| Total   | \$ 82,507                 | \$ 74,798 | 10.3 %   | 141,193                   | 145,019 | (2.6)%   |
| Heating degree days<br>(normal 4,319)   |                           |           |          | 3,887                     | 4,086   | (4.9)%   |
| Average rate per therm of<br>retail customer                                    | \$ 0.761                  | \$ 0.674  | 12.9 %   |                           |         |          |

Gas revenues increased \$7.7 million or 10.3% for the six months ended June 30, 2017, compared to the same period in 2016. These changes are related to the following factors:

*(In millions)*

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|                  |        |
|------------------|--------|
| Rate/PGA changes | \$ 8.6 |
| Volume           | (0.9)  |
| Total            | \$ 7.7 |

*Rate/PGA changes.* In December 2016, the PSCW authorized MGE to increase 2017 rates for retail gas customers by 1.9% or \$3.1 million.

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, 2017, increased 12.9% compared to the same period in 2016, reflecting a \$6.6 million increase in natural gas commodity costs (recovered through the PGA) and an increase in fixed rate charges.

*Volume.* For the six months ended June 30, 2017, retail gas deliveries decreased 1.9% compared to the same period in the prior year primarily resulting from unfavorable weather conditions.

***Cost of gas sold***

For the six months ended June 30, 2017, cost of gas sold increased \$6.1 million compared to the same period in the prior year. The cost per therm of natural gas increased 16.7%, which resulted in \$6.4 million of increased expense. The volume of gas purchased decreased 0.9%, which resulted in \$0.3 million of decreased expense.

***Gas operating and maintenance expenses***

Gas operating and maintenance expenses increased by \$1.1 million for the six months ended June 30, 2017, compared to the same period in 2016. The following changes contributed to the net change:

*(In millions)*

|  |    |       |
|--|----|-------|
| Increased customer account costs           | \$ | 1.0   |
| Increased customer service costs           |    | 0.5   |
| Decreased administrative and general costs |    | (0.3) |
| Decreased distribution expenses            |    | (0.1) |
| Total                                      | \$ | 1.1   |

For the six months ended June 30, 2017, increased customer accounts costs are primarily related to technology improvements.

**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, 2017 and 2016, net income at the nonregulated energy operations segment was \$9.4 million and \$9.6 million, respectively.

**Transmission Investment Operations - MGE Energy and MGE*****Transmission investment other income***

For the six months ended June 30, 2017 and 2016, other income at the transmission investment segment was \$5.0 million and \$4.0 million, respectively. The transmission investment segment holds our interest in ATC and ATC Holdco, and its income reflects our equity in the earnings of the investments. ATC Holdco was formed in December 2016. In the near term, it is expected that ATC Holdco will be pursuing transmission development opportunities that typically have long development and investment lead times before becoming operational. See Footnote 3 of the Notes to Consolidated Financial Statements in this Report 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 six months ended June 30, 2017 and 2016, was 36.4% and 36.7%, respectively. MGE's effective income tax rate for the six months ended June 30, 2017 and 2016, was 35.9% and 36.7%, respectively. For both MGE Energy and MGE, the decrease in the effective tax rate is due in part to a higher estimated domestic manufacturing deduction in 2017. In addition, MGE's effective income tax rate decreased as a result of the transfer in December 2016 of its ownership interest in MGE Transco to MGE Energy.

**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, for the six months ended June 30, 2016, 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,         |        |
|                            | 2017             | 2016   |
| MGE Power Elm Road         | \$ 7.2           | \$ 7.4 |
| MGE Power West Campus      | 3.6              | 3.6    |
| MGE Transco <sup>(a)</sup> | -                | 1.2    |

(a)

MGE Transco holds an ownership interest in ATC. In July 2016, MGE's ownership interest in MGE Transco declined below a majority, resulting in MGE Energy's investment in MGE Transco being deconsolidated from MGE's consolidated financial statements. In December 2016, MGE's ownership interest in MGE Transco was transferred to MGE Energy. See Footnote 3 of the Notes to Consolidated Financial Statements in this Report for additional information.

### **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, 2017, except as noted below. Further discussion of the contractual obligations and commercial commitments is included in Footnote 17 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 2016 Annual Report on Form 10-K.

#### ***Purchase Contracts - MGE Energy and MGE***

See Footnote 7.c. of Notes to Consolidated Financial Statements in this Report for a description of commitments at June 30, 2017, that MGE Energy and MGE have entered with respect to various commodity supply and transportation contracts to meet their obligations to deliver electricity and natural gas to customers.

#### ***Other Commitments - MGE Energy***

In May 2017, MGE Energy entered a subscription agreement to invest in a nonpublic venture capital fund. From time to time, this entity will require capital infusions from its investors. MGE Energy has committed to contribute \$5 million in capital for such infusions. The timing of these infusions is dependent on the needs of the investee and is therefore uncertain at this time.

#### ***Long-term Debt - MGE Energy and MGE***

MGE issued \$40 million of new long-term unsecured debt in January 2017. The proceeds of this debt financing were used to refinance \$30 million of medium-term notes, which matured in January 2017, and assist with the financing of



additional capital expenditures. See Footnote 2 of the Notes to Consolidated Financial Statements in this Report for further discussion.

### *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. See "Credit Facilities" under Part II, Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations – Liquidity and Capital Resources in MGE Energy's and MGE's 2016 Annual Report on Form 10-K for information regarding MGE Energy's and MGE's credit facilities.

### **Cash Flows**

The following summarizes cash flows for MGE Energy and MGE during the six months ended June 30, 2017 and 2016:

| <i>(In thousands)</i>        | MGE Energy |           | MGE       |           |
|------------------------------|------------|-----------|-----------|-----------|
|                              | 2017       | 2016      | 2017      | 2016      |
| Cash provided by/(used for): |            |           |           |           |
| Operating activities         | \$ 67,710  | \$ 93,514 | \$ 64,713 | \$ 93,209 |
| Investing activities         | (46,948)   | (41,973)  | (42,178)  | (42,028)  |
| Financing activities         | (13,805)   | (22,617)  | (27,472)  | (36,994)  |

## 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, 2017, was \$67.7 million, a decrease of \$25.8 million when compared to the same period in the prior year, primarily reflecting changes in working capital items between the periods.

MGE Energy's net income increased \$1.7 million for the six months ended June 30, 2017, when compared to the same period in the prior year.

In 2016, MGE received a \$10.0 million refund from the IRS for the 2015 tax year. Excluding the 2016 refund, MGE Energy's federal and state taxes paid increased \$3.5 million during the six months ended June 30, 2017, when compared to the same period in the prior year.

Working capital accounts (excluding prepaid and accrued taxes) resulted in \$1.3 million in cash used for operating activities for the six months ended June 30, 2017, primarily due to decreased accounts payable and decreased other current liabilities, partially offset by decreased unbilled revenues and decreased accounts receivable.

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.

A decrease in pension contribution resulted in an additional \$3.8 million in cash provided by operating activities for the six months ended June 30, 2017, when compared to the same period in the prior year. Pension contributions reflect amounts required by law and discretionary amounts.

### *MGE*

Cash provided by operating activities for the six months ended June 30, 2017, was \$64.7 million, a decrease of \$28.5 million when compared to the same period in the prior year, primarily reflecting changes in working capital items between the periods.

Net income decreased \$1.0 million for the six months ended June 30, 2017, when compared to the same period in the prior year.

In 2016, MGE received a \$10.0 million refund from the IRS for the 2015 tax year. Excluding the 2016 refund, MGE Energy's federal and state taxes paid increased \$3.5 million during the six months ended June 30, 2017, when compared to the same period in the prior year.

Working capital accounts (excluding prepaid and accrued taxes) resulted in \$1.4 million in cash used for operating activities for the six months ended June 30, 2017, primarily due to decreased accounts payable and decreased other current liabilities, partially offset by decreased unbilled revenues and decreased accounts receivable.

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.

A decrease in pension contribution resulted in an additional \$3.8 million in cash provided by operating activities for the six months ended June 30, 2017, when compared to the same period in the prior year. Pension contributions reflect amounts required by law and discretionary amounts.

## **Cash Used for Investing Activities**

### ***MGE Energy***

MGE Energy's cash used for investing activities increased \$5.0 million for the six months ended June 30, 2017, when compared to the same period in the prior year.

Capital expenditures for the six months ended June 30, 2017, were \$42.2 million. This amount represents an increase of \$1.4 million from the expenditures made in the same period in the prior year. This increase primarily reflects increased expenditures on electric distribution assets.

Capital contributions in ATC and other investments increased \$4.6 million for the six months ended June 30, 2017, when compared to the same period in the prior year.

### ***MGE***

MGE's cash used for investing activities increased \$0.2 million for the six months ended June 30, 2017, when compared to the same period in the prior year.

Capital expenditures for the six months ended June 30, 2017, were \$42.2 million. This amount represents an increase of \$1.4 million from the expenditures made in the same period in the prior year. This increase primarily reflects increased expenditures on electric distribution assets.

Capital contributions in ATC and other investments decreased \$0.7 million for the six months ended June 30, 2017, when compared to the same period in the prior year. In December 2016, MGE transferred its ownership interest to MGE Energy. See Footnote 3 of the Notes to Consolidated Financial Statements in this Report for further details.

## **Cash Used for Financing Activities**

### ***MGE Energy***

Cash used for MGE Energy's financing activities was \$13.8 million for the six months ended June 30, 2017, a decrease of \$8.8 million when compared to the same period in the prior year.

For the six months ended June 30, 2017, dividends paid were \$21.3 million compared to \$20.5 million in the prior year. This increase was a result of a higher dividend per share (\$0.615 vs. \$0.590).

During the six months ended June 30, 2017, MGE issued \$40.0 million of senior unsecured notes, which was used to refinance \$30.0 million of medium-term notes and assist with financing additional capital expenditures.

### ***MGE***

During the six months ended June 30, 2017, cash used for MGE's financing activities was \$27.5 million, a decrease of \$9.5 million when compared to the same period in the prior year.

Dividends paid from MGE to MGE Energy were \$25.0 million for the six months ended June 30, 2017 and 2016.

Distributions to parent from noncontrolling interest, which represent distributions from MGE Power Elm Road and MGE Power West Campus to MGE Energy, were \$10.0 million for the six months ended June 30, 2017, compared to \$10.6 million in the prior year.

For the six months ended June 30, 2016, equity contributions received from noncontrolling interest, which represent contributions to MGE Transco, were \$0.7 million. There were no equity contributions received from noncontrolling interest, which represent contributions to MGE Transco for the six months ended June 30, 2017.

During the six months ended June 30, 2017, MGE issued \$40.0 million of senior unsecured notes, which was used to refinance \$30.0 million of medium-term notes and assist with financing additional capital expenditures.



## Capitalization Ratios

MGE Energy's capitalization ratios were as follows:

|                               | June 30, 2017 | MGE Energy<br>December 31, 2016 |
|-------------------------------|---------------|---------------------------------|
| Common shareholders' equity   | 65.1 %        | 65.2 %                          |
| Long-term debt <sup>(a)</sup> | 34.9 %        | 34.8 %                          |

(a)

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, 2017, capital expenditures for MGE Energy and MGE totaled \$42.2 million, which included \$40.4 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

There were no material updates or developments in environmental matters that occurred during the six months ended June 30, 2017. Further discussion of environmental matters is included in MGE Energy's and MGE's 2016 Annual Report on Form 10-K and Footnote 7.a. of Notes to Consolidated Financial Statements in this Report.

## 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 alleged 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. At the time, MISO's base ROE was 12.38% and ATC's base ROE was 12.2%. In February 2015, a second complaint was filed for the period February 2015 through May 2015 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 for the second complaint that would reduce the transmission owner's base ROE to 9.7%. The initial decision will be reviewed by FERC. It is anticipated FERC will issue an order on this issue in the beginning of 2018. On September 28, 2016, FERC issued an order on the first complaint, for the period November 2013 through February 2015, reducing the base ROE to 10.32%. This base ROE also became effective September 28, 2016, and will apply to future periods until FERC rules in the second complaint, at which time the base ROE ordered by FERC in the second complaint will prospectively become the authorized base ROE.

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.

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 \$0.1 million and \$0.8 million for the three months ended June 30, 2017, and 2016, respectively, and a pre-tax charge of \$0.2 million and \$1.1 million for the six months ended June 30, 2017, and 2016, respectively, recorded by ATC for this matter representing its estimate of its refund liability. We derived approximately 8.7% and 7.1% of our net income for the six months ended June 30, 2017 and 2016, respectively, from our investment in ATC.





**Adoption of Accounting Principles and Recently Issued Accounting Pronouncements**

See Footnote 12 of Notes to Consolidated Financial Statements in this Report for discussion of new accounting pronouncements.

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### **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 in the following year and is then reflected 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 2017, fuel and purchased power costs included in MGE's base fuel rates are \$101.9 million. See Footnote 8.b. of the Notes to Consolidated Financial Statements in this Report 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, 2017, the fair value of these instruments exceeded their cost basis by \$1.3 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 agreement also allows MGE an option to extend the contract after that 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, 2017, reflects a loss position of \$46.6 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, 2017, 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, 2016, 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 2017, 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, MGE Energy does not control or manage certain of its unconsolidated entities and thus, its access and ability to apply its procedures to those entities is more limited than is the case for its consolidated subsidiaries.

As of June 30, 2017, 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, 2017, 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 in this Report for more information.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.****Issuer Purchases of Equity Securities**

| Period           | Total<br>Number of<br>Shares<br>Purchased | Average<br>Price Paid<br>per Share | Total Number of<br>Shares Purchased as<br>Part of Publicly<br>Announced Plans or<br>Programs* | Maximum number (or<br>Approximate Dollar<br>Value) of Shares That<br>May Yet Be<br>Purchased Under the<br>Plans or Programs* |
|------------------|---|------------------------------------|---|--|
| April 1-30, 2017 | 17,858                                    | \$ 64.95                           | -   | -  |
| May 1-31, 2017   | 10,850                                    | 64.25                              | -   | -  |
| June 1-30, 2017  | 53,690                                    | 67.52                              | -   | -  |
| Total            | 82,398                                    | \$ 66.53                           | -   | -  |

\* Under MGE Energy's 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.**

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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, 2017, filed by the following officers for the following companies:

31.1

Filed by Jeffrey M. Keebler for MGE Energy, Inc.

31.2

Filed by Jeffrey C. Newman for MGE Energy, Inc.

31.3

Filed by Jeffrey M. Keebler for Madison Gas and Electric Company

31.4

Filed by Jeffrey C. Newman for Madison Gas and Electric Company



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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, 2017, filed by the following officers for the following companies:

32.1

Filed by Jeffrey M. Keebler for MGE Energy, Inc.

32.2

Filed by Jeffrey C. Newman for MGE Energy, Inc.

32.3

Filed by Jeffrey M. Keebler 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, 2017

/s/ Jeffrey M. Keebler  
Jeffrey M. Keebler

President and Chief Executive Officer

(Duly Authorized Officer)

Date: August 4, 2017

/s/ Jeffrey C. Newman  
Jeffrey C. Newman

Executive 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, 2017

/s/ Jeffrey M. Keebler  
Jeffrey M. Keebler

President and Chief Executive Officer

(Duly Authorized Officer)

Date: August 4, 2017

/s/ Jeffrey C. Newman  
Jeffrey C. Newman

Executive Vice President, Chief Financial Officer, Secretary and  
Treasurer

(Chief Financial and Accounting Officer)