

MGE ENERGY INC  
Form 10-K  
February 25, 2016

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

**FORM 10-K**

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

*For the fiscal year ended:*

**December 31, 2015**

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

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

| <b>Commission<br/>File No.</b> | <b>Name of Registrant, State of Incorporation, Address<br/>of Principal Executive Offices, and Telephone No.</b>  | <b>IRS Employer<br/>Identification No.</b> |
|--------------------------------|---|--|
| 000-49965                      | <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 | 39-2040501                                 |

000-1125

**Madison Gas and Electric Company**

39-0444025

(a Wisconsin Corporation)

133 South Blair Street

Madison, Wisconsin 53788

(608) 252-7000

mge.com

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

|                  | Title of Class                        | Name of Each Exchange on which Registered |
|------------------|---------------------------------------|---|
| MGE Energy, Inc. | Common Stock, \$1 Par Value Per Share | The Nasdaq Stock Market                   |

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

|                                  | Title of Class                        |
|----------------------------------|---------------------------------------|
| Madison Gas and Electric Company | Common Stock, \$1 Par Value Per Share |

Indicate by checkmark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

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

Indicate by checkmark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

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



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

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

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

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

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

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

The aggregate market value of the voting and nonvoting common equity held by nonaffiliates of each registrant as of June 30, 2015, was as follows:

|                                  |                 |
|----------------------------------|-----------------|
| MGE Energy, Inc.                 | \$1,338,879,665 |
| Madison Gas and Electric Company | \$0             |

The number of shares outstanding of each registrant's common stock as of February 1, 2016, were as follows:

|                                  |            |
|----------------------------------|------------|
| MGE Energy, Inc.                 | 34,668,370 |
| Madison Gas and Electric Company | 17,347,894 |

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of MGE Energy, Inc.'s definitive proxy statement to be filed on or before March 28, 2016, relating to its annual meeting of shareholders, are incorporated by reference into Part III of this annual report on Form 10-K.

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

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## **Filing Format**

This combined Form 10-K is being filed separately by MGE Energy, Inc. (MGE Energy) and Madison Gas and Electric Company (MGE). MGE is a wholly owned subsidiary of MGE Energy and represents a 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 Item 1A. Risk Factors, Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations, and Item 8. Financial Statements and Supplementary Data, Footnote 18. Commitments and Contingencies, 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               |
| NGV Fueling Services      | NGV Fueling Services, LLC                 |

Other Defined Terms:

|                     |  |
|---------------------|--|
| AFUDC               | Allowance for Funds Used During Construction   |
| Alliant             | Alliant Energy Corporation   |
| ANR                 | ANR Pipeline Company   |
| ARO                 | Asset Retirement Obligation  |
| ASU                 | Accounting Standard Update   |
| ATC                 | American Transmission Company LLC  |
| BART                | Best Available Retrofit Technology   |
| Blount              | Blount Station   |
| CAA                 | Clean Air Act  |
| CAIR                | Clean Air Interstate Rule  |
| CAVR                | Clean Air Visibility Rule  |
| CCR                 | Coal Combustion Residual   |
| CO <sub>2</sub>     | Carbon Dioxide   |
| 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 |
| COSO                | Committee of Sponsoring Organizations  |
| CPP                 | Clean Power Plan   |
| CSAPR               | Cross-State Air Pollution Rule   |
| CWA                 | Clean Water Act  |
| Dth                 | Dekatherms   |
| EEI                 | Edison Electric Institute  |
| EGUs                | Electric Generating Units  |
| ELG                 | Effluent Limitations Guidelines  |

|                           |  |
|---------------------------|--|
| Elm Road Units            | Elm Road Generating Station  |
| EPA                       | United States Environmental Protection Agency  |
| FASB                      | Financial Accounting Standards Board   |
| FERC                      | Federal Energy Regulatory Commission   |
| FIP                       | Federal Implementation Plan  |
| 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 |
| ICF                       | Insurance Continuance Fund   |
| IRS                       | Internal Revenue Service   |

|                 |  |
|-----------------|--|
| kVA             | Kilovolt Ampere  |
| kWh             | Kilowatt-hour  |
| MATS            | Mercury and Air Toxins Standards   |
| MISO            | Midcontinent Independent System Operator Inc. (a regional transmission organization) |
| MRO             | Midwest Reliability Organization   |
| MW              | Megawatt   |
| MWh             | Megawatt-hour  |
| NAAQS           | National Ambient Air Quality Standards   |
| Nasdaq          | The Nasdaq Stock Market  |
| NERC            | North American Electric Reliability Corporation                                      |
| NNG             | Northern Natural Gas Company   |
| NOV             | Notice of Violation  |
| NO <sub>x</sub> | Nitrogen Oxides  |
| NYSE            | New York Stock Exchange  |
| PCBs            | Polychlorinated Biphenyls  |
| PGA             | Purchased Gas Adjustment clause  |
| PJM             | PJM Interconnection, LLC (a regional transmission organization)                      |
| PM              | Particulate Matter   |
| PPA             | Purchased power agreement  |
| ppb             | Parts Per Billion  |
| PSCW            | Public Service Commission of Wisconsin   |
| REC             | Renewable Energy Credit  |
| ROE             | Return on Equity   |
| RTO             | Regional Transmission Organization   |
| SCR             | Selective Catalytic Reduction  |
| SEC             | Securities and Exchange Commission   |
| SIP             | State Implementation Plan  |
| SO <sub>2</sub> | Sulfur Dioxide   |
| the State       | State of Wisconsin   |
| Stock Plan      | Direct Stock Purchase and Dividend Reinvestment Plan of MGE Energy                   |
| UW              | University of Wisconsin at Madison   |
| VIE             | Variable Interest Entity   |
| WCCF            | West Campus Cogeneration Facility  |
| WDNR            | Wisconsin Department of Natural Resources  |
| WEPCO           | Wisconsin Electric Power Company   |
| Working capital | Current assets less current liabilities  |
| WPDES           | Wisconsin Pollutant Discharge Elimination System                                     |
| WPL             | Wisconsin Power and Light Company  |
| WPSC            | Wisconsin Public Service Corporation   |
| WRERA           | Worker, Retiree and Employer Recovery Act of 2008                                    |
| XBRL            | eXtensible Business Reporting Language   |



**PART I.**

**Item 1. Business.**

MGE Energy operates in the following business segments:

.

Regulated electric utility operations generating, purchasing, and distributing electricity through MGE.

.

Regulated gas utility operations purchasing and distributing natural gas through MGE.

.

Nonregulated energy operations owning and leasing electric generating capacity that assists MGE through MGE Energy's wholly owned subsidiaries MGE Power Elm Road and MGE Power West Campus.

.

Transmission investments representing our investment in American Transmission Company LLC, a company engaged in the business of providing electric transmission services primarily in Wisconsin.

.

All other investing in companies and property that relate to the regulated operations and financing the regulated operations, through its wholly owned subsidiaries CWDC, MAGAEL, MGE State Energy Services, NGV Fueling Services, and Corporate functions.

MGE's utility operations represent a majority of the assets, liabilities, revenues, expenses, and operations of MGE Energy. MGE Energy's nonregulated energy operations currently include an undivided interest in two coal-fired generating units located in Oak Creek, Wisconsin, which we refer to as the Elm Road Units, and an undivided interest in a cogeneration facility located on the Madison campus of the University of Wisconsin, which we refer to as the

West Campus Cogeneration Facility or WCCF.

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

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

MGE Energy was organized as a Wisconsin corporation in 2001. MGE was organized as a Wisconsin corporation in 1896. Their principal offices are located at 133 South Blair Street, Madison, Wisconsin 53788, and their telephone number is (608) 252-7000.

### **Electric Utility Operations**

MGE distributes electricity in a service area covering a 316 square-mile area of Dane County, Wisconsin. The service area includes the city of Madison, Wisconsin. It owns or leases ownership interests in electric generation facilities located in Wisconsin and Iowa.

At December 31, 2015, MGE supplied electric service to approximately 146,000 customers, with approximately 90% located in the cities of Fitchburg, Madison, Middleton, and Monona and 10% in adjacent areas. Of the total number of customers, approximately 87% were residential and 13% were commercial or industrial. Electric retail revenues for 2015, 2014, and 2013 were comprised of the following:

|                                       | Year Ended December 31, |        |        |
|---------------------------------------|-------------------------|--------|--------|
|                                       | 2015                    | 2014   | 2013   |
| Residential                           | 32.6%                   | 33.3%  | 33.2%  |
| Commercial                            | 53.2%                   | 52.8%  | 52.4%  |
| Industrial                            | 4.8%                    | 4.8%   | 4.8%   |
| Public authorities (including the UW) | 9.4%                    | 9.1%   | 9.6%   |
| Total                                 | 100.0%                  | 100.0% | 100.0% |

Electric operations accounted for approximately 74.2%, 64.0%, and 69.0% of MGE's total 2015, 2014, and 2013 regulated revenues, respectively.

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

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MGE is registered with North American Electric Reliability Corporation (NERC) and one regional entity, the Midwest Reliability Organization (MRO). The essential purposes of these entities are the development and implementation of regional and NERC reliability standards; and determining compliance with those standards, including enforcement mechanisms.

### ***Transmission***

American Transmission Company LLC (ATC) is owned by the utilities that contributed facilities or capital to it in accordance with Wisconsin law. ATC's purpose is to provide reliable, economic transmission service to all customers in a fair and equitable manner. ATC plans, constructs, operates, maintains, and expands transmission facilities that it owns to provide adequate and reliable transmission of power. ATC is regulated by FERC for all rate terms and conditions of service and is a transmission-owning member of the MISO.

### ***Regional Transmission Organizations (RTO)***

#### ***MISO***

MGE is a nontransmission owning member of the MISO. MISO, a FERC approved RTO, is responsible for monitoring the electric transmission system that delivers power from generating plants to wholesale power transmitters. MISO's role is to ensure equal access to the transmission system and to maintain or improve electric system reliability in the Midwest.

MISO maintains a bid-based energy market. MGE offers substantially all of its generation on the MISO market and purchases much of its load requirement from the MISO market in accordance with the MISO Tariff. MGE participates in the ancillary services market operated by MISO. That market is an extension of the existing energy market in which MISO assumes the responsibility of maintaining sufficient generation reserves. In the ancillary services market, MISO provides the reserves for MGE's load, and MGE may offer to sell reserves from its generating units.

MGE participates in the voluntary capacity auction, which provides an optional monthly forum for buyers and sellers of aggregate planning resource credits to interact. Load serving entities, such as MGE, may participate in the voluntary capacity auction potentially to obtain the necessary aggregate planning resource credits needed to meet their planning reserve margin requirement established by the PSCW. Generator owners may participate to sell any excess aggregate planning resource credits that are not needed by them.

#### ***PJM***

MGE is a member of PJM. PJM, an RTO, is a neutral and independent party that coordinates and directs the operation of the transmission grid within its area of coverage, administers a competitive wholesale electricity market, and plans regional transmission expansion improvements to maintain grid reliability and relieve congestion.

### *Fuel supply and generation*

MGE satisfies its customers' electric demand with internal generation and purchased power. During the years ended December 31, 2015, 2014, and 2013, MGE's electric energy delivery requirements were satisfied from the following fuel sources:

|                   | Year Ended December 31, |        |        |
|-------------------|-------------------------|--------|--------|
|                   | 2015                    | 2014   | 2013   |
| Coal              | 47.9%                   | 47.8%  | 54.1%  |
| Natural gas       | 9.1%                    | 3.2%   | 5.8%   |
| Fuel oil          | 0.1%                    | 0.1%   | 0.1%   |
| Renewable sources | 3.0%                    | 3.1%   | 2.9%   |
| Purchased power   |                         |        |        |
| Renewable         | 8.2%                    | 8.7%   | 7.6%   |
| Other             | 31.7%                   | 37.1%  | 29.5%  |
| Total             | 100.0%                  | 100.0% | 100.0% |

Sources used depend on market prices, generating unit availability, weather, and customer demand.

*Generation Sources*

MGE receives electric generation supply from coal-fired, gas-fired, and renewable energy sources. These sources include owned facilities as well as facilities leased from affiliates and accounted for under our nonregulated energy operations. See Item 2. Properties for more information regarding these generation sources, including location, capacity, ownership or lease arrangement, and fuel source. See "Nonregulated Energy Operations" below for more information regarding generating capacity leased to MGE by nonregulated subsidiaries.

*Purchased power*

MGE enters into short and long-term purchase power commitments with third parties to meet a portion of its anticipated electric energy supply needs. The following table identifies purchase power commitments at December 31, 2015, with unaffiliated parties for the next five years.

|                            |       |       |       |      |      |
|----------------------------|-------|-------|-------|------|------|
| <i>(Megawatts)</i>         | 2016  | 2017  | 2018  | 2019 | 2020 |
| Purchase power commitments | 162.4 | 152.5 | 152.5 | 98.5 | 98.5 |

**Gas Utility Operations**

MGE transports and distributes natural gas in a service area covering 1,682 square miles in seven south-central Wisconsin counties. The service area includes the city of Madison, Wisconsin and surrounding areas.

At December 31, 2015, MGE supplied natural gas service to approximately 152,000 customers in the cities of Elroy, Fitchburg, Lodi, Madison, Middleton, Monona, Prairie du Chien, Verona, and Viroqua; 24 villages; and all or parts of 49 townships. Of the total number of customers, approximately 89% were residential and 11% were commercial or industrial. Gas revenues for 2015, 2014, and 2013 were comprised of the following:

|   | Year Ended December 31, |        |        |
|---|-------------------------|--------|--------|
|   | 2015                    | 2014   | 2013   |
| Residential                                     | 59.4%                   | 53.0%  | 54.3%  |
| Commercial                                      | 35.7%                   | 34.3%  | 33.4%  |
| Industrial <sup>(a)</sup>                       | 1.3%                    | 11.0%  | 10.3%  |
| Transportation service and other <sup>(a)</sup> | 3.6%                    | 1.7%   | 2.0%   |
| Total   | 100.0%                  | 100.0% | 100.0% |

(a)

During the year ended December 31, 2015, a large interruptible industrial customer decided to purchase gas from a third party supplier and to use MGE's facilities for the transport of that gas resulting in a shift in gas revenues between industrial and transportation services.

Gas operations accounted for approximately 25.8%, 36.0%, and 31.0% of MGE's total 2015, 2014, and 2013 regulated revenues, respectively.

MGE can curtail gas deliveries to its interruptible customers. Approximately 3% of retail gas deliveries in 2015 and 17% in 2014 were to interruptible customers.

### *Gas supply*

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

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

By contract, a total of 5,953,689 Dth of gas can be injected into ANR's storage fields in Michigan from April 1 through October 31. These gas supplies are then available for withdrawal during the subsequent heating season, November 1 through March 31. Using storage allows MGE to buy gas supplies during the summer season, when prices are normally lower, and withdraw these supplies during the winter season, when prices are typically higher. Storage also gives MGE more flexibility in meeting daily load fluctuations.

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

.  
162,150 Dth (including 106,078 Dth of storage withdrawals) on ANR.

.  
65,108 Dth on NNG.

### **Nonregulated Energy Operations**

MGE Energy, through its subsidiaries, has developed generation sources that assist MGE in meeting the electricity needs of its customers. These sources consist of the Elm Road Units and the WCCF, which are leased by MGE Power Elm Road and MGE Power West Campus, respectively, to MGE. See Item 2. Properties for a description of these facilities, their joint owners, and the related lease arrangements.

### **Transmission Investments**

American Transmission Company owns and operates electric transmission facilities primarily in Wisconsin. MGE received an interest in ATC when it, like other Wisconsin electric utilities, contributed its electric transmission facilities to ATC as required by Wisconsin law. That interest is presently held by MGE Transco, which is jointly owned by MGE Energy and MGE. At December 31, 2015, MGE Transco held a 3.6% ownership interest in ATC.

In 2011, ATC and Duke Energy announced the creation of a joint venture, Duke-American Transmission Company, LLC, that seeks to build, own, and operate new electric transmission infrastructure in North America to address increasing demand for affordable, reliable transmission capacity.

### **Environmental**

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

discussed below, MGE continues to track state and federal initiatives such as potential changes to regulations governing polychlorinated biphenyl (PCB), potential changes to air and water standards, and potential climate change legislation.

### *Water Quality*

#### *EPA's Finalization of its Effluent Limitations Guidelines Rule for Steam Electric Power Plants*

In September 2015, the EPA released its final rule for Effluent Limitations Guidelines (ELG) for the Steam Electric Power Generating industry. The ELG rule lowers the existing permissible water discharge of metals and other pollutants in wastewater from new and existing steam electric generation plants. The rule mostly covers certain wastewater pollutants attributed to air pollution control and ash handling systems at coal-burning power plants with units greater than 50 megawatt (MW) generation capacity. We are currently evaluating the rule for its effects on our operation and expect that equipment upgrades may be necessary at our Elm Road Units and Columbia plants. The rule will go into effect in 2018 and will apply to Wisconsin-based power plants as they renew their WPDES permits.

MGE cannot estimate costs associated with this rule with any certainty until we complete our evaluation. Management believes compliance costs will be recovered in future rates based on previous treatment of environmental compliance projects.

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

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

Our WCCF, Blount, and Columbia plants are considered existing plants under this rule. Our WCCF facility already employs a system that meets the 316(b) rule. Our Blount plant has conducted studies showing that it will likely be in compliance with this rule when its WPDES permit is renewed in 2017. The operator of our Columbia plant plans to conduct an intake study to demonstrate compliance with the 316(b) rule and/or identify design criteria needed to meet the new rule requirements prior to Columbia's 2017 WPDES permit renewal. The exact requirements at Blount and



Columbia, however, will not be known until the WDNR finalizes its rule, approves the plant operators' approach, and those sites' WPDES permits are modified to account for this rule. Nonetheless, MGE expects that the 316(b) rule will not have material effects on its existing plants.

### *Energy Efficiency and Renewables*

The Wisconsin Energy Efficiency and Renewables Act requires that, by 2015, 10% of the state's electricity be generated from renewable sources. As of December 31, 2015, MGE is in compliance with the 2015 requirement. The costs to comply with the Act and its accompanying regulations are being recovered in rates.

### *Air Quality*

Air quality regulations promulgated by the EPA and Wisconsin Department of Natural Resources (WDNR) in accordance with the Federal Clean Air Act and the Clean Air Act Amendments of 1990 impose restrictions on emission of particulates, sulfur dioxide (SO<sub>2</sub>), nitrogen oxides (NO<sub>x</sub>), hazardous air pollutants and other pollutants, and require permits for operation of emission sources. These permits must be renewed periodically. Various newly enacted and/or proposed federal and state initiatives are expected to result in additional operating and capital expenditure costs for fossil-fueled electric generating units.

### *Mercury and Air Toxic Standards (MATS) Rule*

In June 2015, the U.S. Supreme Court remanded the EPA's MATS rule to the D.C. Circuit Court. The Supreme Court's decision held that the EPA was required to consider the cost of compliance when deciding that it was "appropriate and necessary" to regulate mercury emissions from EGUs under Section 112 of the Clean Air Act. The remand was sent back to the D.C. Circuit Court. In December 2015, the D.C. Circuit Court ruled to keep the MATS rule in place while the EPA works to resolve the issues on remand. In November 2015, the EPA filed a proposed supplemental finding that the cost considerations of the rule do not alter the EPA's original determination that it is "appropriate and necessary" to regulate emissions of mercury from EGUs under Section 112 of the Clean Air Act. If the MATS rule is vacated or further delayed, the Wisconsin mercury rule, which has similar regulatory requirements as MATS, will remain in effect for utilities in Wisconsin. While the final version of the MATS rule remains uncertain, MGE has previously determined that current pollution controls on its Columbia and Elm Road Units would meet both MATS and the Wisconsin mercury rule. We do not expect any operational changes once the EPA's actions on remand are finalized.

### *Ozone NAAQS*

In October 2015, the EPA revised the primary and secondary ozone NAAQS, lowering it to 70 ppb. The final standard will likely cause Milwaukee County, where our Elm Road Units are located, to be designated as nonattainment for ozone. The rule may also cause Columbia County (where our Columbia plant is located) and/or Dane County (where

our WCCF and Blount plants are located) to be in nonattainment. Attainment and nonattainment designations are based on ozone data from 2014-2016 and thus are not known at this time. A nonattainment designation may have an effect on operations at our facilities, however, the NAAQS process involves many steps and any effect on our generation units will not be fully understood until the State of Wisconsin develops, receives approval for, and finalizes an implementation plan for any counties found to be in nonattainment. MGE will continue to monitor developments, attainment designations, and state and federal actions.

Sulfur Dioxide (SO<sub>2</sub>) NAAQS

In March 2015, the EPA entered into a court-approved consent decree requiring 1-hour SO<sub>2</sub> attainment/nonattainment area designations to be completed in three phases extending out until 2020. In August 2015, the EPA published its data requirements rule that lays out expectations, designation process options, and timeframes for states and tribes to meet for the SO<sub>2</sub> NAAQS set in 2013. Under this new rule, states must submit their first designation proposals in July 2016 for those areas that contain large stationary sources of SO<sub>2</sub> (sources that emit over a threshold mass of SO<sub>2</sub>, and/or over a threshold emissions rate). These proposals must identify one of the following options for demonstrating attainment with the 1-hour SO<sub>2</sub> NAAQS: modeling of SO<sub>2</sub> emissions; monitoring of SO<sub>2</sub> emissions; or limiting large stationary sources to 2,000 ton per year of SO<sub>2</sub> emissions by January 13, 2017. The EPA must make final designation determinations for these areas between 2017 and 2020 depending on the area.

In March 2015, MGE's Columbia plant was identified in the Federal Register as meeting the criteria of a large stationary source of SO<sub>2</sub> (based on 2012 data). As such, the State of Wisconsin must submit an attainment/nonattainment area designation plan for Columbia County (the county in which the Columbia plant is located). Since the 2012 data was collected, Columbia has installed pollution control equipment that has lowered its total SO<sub>2</sub> emissions and its SO<sub>2</sub> emissions rate. We anticipate, based on recent SO<sub>2</sub> emissions modeling, that Columbia County will be recommended as an attainment area by the state. An attainment recommendation, however, has not yet been submitted by the State of Wisconsin to the EPA. Once the state submits its recommendation, the EPA will make final designations. While the

attainment designation seems likely for Columbia, a nonattainment designation may have an adverse effect on the operation of the Columbia plant. MGE will continue to monitor the developments with the Columbia County designation process. Management believes compliance costs will be recovered in future rates based on previous treatment of environmental compliance projects.

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

In December 2015, the EPA published a proposed rule to amend the existing Cross-State Air Pollution Rule (CSAPR). The proposed rule is designed to incorporate 2008 Ozone NAAQS attainment levels (current CSAPR is based on 1997 Ozone NAAQS levels) in 23 states, including Wisconsin, by establishing a federal implementation plan (FIP) to identify and limit summertime NO<sub>x</sub> levels, a precursor to ozone that contributes to ozone transport. The proposed rule also includes revisions to CSAPR that are designed to resolve issues remaining from the D.C. Circuit remand of CSAPR, including Wisconsin's inclusion in the NO<sub>x</sub> ozone season portion of the rule.

The proposed rule's FIP goes into effect in 2017, which coincides with Phase II of the existing CSAPR. The rule as proposed would reduce ozone season NO<sub>x</sub> emissions by about half as compared to Phase II numbers in the current rule. We are currently evaluating the rule for its impact to MGE and thus do not know with certainty the exact impact. Initial reviews, however, indicate that the proposed CSAPR update as written could have material effects on MGE. We will continue to monitor the rule developments and legal developments to help determine how this rule will ultimately affect MGE.

*Clean Air Visibility Rule (CAVR)*

Columbia may be subject to the best available retrofit technology (BART) regulations, a subsection of the EPA's Clean Air Visibility Rule (CAVR), which may require pollution control retrofits. Columbia's pollution control upgrades and the EPA's stance that compliance with the CSAPR equals compliance with BART should mean that Columbia will not need to do additional work to meet BART requirements. In addition, the EPA has indicated that they intend to extend deadlines in this rule. At this time, however, the BART regulatory obligations, compliance strategies, and costs remain uncertain due to the continued legal uncertainty surrounding CSAPR.

***Global Climate Change***

MGE is a producer of GHG emissions, primarily from the fossil fuel generating facilities it uses to meet customers' energy needs, as well as from its natural gas pipeline system and fleet vehicles. Climate change and the regulatory response to it could significantly affect our operations in a number of ways, including increased operating costs and capital expenditures, restrictions on energy supply options, operational limits on our coal plants, permitting difficulties, and emission limits. MGE management would expect to seek and receive rate recovery of such compliance costs, if and when required. MGE continues to monitor proposed climate change legislation and regulation.

MGE has taken steps to address GHG emissions through voluntary actions. In 2005, MGE announced its Energy 2015 Plan, which committed to ensuring a balanced, economic energy supply with reduced environmental emissions. The Plan emphasized increased renewable energy, energy efficiency, and new cleaner generation three strategies that reduced GHG emissions. Under MGE's Energy 2015 Plan and other actions, our CO<sub>2</sub> emissions declined from 2005 to 2015 by approximately 20% even though total system energy increased. In 2015, MGE announced its Energy 2030 framework and will continue to take steps to reduce CO<sub>2</sub> emissions. Subject to regulatory approvals and other conditions, MGE aims to increase renewable energy to 25% of retail electric sales by 2025 and to 30% by 2030. Under our Energy 2030 framework, we will also work to reduce CO<sub>2</sub> emissions by 40% from 2005 levels by 2030.

### ***Climate Change Legislation***

#### *Federal Legislative Actions on Climate Change*

Several bills and/or actions related to GHG regulation, including those to limit, prevent or delay the EPA's regulation of GHGs under the current Clean Air Act, have been proposed in both the House and the Senate. It is not anticipated that Congress will enact broad GHG reduction legislation in 2016.

#### *State and Regional Legislative Actions on Climate Change*

It is not expected that the Wisconsin Legislature will enact broad GHG regulation in 2016. MGE continues to monitor legislative developments.

## ***Greenhouse Gas Regulation***

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

In October 2015, the EPA published its Clean Power Plan rule, which became effective in December 2015, setting guidelines for states to use in developing plans to control GHG emissions from existing fossil fuel-fired EGUs and systems. In October 2015, the EPA also published a proposed federal implementation plan to be used as an example, or in the event that a state does not submit a plan under this rule. When fully implemented in 2030, the Clean Power Plan is projected to reduce GHG emissions from this sector by 32% below 2005 levels. States are given up to three years to submit a plan or be subject to a federal plan to meet the reduction goals, and states are expected to meet interim goals starting in 2022 and the final goal in 2030. Implementation of the rule is expected to have a direct impact on coal and natural gas fired generating units, including possible changes in dispatch and additional operating costs.

In October 2015, many states (including Wisconsin) and other litigants filed petitions with the U.S. Court of Appeals for the District of Columbia Circuit asking for a stay of the CPP rule, which would otherwise become effective on December 22, 2015, and seeking expedited review of the petitioners' challenges to the CPP's legality. The parties' request to stay the rule was denied by the D.C. Circuit on January 20, 2016, but the D.C. Circuit issued an expedited schedule for resolving the merits of the litigation including oral arguments that will be held in early June 2016. However, on January 26, 2016, several parties filed a request for a stay of the CPP with the U.S. Supreme Court; and on February 9, 2016, the U.S. Supreme Court granted that request. The CPP may not now be implemented until the courts ultimately resolve the underlying legality of the rule. Oral arguments are scheduled before the D.C. Circuit for June 2, 2016.

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

## ***Solid Waste***

### ***EPA's Coal Combustion Residuals Rule***

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

The Columbia and Elm Road Units co-owners and plant operators are evaluating the final rule to determine what changes may be necessary at those facilities and the associated timeframes. We anticipate that some design and operational changes may need to be made at these facilities. Review of our Elm Road facility has indicated that the costs to comply with this rule are not expected to be significant. We are still evaluating the rule's full effects at Columbia. Columbia's operator has developed a preliminary implementation schedule for meeting the various deadlines spelled out in the rule. Management believes compliance costs will be recovered in future rates based on previous treatment of environmental compliance projects.

### *Columbia*

Columbia is a coal-fired generating station operated by WPL in which WPL, WPSC, and MGE have ownership interests. In December 2009, the EPA sent a Notice of Violation (NOV) to MGE as one of the co-owners of Columbia. The NOV alleged that WPL and the Columbia co-owners failed to comply with appropriate pre-construction review and permitting requirements and, as a result, violated the Prevention of Significant Deterioration program requirements, Title V Operating Permit requirements of the CAA, and the Wisconsin SIP. In April 2013, the EPA filed a lawsuit against the co-owners of Columbia asserting similar allegations. In September 2010 and April 2013, the Sierra Club filed civil lawsuits against WPL alleging violations of the CAA at Columbia and other Wisconsin facilities operated by WPL. In June 2013, the court approved and entered a consent decree entered by the EPA, Sierra Club, and the co-owners of Columbia to resolve these claims, while admitting no liability. One of the requirements of the consent decree requires installation of an SCR system at Columbia Unit 2 by December 31, 2018. Installation of the SCR has been approved by the PSCW. MGE's share of the projected cost for the SCR system is approximately \$19-29 million. See Footnote 18.c. of the Notes to Consolidated Financial Statements for additional information regarding this matter.

## Employees

As of December 31, 2015, MGE had 708 employees. MGE employs 222 employees who are covered by a collective bargaining agreement with Local Union 2304 of the International Brotherhood of Electrical Workers and 93 employees who are covered by a collective bargaining agreement with Local Union No. 39 of the Office and Professional Employees International Union. Both of these collective bargaining agreements expire on April 30, 2018. There are also 5 employees covered by a collective bargaining agreement with Local Union No. 2006, Unit 6 of the United Steel, Paper and Forestry, Rubber, Manufacturing, Energy, Allied Industrial, and Service Workers International Union. This collective bargaining agreement expires on October 31, 2018.

## Financial Information About Segments

See Footnote 21 of the Notes to the Consolidated Financial Statements for financial information relating to MGE Energy's and MGE's business segments.

## Executive Officers of the Registrants

| Executive                         | Title  | Effective Date           | Service Years as an Officer |
|-----------------------------------|--|--------------------------|-----------------------------|
| Gary J. Wolter <sup>(a)</sup>     |  |                          |                             |
| Age: 61                           | Chairman of the Board, President and Chief Executive Officer   | 02/01/2002               | 26                          |
| Lynn K. Hobbie <sup>(b)</sup>     |  |                          |                             |
| Age: 57                           | Senior Vice President - Marketing and Communications<br>Senior Vice President - Energy Supply and Planning | 02/01/2000<br>07/23/2015 | 21                          |
| Jeffrey M. Keebler <sup>(b)</sup> | Assistant VP - Energy Supply and Customer Service  | 01/01/2012               | 4                           |
| Age: 44                           | Senior Director - Energy Supply Procurement<br>Vice President and General Counsel                          | 05/01/2007<br>11/02/2015 |                             |
| Cari Anne Renlund <sup>(b)</sup>  | Dewitt Ross & Stevens S.C. (law firm) - Partner  | 06/11 - 10/15            | -                           |
| Age: 42                           | Wisconsin Department of Administration - Chief Legal Counsel   | 01/11 - 05/11            |                             |
| Craig A. Fenrick <sup>(b)</sup>   | Senior Vice President - Energy Operations  | 07/23/2015               | 9                           |
| Age: 56                           | Vice President - Energy Delivery   | 02/10/2015               |                             |

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|                                    |   |            |    |
|------------------------------------|---|------------|----|
|                                    | Vice President - Electric Transmission and Distribution                 | 01/01/2012 |    |
|                                    | Assistant VP - Electric Transmission and Distribution                   | 09/01/2006 |    |
|                                    | Senior Vice President, Chief Financial Officer, Secretary and Treasurer | 07/23/2015 |    |
| Jeffrey C. Newman <sup>(a)</sup>   |   |            | 18 |
| Age: 53                            | Vice President, Chief Financial Officer, Secretary and Treasurer        | 01/01/2009 |    |
|                                    | Vice President - Energy Production                                      | 07/23/2015 |    |
| Peter J. Waldron <sup>(b, c)</sup> | Vice President and Chief Information Officer                            | 01/01/2012 | 19 |
| Age: 58                            | Vice President and Operations Officer                                   | 09/01/2006 |    |

Note: Ages, years of service, and positions as of December 31, 2015.

(a)

Executive officer of MGE Energy and MGE.

(b)

Executive officer of MGE.

(c)

Retired as of December 31, 2015.

**Item 1A. Risk Factors.**

MGE Energy and its subsidiaries, including MGE, operate in a market environment that involves significant risks, many of which are beyond their control. The following risk factors may adversely affect their results of operations, cash flows and market price for their publicly traded securities. While MGE Energy and MGE believe they have identified and discussed below the key risk factors affecting their business, there may be additional risks and uncertainties that are not presently known or that are not currently believed to be significant that may adversely affect their performance or financial condition in the future.

**Regulatory Risk**

*We are subject to extensive government regulation in our business, which affects our costs and responsiveness to changing events and circumstances.*

Our business is subject to regulation at the State and Federal levels. We are subject to regulation as a holding company by the PSCW. MGE is regulated by the PSCW as to its rates, terms and conditions of service; various business practices

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and transactions; financing; and transactions between it and its affiliates, including MGE Energy. MGE is also subject to regulation by the FERC, which regulates certain aspects of its business. The regulations adopted by the State and Federal agencies affect the manner in which we do business, our ability to undertake specified actions since pre-approval or authorization may be required, the costs of operations, and the level of rates charged to recover such costs. Our ability to attract capital is also dependent, in part, upon our ability to obtain a fair return from the PSCW.

***We could be subject to higher costs and potential penalties resulting from mandatory reliability standards.***

MGE must adhere to mandatory reliability standards for its electric distribution system established by NERC. These standards cover areas such as critical infrastructure protection, emergency preparedness, facility design, and transmission operations, among others. The critical infrastructure protection standards focus on physical and access security of cyber assets, as well as incident response and recovery planning. MGE could be subject to higher operating costs in order to maintain compliance with the mandatory reliability standards, and any noncompliance could result in sanctions including monetary penalties.

***We face risk for the recovery of fuel and purchased power costs.***

MGE has price risk exposure with respect to the price of natural gas, electricity, coal, emission credits, and oil. MGE burns natural gas in several of its peak electric generation facilities, and in many cases, the cost of purchased power is tied to the cost of natural gas. Under the electric fuel rules, MGE would defer electric fuel-related costs that fall outside a symmetrical cost tolerance band that is currently plus or minus 2% around the amount approved in its most recent rate order. Any over/under recovery of the actual costs is determined on an annual basis and will be adjusted in future billings to its electric retail customers. Under the electric fuel rules, MGE is required to defer the benefit of lower costs, if its actual fuel costs fall outside the lower end of the range, and would defer costs, less any excess revenues, if its actual fuel costs exceeded 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. MGE assumes the risks and benefits of variances that are within the cost tolerance band.

***We are subject to changing environmental laws and regulations that may affect our costs and business plans.***

Our subsidiaries are subject to environmental laws and regulations that affect the manner in which they conduct business, including capital expenditures, operating costs and potential liabilities. Changes and developments in these laws and regulations may alter or limit our business plans, make them more costly, or expose us to liabilities for past or current operations.

Numerous environmental laws and regulations govern many aspects of our present and future operations, including air emissions, water quality, wastewater discharges, solid waste, threatened and endangered species, and hazardous waste.

These evolving regulations can introduce uncertainty with respect to capital expenditures and operational planning, and can introduce costly delays if previous decisions need to be revisited as a result of judicial mandate or regulatory change. These regulations generally require us to obtain and comply with a wide variety of environmental permits and approvals, and can result in increased capital, operating, and other costs and operating restrictions, particularly with regard to enforcement efforts focused on obligations under existing regulations with respect to power plant emissions and compliance costs associated with regulatory requirements. These effects can be seen not only with respect to new construction but could also require the installation of additional control equipment or other compliance measures such as altered operating conditions at existing facilities.

In addition, we may be a responsible party for environmental clean-up at current or future sites identified as containing hazardous materials or to which waste was sent that is subsequently determined to be hazardous. It is difficult to predict the costs potentially associated with a site clean-up due to the potential joint and several liability for all potentially responsible parties, the nature of the clean-up required, and the availability of recovery from other potentially responsible parties.

The following are significant proposed regulations that are expected to impact our operations:

The EPA's Cross-State Air Pollution Rule (CSAPR) is an interstate air pollution transport rule designed to reduce ozone and fine particulate (PM<sub>2.5</sub>) air levels in areas that the EPA has determined are being affected by pollution from neighboring and upwind states. In December 2015, the EPA published a proposed rule to amend the existing CSAPR. The proposed rule is designed to incorporate 2008 Ozone NAAQS attainment levels (current CSAPR is based on 1997 Ozone NAAQS levels) in 23 states, including Wisconsin, by establishing a federal implementation plan (FIP) to identify and limit summertime nitrogen oxide (NO<sub>x</sub>) levels, a precursor to ozone that contributes to ozone transport. The rule as proposed would reduce ozone season NO<sub>x</sub> emissions by about half as compared to existing Phase II numbers. We are

currently evaluating the rule for its impact to MGE and thus do not know with certainty the exact impact. Initial reviews, however, indicate that the proposed CSAPR update as written could have material effects on MGE.

In October 2015, the EPA published its Clean Power Plan rule, which became effective in December 2015, setting guidelines for states to use in developing plans to control GHG emissions from existing fossil fuel-fired EGUs and systems. When fully implemented in 2030, the Clean Power Plan is projected to reduce GHG emissions from this sector by 32% below 2005 levels. Implementation of the rule is expected to have a direct impact on coal and natural gas fired generating units, including possible changes in dispatch and additional operating costs. Given the pending legal proceedings and the need for a yet-to-be-developed state implementation plan or federal implementation plan, the nature and timing of any final requirements is subject to uncertainty. If the rule remains substantially in its present form, it is expected to have a material impact on MGE.

## **Operating Risk**

*We are affected by weather, which affects customer demand and can affect the operation of our facilities.*

The demand for electricity and gas is affected by weather. Very warm and very cold temperatures, especially for prolonged periods, can dramatically increase the demand for electricity and gas for cooling and heating, respectively, as opposed to the softening effect of more moderate temperatures. Our electric revenues are sensitive to the summer cooling season and, to a lesser extent, the winter heating season. Similarly, very cold temperatures can dramatically increase the demand for gas for heating. A significant portion of our gas system demand is driven by heating. Extreme summer conditions or storms may stress electric transmission and distribution systems, resulting in increased maintenance costs and limiting the ability to meet peak customer demand.

*We could be adversely affected by changes in the development, and utilization by our customers, of power generation and storage technology.*

Developments in power generation and storage could affect our revenues and the timing of the recovery of our costs. Advancements in power generation technology, including commercial and residential solar generation installations and commercial micro turbine installations, are improving the cost-effectiveness of customer self-supply of electricity. Improvements in energy storage technology, including batteries and fuel cells, could also better position customers to meet their around-the-clock electricity requirements. Such developments could reduce customer purchases of electricity, but may not necessarily reduce our investment and operating requirements due to our obligation to serve customers, including those self-supply customers whose equipment has failed for any reason to provide the power they need. In addition, since a portion of our costs are recovered through charges based upon the volume of power delivered, reductions in electricity deliveries will affect the timing of our recovery of those costs and may require changes to our rate structures. Changes in power generation and storage technology could have significant effects on customer behaviors and their energy consumption. Customers could engage in individual conservation efforts by voluntarily reducing their consumption of electricity and pursuing alternative energy sources. Customer energy

conservation could adversely affect our results of operations by reducing our revenues without necessarily changing our operating costs due to our obligation to serve.

*We are affected by economic activity within our service area.*

Higher levels of development and business activity generally increase the numbers of customers and their use of electricity and gas. Likewise, periods of recessionary economic conditions generally adversely affect our results of operations.

*Our ability to obtain an adequate supply of coal could limit our ability to operate our coal-fired facilities.*

The availability of coal and the means to transport coal could:

.

Affect our operating costs due to increased costs associated with lower levels of generation or the need for alternate supply or alternate transportation,

.

Limit our ability to generate electricity if we are unable to arrange adequate deliveries of coal, and

.

Result in potentially higher costs for replacement purchased power as well as potential lost market sales opportunities.

A significant portion of our electric generating capacity is dependent on coal. Increased oil exploration and production in the United States can increase the amount of oil being transported by railroad, which can affect the availability and scheduling of trains to transport coal. Demand for coal has also been impacted by prevailing prices for natural gas and may affect mine performance. Consequently, we are exposed to the risk that counterparties to these contracts will not be able to fulfill their obligations. Disruption in the delivery of fuel, including disruptions as a result of transportation delays, weather, labor relations, force majeure events, or environmental regulations affecting any of these fuel suppliers, could limit our ability to generate electricity at our facilities at the desired level. Should counterparties fail to perform, or other unplanned disruptions occur, we may be forced to replace the underlying commitment at higher prices, or we may be forced to reduce generation at our coal units and replace this lost generation through additional power purchases from third parties. These factors may also affect the terms under which any of our existing coal supply or transportation agreements are renewed or replaced upon the expiration of their current terms.

*Our ability to manage our purchased power costs is influenced by a number of uncontrollable factors.*

We are exposed to additional purchased power costs to the extent that our power needs cannot be fully covered by the supplies available from our existing facilities and contractual arrangements. Those needs, and our costs, could be affected by:

.

Increased demand due to, for example, abnormal weather, customer growth, or customer obligations,

.

The inability to transmit our contracted power from its generation source to our customers due to transmission line constraints, outages, or equipment failures,

.

Reductions in the availability of power from our owned or contracted generation sources due to equipment failures, shortages of fuel or environmental limitations on operations, and

.

Failure to perform on the part of any party from which we purchase capacity or energy, whether due to equipment failures or other causes.

An unexpected change in demand or the availability of generation or transmission facilities can expose us to increased costs of sourcing electricity in the short-term market where pricing may be more volatile.

***The equipment and facilities in our operational system are subject to risks which may adversely affect our financial performance.***

Weather conditions, accidents, and catastrophic events can result in damage or failures of equipment or facilities and disrupt or limit our ability to generate, transmit, transport, purchase, or distribute electricity and gas. Efforts to repair or replace equipment and facilities may take prolonged periods or may be unsuccessful, or we may be unable to make the necessary improvements to our operational system, causing service interruptions. The resulting interruption of services would result in lost revenues and additional costs. We are also exposed to the risk of accidents or other incidents that could result in damage to or destruction of our facilities or damage to persons or property. Such issues could adversely affect revenues or increase costs to repair and maintain our systems.

***Acts of terrorism could materially and adversely impact our operations and financial condition.***

Facilities for electric generation, transmission, and gas distribution are subject to the risk of being potential targets of terrorist threats and activities. A terrorist act at our facilities could result in a disruption of our ability to generate, transmit, transport, purchase, or distribute electricity or natural gas. A possible attack would have additional adverse effects, including environmental ramifications, increased security and insurance costs, as well as general economic volatility or uncertainty within our service territories. The inability to maintain operational continuity and any additional costs incurred for repairing our facilities could materially and adversely affect our financial condition and results of operations.

***We rely on the performance of our information technology systems, the failure of which could have an adverse effect on our business and performance.***

We operate in a highly engineered industry that requires the continued operation of sophisticated information technology systems and network infrastructure to manage our finances, to operate our control facilities, to provide electric and gas service to our customers, and to enable compliance with applicable regulatory requirements. Our computer-based systems are vulnerable to interruption or failure due to the age of certain systems, the introduction of viruses, malware, security breaches, fire, power loss, system malfunction, network outages and other events, which may



be beyond our control. System interruptions or failures, whether isolated or more widespread, could impact our ability to provide service to our customers, which could have a material adverse effect on our operations and financial performance.

***Our operations and confidential information are subject to the risk of cyber-attacks.***

Our operations rely on sophisticated information technology systems and networks. Cyber-attacks targeting our electronic control systems used at our generating facilities and for electric and gas distribution systems, could result in a full or partial disruption of our operations. Any disruption of these operations could result in a loss of service to customers and loss of revenue, as well as significant expense to repair system damage and remedy security breaches.

Our business requires the collection and retention of personally identifiable information of our customers, shareholders, and employees, who expect that we will adequately protect such information. A significant theft, loss, or fraudulent use of personally identifiable information may cause our business reputation to be adversely impacted and could lead to potentially large costs to notify and protect the impacted persons. The occurrence of such an event may cause us to become subject to legal claims, fines, or penalties, any of which could adversely impact our results of operations.

The safeguards we have may not always be effective due to the evolving nature of cyber-attacks. We cannot guarantee that such protections will be completely successful in the event of a cyber-attack. If the technology systems were to fail or be breached by a cyber-attack, and not be recovered in a timely fashion, we may be unable to fulfill critical business functions and confidential data could be compromised, adversely impacting our financial condition and results of operations.

***Failure to attract and retain an appropriately qualified workforce could affect our operations.***

Events such as an aging workforce and retirement of key employees without appropriate replacements may lead to operating challenges and increased costs. Some of the challenges include lack of resources, loss of knowledge, and length of time period associated with skill development. Failure to identify qualified replacement employees could result in decreased productivity and increased safety costs. If we are unable to attract and retain an appropriately qualified workforce, our operations could be negatively affected.

**Financial Risk**

***We are exposed to commodity price risk relating to our purchases of natural gas, electricity, coal and oil.***

We face commodity price risk exposure with respect to our purchases of natural gas, electricity, coal and oil, SO<sub>2</sub> allowances and risk through our use of derivatives, such as futures, forwards and swaps, to manage that commodity price risk. We could experience increased costs as a result of volatility in the market values of those commodities. We could also experience losses on our derivative contracts as a result of that market value volatility or if a counterparty fails to perform under a contract. In the absence of actively quoted market prices and pricing information from external sources, the valuation of these derivative contracts involves our exercise of judgment and use of estimates. As a result, changes in the underlying assumptions or use of alternative valuation methods could affect the reported fair value of these contracts.

***We are exposed to interest rate risk.***

We are exposed to interest rate risk on our variable rate financing. Borrowing levels under commercial paper arrangements vary from period to period depending upon capital investments and other factors. Such interest rate risk means that we are exposed to increased financing costs and associated cash payments as a result of changes in the short-term interest rates.

***Interest rate movements and market performance affects our employee benefit plan costs.***

Prevailing interest rates affect our assessment and determination of discount rates that are a key assumption in the determination of the costs and funding of our defined benefit pension plans and may impact the amount of expense and timing of contributions to those plans. The performance of the capital markets affects the values of the assets that are held in trust to satisfy the future obligations under our pension and postretirement benefit plans. We have significant obligations in these areas and hold significant assets in these trusts. A decline in the market value of those assets may increase our current and longer-term funding requirements for these obligations. Changes in the value of trust fund assets may affect the level of required contributions to these trusts to meet benefit obligations. Reduced benefit plan

assets could result in increased benefit costs in future years and may increase the amount and accelerate the timing of required future funding contributions.

*We are exposed to credit risk primarily through our regulated energy business.*

Credit risk is the loss that may result from counterparty nonperformance. We face credit risk primarily through MGE's regulated energy business. Failure of contractual counterparties to perform their obligations under purchase power agreements, commodity supply arrangements or other agreements may result in increased expenses for MGE as a result of being forced to cover the shortfall in the spot or short-term market, where prices may be more volatile.

*As a holding company, we are dependent on upstream cash flows from our subsidiaries for the payment of dividends on our common stock.*

As a holding company, we have no operations of our own, and our ability to pay dividends on our common stock is dependent on the earnings and cash flows of our operating subsidiaries and their ability to pay upstream dividends or to repay funds to us. Prior to funding us, our subsidiaries have financial obligations that must be satisfied, including among others, debt service and obligations to trade creditors, and are subject to contractual and regulatory restrictions on the payment of dividends.

*Disruptions in the financial markets or changes to our credit ratings may affect our ability to finance at a reasonable cost and in accordance with our planned schedule.*

The credit markets have experienced disruption and uncertainty in recent years. To the extent that such issues affect the ability or willingness of credit providers or investors to participate in the credit markets or particular types of investments, or affect their perception of the risk associated with particular types of investments, our cost of borrowing could be affected. We also rely on our strong credit ratings to access the credit markets. If our credit ratings are downgraded for any reason, borrowing costs could increase, potential investors could decrease, or we could be required to provide additional credit assurance, including cash collateral, to contract counterparties.

*General economic conditions may affect our operating revenues and our counterparty risks.*

#### *Operational*

MGE Energy's and MGE's operations are affected by local, national and worldwide economic conditions. The consequences of a prolonged period of reduced economic activity may include lower demand for energy, uncertainty

regarding energy prices and the capital and commodity markets, and increased credit risk. A decline in energy consumption may adversely affect our revenues and future growth. Increased credit risk reflects the risk that our retail customers will not pay their bills in a timely manner or at all, which may lead to a reduction in liquidity and an eventual increase in bad debt expense.

*Counterparty creditworthiness*

Credit risk also includes the risk that trading counterparties that owe us money or product will breach their obligations. MGE's risk management policy is to limit transactions to a group of high quality counterparties. Should the counterparties to these arrangements fail to perform, we may be forced to enter into alternative arrangements. In that event, our financial results could be adversely affected and we could incur losses.

**Item 1B. Unresolved Staff Comments.**

**MGE Energy and MGE**

None.

**Item 2. Properties.****Electric Generation**

Net summer rated capacity in service at December 31, 2015, was as follows:

| Plants              | Location          | Commercial<br>Operation Date | Fuel            | Net Summer<br>Rated<br>Capacity<br>(MW) <sup>(1)</sup> | No. of<br>Units |
|---------------------|-------------------|------------------------------|-----------------|--|-----------------|
| Steam plants:       |                   |                              |                 |  |                 |
| Columbia            | Portage, WI       | 1975 & 1978                  | Low-sulfur coal | 242 <sup>(2,3)</sup>                                   | 2               |
| Blount              | Madison, WI       | 1957 & 1961                  | Gas             | 103 <sup>(7)</sup>                                     | 2               |
| WCCF                | Madison, WI       | 2005                         | Gas/oil         | 127 <sup>(4)</sup>                                     | 2               |
| Elm Road Units      | Oak Creek, WI     | 2010 & 2011                  | Coal            | 106 <sup>(2,5)</sup>                                   | 2               |
| Combustion turbines | Madison, WI       | 1964-2000                    | Gas/oil         | 153 <sup>(6)</sup>                                     | 6               |
|                     | Marinette, WI     |                              |                 |  |                 |
| Portable generators | Madison, WI       | 1998-2001                    | Diesel          | 50 <sup>(7)</sup>                                      | 54              |
|                     | Townships of      |                              |                 |  |                 |
| Wind turbines       | Lincoln           |                              |                 |  |                 |
|                     | and Red River, WI | 1999                         | Wind            | 1 <sup>(7,8)</sup>                                     | 17              |
|                     | Township of       |                              |                 |  |                 |
|                     | Brookfield, IA    | 2008                         | Wind            | 3 <sup>(7,9)</sup>                                     | 18              |
| Total               |                   |                              |                 | 785  |                 |

(1)

Net summer rated capacity is determined by annual testing and may vary from year to year due to, among other things, the operating and physical conditions of the units.

(2)

Baseload generation.

(3)

MGE's share. See "Columbia" below.

(4)

Facility is jointly owned. Based on the terms of the joint plant agreement between MGE and the UW, the UW has the ability to reduce net capability of these units by approximately 17 MW in the summer. The net summer rated capacity shown reflects this decrease. See "WCCF" below.

(5)

MGE's share. See "Elm Road" below.

(6)

Three facilities are owned by MGE and three facilities are leased.

(7)

These facilities are owned by MGE.

(8)

Nameplate capacity rating is 11 MW.

(9)

Nameplate capacity rating is 30 MW.

### *Columbia*

MGE and two other utilities jointly own Columbia, a coal-fired generating facility consisting of two 512 MW units, which accounts for 31% of MGE's net summer rated capacity. Power from this facility is shared in proportion to each owner's ownership interest. MGE has a 22% ownership interest in Columbia. The other owners are WPL, which operates Columbia, and WPSC. The Columbia units burn low-sulfur coal obtained from the Powder River Basin coal fields located in Wyoming. The coal inventory supply for the Columbia units increased from approximately 48 days on December 31, 2014, to approximately 88 days on December 31, 2015. See "Executive Overview" under Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations, for a discussion of a possible reduction in MGE's future ownership share in Columbia.

*Elm Road Units*

MGE Power Elm Road and two other owners own undivided interests in the Elm Road Units, consisting of two 615 MW units, which account for 14% of MGE's net summer rated capacity. Power from these units is shared in proportion to each owner's ownership interest. MGE Power Elm Road owns an 8.33% ownership interest in the Elm

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Road Units, and its interest in the Elm Road Units is leased to MGE. The other owners are Wisconsin Energy Corporation, which operates the Units, and WPPI Energy, Inc. The Elm Road Units burn bituminous coal obtained from northern West Virginia and southwestern Pennsylvania, and Powder River Basin coal from Wyoming. MGE's share of the coal inventory supply for the Elm Road Units decreased from approximately 53 days on December 31, 2014, to approximately 50 days on December 31, 2015.

MGE leases MGE Power Elm Road's ownership interest in the Elm Road Units pursuant to two separate facility leases. The financial terms of each facility lease include a capital structure of 55% equity and 45% long-term debt, return on equity of 12.7%, and a lease term of 30 years. At the end of the respective lease terms, MGE may, at its option, renew the facility lease for an additional term, purchase the leased ownership interest at fair market value, or allow the lease to end. The Unit 1 and Unit 2 leases commenced with the commercial operation of each respective unit.

#### *WCCF*

MGE Power West Campus and the UW jointly own undivided interests in a natural gas-fired cogeneration facility on the UW campus. The facility has the capacity to produce 20,000 tons of chilled water, 500,000 pounds per hour of steam, and approximately 150 MW of electricity. The UW owns 45% of the facility, which represents its interest in the chilled-water and steam assets. These assets are used to meet a part of the UW's need for air-conditioning and steam-heat capacity. MGE Power West Campus owns 55% of the facility, which represents its interest in the electric generating assets. These assets are used to provide electricity to MGE's customers. The UW's share of the plant and portion of the earnings from the WCCF are not reflected in the consolidated financial statements of MGE Energy or MGE. MGE Power West Campus' share of the cost of this project is reflected in property, plant, and equipment on MGE Energy's and MGE's consolidated balance sheets.

MGE leases the electric generating assets owned by MGE Power West Campus and is responsible for operating the entire facility. The financial terms of the facility lease include a capital structure of 53% equity and 47% long-term debt, return on equity of 12.1%, and a lease term of 30 years. At the end of the lease term in 2035, MGE may, at its option, renew the facility lease for an additional term, purchase the generating facility at fair market value, or allow the lease contract to end.

#### **Electric and Gas Distribution Facilities**

At December 31, 2015, MGE owned 880 miles of overhead electric distribution line and 1,210 miles of underground electric distribution cable, all of which are located in Wisconsin. These electric distribution facilities are connected by approximately 52 substations, installed with a capacity of 1,279,550 kVA. MGE's gas facilities include 2,690 miles of distribution mains, which are all owned by MGE.

A significant portion of MGE's electric and gas distribution facilities are located above or underneath highways, streets, other public places or property that others own. MGE believes that it has satisfactory rights to use those places or property in the form of permits, grants, easements, and licenses; however, it has not necessarily undertaken to examine the underlying title to the land upon which the rights rest.

## **Encumbrances**

The principal plants and properties of MGE are subject to the lien of its Indenture of Mortgage and Deed of Trust dated as of January 1, 1946, as amended and supplemented, under which MGE's first mortgage bonds are issued. As of December 31, 2015, there were \$1.2 million of first mortgage bonds outstanding. See Footnote 9 of the Notes to Consolidated Financial Statements for additional information regarding MGE's first mortgage bonds.

MGE Power Elm Road has collaterally assigned its right to lease payments from MGE for the Elm Road Units in order to secure the repayment of \$65.3 million of senior secured notes issued by MGE Power Elm Road. See Footnote 9 of the Notes to Consolidated Financial Statements for additional information regarding these senior notes.

MGE Power West Campus has collaterally assigned its right to lease payments from MGE for the WCCF in order to secure the repayment of \$46.7 million of senior secured notes issued by MGE Power West Campus. See Footnote 9 of the Notes to Consolidated Financial Statements for additional information regarding these senior notes.

**Item 3. 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 "Environmental" under Item 1. Business and Footnote 18.c. of the Notes to Consolidated Financial Statements for a description of several environmental proceedings involving MGE. See Footnote 18.d. of the Notes to Consolidated Financial Statements for a description of other legal matters.

**Item 4. Mine Safety Disclosures.**

**MGE Energy and MGE**

Not applicable.

**PART II.****Item 5. Market for Registrants' Common Equity, Related Stockholder Matters, and Issuer Purchases of Equity Securities.****Market for Common Equity***MGE Energy*

MGE Energy common stock is traded on Nasdaq under the symbol MGEE. On February 1, 2016, there were approximately 38,308 shareholders of record. The following table shows high and low sale prices for the common stock on Nasdaq for each quarter over the past two years.

|                | Common Stock Price Range |          |          |          |
|----------------|--------------------------|----------|----------|----------|
|                | 2015                     |          | 2014     |          |
|                | High                     | Low      | High     | Low      |
| Fourth quarter | \$ 47.23                 | \$ 39.18 | \$ 48.00 | \$ 37.25 |
| Third quarter  | \$ 41.97                 | \$ 36.75 | \$ 40.85 | \$ 37.25 |
| Second quarter | \$ 45.33                 | \$ 36.46 | \$ 39.68 | \$ 36.30 |
| First quarter  | \$ 47.97                 | \$ 40.66 | \$ 40.71 | \$ 35.66 |

*MGE*

As of February 1, 2016, there were 17,347,894 outstanding shares of common stock, all of which were held by MGE Energy. There is no market for shares of common stock of MGE.

**Dividends***MGE Energy*

The following table sets forth MGE Energy's quarterly cash dividends per share declared during 2015 and 2014:

| <i>(Per share)</i> | 2015     | 2014     |
|--------------------|----------|----------|
| Fourth quarter     | \$ 0.295 | \$ 0.283 |
| Third quarter      | \$ 0.295 | \$ 0.283 |
| Second quarter     | \$ 0.283 | \$ 0.272 |
| First quarter      | \$ 0.283 | \$ 0.272 |

### ***MGE***

The following table sets forth MGE's quarterly cash dividends declared during 2015 and 2014:

| <i>(In thousands)</i> | 2015      | 2014     |
|-----------------------|-----------|----------|
| Fourth quarter        | \$ 10,000 | \$ -     |
| Third quarter         | \$ 10,000 | \$ 9,750 |
| Second quarter        | \$ 10,000 | \$ 9,750 |
| First quarter         | \$ -      | \$ 7,000 |

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

### ***Dividend Restrictions***

Dividend payments by MGE to MGE Energy are subject to restrictions arising under a PSCW rate order and, to a lesser degree, MGE's first mortgage bonds. The PSCW order restricts any dividends, above the PSCW authorized amount of \$43 million, that MGE may pay MGE Energy if its common equity ratio, calculated in the manner used in the rate proceeding, is less than 55%. MGE's thirteen month rolling average common equity ratio at December 31, 2015, is 59.7%, as determined under the calculation used in the rate proceeding. MGE paid cash dividends of \$30.0 million to MGE Energy in 2015. The rate proceeding calculation includes as indebtedness imputed amounts for MGE's



outstanding purchase power capacity payments and other PSCW adjustments, but does not include the indebtedness associated with MGE Power Elm Road and MGE Power West Campus, which are consolidated into MGE's financial statements but are not direct obligations of MGE.

MGE has covenanted with the holders of its first mortgage bonds not to declare or pay any dividend or make any other distribution on or purchase any shares of its common stock unless, after giving effect thereto, the aggregate amount of all such dividends and distributions and all amounts applied to such purchases, after December 31, 1945, shall not exceed the earned surplus (retained earnings) accumulated subsequent to December 31, 1945. As of December 31, 2015, approximately \$353.0 million was available for the payment of dividends under this covenant.

### *Stock Split*

On December 20, 2013, MGE Energy's Board of Directors declared a three-for-two stock split of MGE Energy's outstanding shares of common stock, effective in the form of a stock dividend. Shareholders of record at the close of business on January 24, 2014, received one additional share of MGE Energy common stock for every two shares of common stock owned on that date. The additional shares were distributed on February 7, 2014. Shareholders received cash in lieu of any fractional shares of common stock they otherwise would have received in connection with the dividend. All share and per share data provided in this report give effect to this stock split.

### **Issuer Purchases of Equity Securities**

#### *MGE Energy*

| 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* |
|---------------------|---|------------------------------------|---|--|
| October 1-31, 2015  | 31,025                                    | \$ 41.61                           | -   | -  |
| November 1-30, 2015 | 20,350                                    | 42.44                              | -   | -  |
| December 1-31, 2015 | 69,200                                    | 43.26                              | -   | -  |
| Total               | 120,575                                   | \$ 42.70                           | -   | -  |

\*

*Under the MGE Energy, Inc. Direct Stock Purchase and Dividend Reinvestment Plan (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. MGE Energy uses 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 by MGE Energy pursuant to a registration statement that was filed with the SEC and is currently effective.*

***MGE***

None.

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**Stock Performance Graph**

The performance graph below illustrates a five-year comparison of cumulative total returns based on an initial investment of \$1,000 in MGE Energy common stock, as compared with the Russell 2000 and the EEI Index for the period 2010 through 2015. The EEI Index reflects the consolidated performance of Edison Electric Institute investor-owned electric utilities.

**Cumulative Five-Year Total Return Comparison**

*(assumes \$1,000 invested on 12/31/2010 with dividends reinvested)*

**Value of Investment at December 31,**

|              | 2010     | 2011     | 2012     | 2013     | 2014     | 2015     |
|--------------|----------|----------|----------|----------|----------|----------|
| MGEE         | \$ 1,000 | \$ 1,134 | \$ 1,277 | \$ 1,490 | \$ 1,815 | \$ 1,900 |
| Russell 2000 | 1,000    | 958      | 1,115    | 1,548    | 1,624    | 1,552    |

|           |       |       |       |       |       |       |
|-----------|-------|-------|-------|-------|-------|-------|
| EEI Index | 1,000 | 1,200 | 1,225 | 1,384 | 1,784 | 1,715 |
|-----------|-------|-------|-------|-------|-------|-------|

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**Item 6. Selected Financial Data.****MGE Energy, Inc.***(In thousands, except per share amounts)*

|   | For the Years Ended December 31, |              |              |              |              |
|---|----------------------------------|--------------|--------------|--------------|--------------|
|   | 2015                             | 2014         | 2013         | 2012         | 2011         |
| <b>Summary of Operations</b>                    |                                  |              |              |              |              |
| Operating revenues:                             |                                  |              |              |              |              |
| Regulated electric                              | \$ 412,528                       | \$ 394,849   | \$ 403,957   | \$ 392,365   | \$ 375,858   |
| Regulated gas                                   | 143,737                          | 221,720      | 181,462      | 139,727      | 165,271      |
| Nonregulated                                    | 7,763                            | 3,283        | 5,468        | 9,231        | 5,253        |
| Total operating revenues                        | 564,028                          | 619,852      | 590,887      | 541,323      | 546,382      |
| Operating expenses                              | 419,894                          | 462,102      | 444,293      | 410,200      | 421,170      |
| Other general taxes                             | 19,879                           | 19,652       | 18,607       | 18,360       | 17,344       |
| Operating income                                | 124,255                          | 138,098      | 127,987      | 112,763      | 107,868      |
| Other income, net                               | 8,613                            | 10,079       | 10,701       | 10,069       | 9,214        |
| Interest expense, net                           | (20,162)                         | (19,673)     | (18,924)     | (19,467)     | (20,162)     |
| Income before taxes                             | 112,706                          | 128,504      | 119,764      | 103,365      | 96,920       |
| Income tax provision                            | (41,363)                         | (48,185)     | (44,859)     | (38,919)     | (35,992)     |
| Net income                                      | \$ 71,343                        | \$ 80,319    | \$ 74,905    | \$ 64,446    | \$ 60,928    |
| Average shares outstanding                      | 34,668                           | 34,668       | 34,668       | 34,668       | 34,668       |
| Basic and diluted earnings per share            | \$ 2.06                          | \$ 2.32      | \$ 2.16      | \$ 1.86      | \$ 1.76      |
| Dividends declared per share                    | \$ 1.16                          | \$ 1.11      | \$ 1.07      | \$ 1.04      | \$ 1.01      |
| <b>Assets<sup>(a)</sup></b>                     |                                  |              |              |              |              |
| Electric  | \$ 976,271                       | \$ 948,005   | \$ 899,257   | \$ 892,039   | \$ 794,738   |
| Gas   | 299,792                          | 307,582      | 265,694      | 284,249      | 285,702      |
| Assets not allocated                            | 49,753                           | 41,124       | 19,853       | 18,549       | 32,882       |
| Nonregulated energy operations                  | 278,735                          | 281,514      | 288,116      | 292,072      | 299,421      |
| Transmission investments                        | 69,470                           | 67,697       | 64,504       | 61,064       | 57,006       |
| All others                                      | 434,868                          | 438,898      | 431,436      | 412,840      | 401,862      |
| Eliminations                                    | (378,216)                        | (390,636)    | (389,800)    | (397,372)    | (412,729)    |
| Total assets                                    | \$ 1,730,673                     | \$ 1,694,184 | \$ 1,579,060 | \$ 1,563,441 | \$ 1,458,882 |
| <b>Capitalization including Short-Term Debt</b> |                                  |              |              |              |              |
| Common shareholders' equity                     | \$ 690,458                       | \$ 659,401   | \$ 617,510   | \$ 579,429   | \$ 550,952   |
| Long-term debt <sup>(b)</sup>                   | 395,280                          | 399,438      | 403,516      | 361,504      | 363,570      |
| Short-term debt                                 | -                                | 7,000        | -            | -            | -            |
| Total capitalization and short-term debt        | \$ 1,085,738                     | \$ 1,065,839 | \$ 1,021,026 | \$ 940,933   | \$ 914,522   |

(a)

Reflects retrospective application of new accounting pronouncement. See Footnote 12 of the Notes to the Consolidated Financial Statements for additional information.

(b)

Includes current maturities.

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

*General*

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

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

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

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

*Executive Overview*

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

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

.

Weather, and its impact on customer sales,

.

Economic conditions, including current business activity and employment and their impact on customer demand,

.

Regulation and regulatory issues, and their impact on the timing and recovery of costs,

.

Energy commodity prices, including natural gas prices,

.

Equity price risk pertaining to pension related assets,

.

Credit market conditions, including interest rates and our debt credit rating,

.

Environmental laws and regulations, including adopted and pending environmental rule changes,

and other factors listed in Item 1A. Risk Factors.

For the year ended December 31, 2015, MGE Energy's earnings were \$71.3 million or \$2.06 per share compared to \$80.3 million or \$2.32 per share for the same period in the prior year. MGE's earnings for the year ended December 31, 2015, were \$45.4 million compared to \$55.6 million for the same period in the prior year.

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

| <i>(In millions)</i><br><b>Business Segment:</b> | Year Ended December 31, |         |         |
|--|-------------------------|---------|---------|
|  | 2015                    | 2014    | 2013    |
| Electric Utility                                 | \$ 36.4                 | \$ 41.4 | \$ 36.7 |
| Gas Utility                                      | 10.4                    | 15.8    | 13.4    |
| Nonregulated Energy                              | 20.1                    | 19.3    | 20.7    |
| Transmission Investments                         | 4.6                     | 5.5     | 5.6     |
| All Other  | (0.2)                   | (1.7)   | (1.5)   |
| Net Income                                       | \$ 71.3                 | \$ 80.3 | \$ 74.9 |

Our net income during 2015 compared to 2014 primarily reflects the effects of the following factors:

Electric net income decreased due to lower AFUDC and higher depreciation expense primarily related to the Columbia environmental project being placed in service in April (Unit 2) and July 2014 (Unit 1). In addition, there was a 0.3% decrease in electric retail sales in 2015 compared to the same period in the prior year.

Gas net income decreased due to a 27.0% decrease in gas retail sales reflecting lower customer demand compared to the demand resulting from the extremely cold weather experienced in 2014. Heating degree days (a measure for determining the impact of weather during the heating season) decreased by 18.9% compared to the prior year. The average temperature in January 2015 was 20.1 degrees compared to 11.5 degrees in the prior year.

Transmission investment income reflects our share of ATC's earnings. ATC's earnings for 2015 reflect a charge representing its estimate of its refund liability associated with the return on equity complaint filed with FERC. See "Other Matters" below for additional information concerning ATC.

The increase in all other income primarily results from a decrease in voluntary contributions.

Our net income during 2014 compared to 2013 primarily reflects the effects of the following factors:

Electric net income increased compared to the prior period primarily related to ongoing efforts to manage electric operating and maintenance expenditures.

Gas net income increased due to a 4.8% increase in gas retail sales reflecting higher customer demand due to a colder winter. The average temperatures in January and February 2014 were 11.5 degrees and 12.5 degrees, respectively, compared to 21.8 degrees and 21.3 degrees in the prior year. During 2014, heating degree days increased by 3.4% compared to the prior year. In addition, gas operating and maintenance expenditures decreased over the prior year.

In 2013, the PSCW approved recovery of the force majeure costs incurred during construction of the Elm Road Units. The higher non-regulated revenue in 2013 reflects the one-time adjustment for the carrying costs incurred in the prior periods on the force majeure costs.

During 2015, the following events occurred:

**2015 Rate Filing:** In December 2014, the PSCW authorized MGE to increase 2015 rates for retail electric customers by 3.8% and to decrease rates for gas customers by 2.0%. The increase in retail electric rates cover costs associated with the construction of emission-reduction equipment at Columbia, improvements and reliability of the state's electric transmission system, fuel and purchased power related to coal delivery costs, partially offset by lower cost as a result of market conditions for pension and post-retirement benefit costs.

The PSCW approved a change in the electric and gas rate design as part of the December 2014 rate order. The rate design better aligns the related fixed costs of providing gas and electric services. For example, the change lowers the gas distribution variable rate (excluding purchased gas) by approximately two-thirds and increases the fixed customer charge. Thus, gas earnings will be less sensitive to weather as a result of the change in rate design. Also, gas earnings will be more evenly spread throughout the year rather than being predominantly recognized in the winter months.

**ATC Return on Equity:** Several parties have filed a complaint with the FERC seeking to reduce the base return on equity (ROE) used by MISO transmission owners, including ATC. MISO's base ROE is 12.38% and ATC's base ROE is 12.2%. In December 2015, an administrative law judge issued an initial decision authorizing transmission owners to collect a base ROE of 10.32%. The initial decision will be reviewed by FERC and it is anticipated FERC will issue an



order on this issue by October 2016. In February 2015, a second complaint was filed with the FERC requesting a reduction in the base ROE used by MISO transmission owners, including ATC, to 8.67%, with a refund effective date retroactive to the filing date of the complaint. An initial decision from the administrative law judge is expected by June 30, 2016. In January 2015, FERC accepted the transmission owner's request for a 50 basis-point incentive ROE adder for participating in MISO. The adder became effective January 6, 2015, subject to refund, and FERC accepted the transmission owner's request to defer collection of the adder pending the outcome of the first ROE complaint proceeding. Our share of ATC's earnings for 2015 and 2014 reflects a pre-tax charge of \$2.4 million and \$0.7 million, respectively, recorded by ATC for this matter representing its estimate of its refund liability for the period of November 2013 through December 2015. Any change to ATC's ROE could result in lower equity earnings and distributions from ATC in the future. We derived approximately 6.4% and 6.7% of our net income for the years ended December 31, 2015 and 2014, respectively, from our investment in ATC. See "Other Matters" below for additional information concerning ATC.

During 2016, several items may affect us, including:

**2016 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. This accounting treatment will allow MGE to reflect any differential between transmission costs reflected in rates and actual costs incurred in its next rate case filing.

**2016 Annual Fuel Proceeding:** In August 2015, the PSCW approved a \$0.00256/kWh fuel credit to begin on September 1, 2015, and continue throughout 2016. The fuel credit established a mechanism to return fuel savings to electric customers as a bill credit. MGE returned \$2.6 million of electric fuel-related savings in customer bill credits during the period from September 1, 2015, through December 31, 2015. As of December 31, 2015, MGE has deferred \$9.5 million of 2015 electric fuel-related savings that are outside the range authorized by the PSCW. These costs are subject to PSCW's annual review, expected to be completed in 2016.

In January 2016, the PSCW lowered MGE's 2016 fuel rules monitored costs by \$14.8 million as a result of continued lower projected fuel costs in 2016. The PSCW will address the return of the 2016 fuel savings to customers as an update to the fuel credit or through another approved mechanism. The return of the fuel savings to customers for 2016 will be addressed during the PSCW's annual review during 2016 of 2015 fuel costs. MGE will defer these fuel savings until a determination is made by the PSCW.

**Loss of Industrial Customer:** In November 2015, a large industrial customer announced its intention to relocate its operations out of state and to close its manufacturing facilities within our service territory. That closure is expected to occur in early 2017. This customer contributed approximately \$3.8 million of pre-tax earnings for the year ended December 31, 2015. While we expect that our rate request for 2017, which would be filed during 2016, will be structured to address the effects of the closure, there could be some impact on our electric revenues during 2016 if the customer's operations are curtailed as a result of the impending closure.

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

EPA's Clean Power Plan: On August 3, 2015, the EPA finalized its Clean Power Plan rule setting guidelines for states to use in developing plans to control GHG emissions from existing fossil fuel-fired EGUs and systems.

Implementation of the rule is expected to have a direct impact on coal-based generating units, including possible changes in dispatch and additional operating costs. MGE is currently evaluating the rule and its requirements.

Although the implementation of the rule is presently stayed as a result of a February 9, 2016, U.S. Supreme Court ruling, compliance with the rule's requirements, including the yet-to-be-developed state implementation plan, could have a material impact on MGE if the rule is upheld and becomes effective.

Pension and Other Postretirement Benefit Costs: Costs for pension and other postretirement benefits are affected by actual investment returns on the assets held for those benefits and by the discount rate, which is sensitive to interest rates, used to calculate those benefits. Interest rates and investment returns have experienced volatility since the end of the year which could affect the value of the pension and postretirement benefit obligations. The changes in the discount

rates and value of plan assets are not expected to have an impact on the income statements for 2016. However, these changes may affect benefit costs in future years. MGE expects changes in the cost for employee benefit plans will be factored into future rate actions.

**Future Generation:** MGE is negotiating an agreement in 2016 with Alliant Energy that would allow MGE to reduce its coal ownership in Columbia and give MGE potential investment ability in efficient new natural gas generation. In the proposed agreement with Alliant Energy, MGE may acquire up to a 50 MW share of the capacity of Alliant Energy's proposed Riverside Energy Center project. Alliant Energy's Riverside project, which calls for an approximately 700 MW expansion of its existing natural gas generation facility, is currently under review by the PSCW. A final decision is expected this spring. If approved, project completion is expected by early 2020. Also as part of the proposed agreement, MGE may forgo certain capital expenditures at Columbia, which Alliant Energy then will pay for in exchange for a proportional increase in its ownership share of the plant. The arrangement excludes capital expenditures related to the recently approved project to install additional environmental controls on Unit 2 at Columbia. MGE currently owns 22% of Columbia.

**General Economic Conditions:** Economic conditions both inside and outside our service area are expected to continue to affect the level of demand for our utility services and may affect the collection of our accounts receivable and the creditworthiness of counterparties with whom we do business. We have in place lines of credit aggregating \$150 million for MGE Energy (including MGE) and \$100 million for MGE to address our liquidity needs. As of December 31, 2015, there were no borrowings outstanding under MGE Energy's or MGE's lines of credit.

The following discussion is based on the business segments as discussed in Footnote 21 of the Notes to Consolidated Financial Statements.

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

#### ***Year Ended December 31, 2015, Versus the Year Ended December 31, 2014***

#### **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:

Revenues

Sales (kWh)

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| <i>(In thousands, except cooling degree days)</i> | 2015       | 2014       | % Change | 2015      | 2014      | % Change |
|---|------------|------------|----------|-----------|-----------|----------|
| Residential                                       | \$ 135,201 | \$ 132,359 | 2.1 %    | 786,741   | 807,265   | (2.5)%   |
| Commercial  | 220,745    | 210,141    | 5.0 %    | 1,831,251 | 1,834,473 | (0.2)%   |
| Industrial  | 20,283     | 19,163     | 5.8 %    | 248,443   | 246,267   | 0.9 %    |
| Other-retail/municipal                            | 38,824     | 36,281     | 7.0 %    | 422,188   | 409,737   | 3.0 %    |
| Total retail                                      | 415,053    | 397,944    | 4.3 %    | 3,288,623 | 3,297,742 | (0.3)%   |
| Sales to the market                               | 2,154      | 2,547      | (15.4)%  | 68,886    | 68,727    | 0.2 %    |
| Other revenues                                    | 1,705      | 1,489      | 14.5 %   | -         | -         | -%       |
| Adjustments to revenues                           | (6,384)    | (7,131)    | 10.5 %   | -         | -         | -%       |
| Total   | \$ 412,528 | \$ 394,849 | 4.5 %    | 3,357,509 | 3,366,469 | (0.3)%   |
| Cooling degree days<br>(normal 665)               |            |            |          | 666       | 620       | 7.4 %    |

Electric operating revenues increased \$17.7 million or 4.5% for the year ended December 31, 2015, due to the following:

| <i>(In millions)</i>    |         |
|-------------------------|---------|
| Rate changes            | \$ 14.4 |
| Fuel credit             | 3.9     |
| Adjustments to revenues | 0.8     |
| Other revenues          | 0.4     |
| Volume                  | (1.4)   |
| Sales to the market     | (0.4)   |
| Total                   | \$ 17.7 |

*Rate changes.* Rates charged to retail customers for the year ended December 31, 2015, were \$14.4 million or 3.6% higher than those charged during the same period in the prior year.

In December 2014, the PSCW authorized MGE to increase 2015 rates for retail electric customers by \$15.4 million or 3.8%. See "2015 Rate Filing" under "Executive Overview" for more information.

*Fuel Credit.* During the years ended December 31, 2015 and 2014, customers received a fuel credit on their bill related to the fuel savings of \$2.6 million and \$6.5 million, respectively, which increased electric revenues when compared to the same period in the prior year.

*Adjustments to Revenue.* The adjustments to revenues amount includes the elimination of carrying costs for the Elm Road Units and the WCCF that were collected in electric rates, which are recognized as nonregulated energy operating revenues in our Nonregulated Energy Operations segment.

*Volume.* During the year ended December 31, 2015, there was a 0.3% decrease in total retail sales volumes compared to the same period in the prior year primarily driven by lower use per residential customer.

*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. 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 year ended December 31, 2015, market volumes increased compared to the same period in the prior year, reflecting increased opportunities for sales. In addition, market settlement resulted in lower revenue per kWh for the year ended December 31, 2015, reflecting lower market prices.

***Electric fuel and purchased power***

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

Fuel for electric generation

The expense for fuel for internal electric generation increased \$11.0 million during the year ended December 31, 2015, compared to the same period in the prior year, due to the following:

|                           |         |
|---------------------------|---------|
| <i>(In millions)</i>      |         |
| Increase in per-unit cost | \$ 5.8  |
| Increase in volume        | 5.2     |
| Total                     | \$ 11.0 |

This increase in expense reflects a 13.6% increase in per-unit cost of internal electric generation primarily at Columbia and a 10.7% increase in internal generated volume delivered to the system.

Purchased power

Purchased power expense increased \$8.0 million during the year ended December 31, 2015, compared to the same period in the prior year, due to the following:

|  |           |
|--|-----------|
| <i>(In millions)</i>                           |           |
| Decrease in volume                             | \$ (11.0) |
| Decrease in per-unit cost                      | (2.8)     |
| Fuel Rules Adjustments                         |           |
| Increase in recorded fuel rule credit          | 11.6      |
| Return of fuel credit in 2015                  | (2.6)     |
| Amortization of 2012 fuel rule credits in 2014 | 6.3       |
| Return of fuel credit in 2014                  | 6.5       |
| Total  | \$ 8.0    |

The decrease in expense (before fuel rules adjustments) reflects a 3.8% decrease in the per-unit cost of purchased power and a 12.8% decrease in the volume of power purchased from third parties primarily as a result of increased internal generation.



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. Any over/under recovery of the deferred costs is determined on an annual basis and adjusted in future billings to customers. During the year ended December 31, 2015, MGE deferred \$11.6 million in fuel related cost savings to be returned to customers. In addition, MGE returned \$2.6 million of electric fuel-related savings on customer bills during the year ended December 31, 2015. During the year ended December 31, 2014, as part of its rate freeze, MGE amortized \$6.3 million of the 2012 fuel rule credits, which reduced purchased power expense for that period. In addition, MGE returned \$6.5 million on customer bills in October 2014 related to the 2013 fuel rules credit.

### *Electric operating and maintenance expenses*

Electric operating and maintenance expenses increased \$4.0 million during the year ended December 31, 2015, compared to the same period in 2014. The following changes contributed to the net change:

*(In millions)*

|  |    |       |
|--|----|-------|
| Increased transmission costs               | \$ | 3.3   |
| Increased administrative and general costs |    | 1.6   |
| Increased customer service costs           |    | 0.5   |
| Increased production costs                 |    | 0.1   |
| Decreased customer accounts costs          |    | (1.5) |
| Total                                      | \$ | 4.0   |

For the year ended December 31, 2015, increased transmission costs are primarily related to an increase in transmission reliability enhancements. In addition, increased administrative and general costs are primarily due to increased pension and other postretirement benefits costs predominantly driven by a reduction in the discount rate, which has the effect of increasing the related costs. Decreased customer account costs are primarily related to lower uncollectible accounts receivable.

### *Electric depreciation expense*

Electric depreciation expense increased \$3.0 million for the year ended December 31, 2015, compared to the same period in the prior year. This increase is primarily related to the completion of the Columbia environmental project. The systems and equipment for Unit 2 and Unit 1 were placed into service in April 2014 and July 2014, respectively.

### *Other Electric Income*

Other electric income decreased \$2.4 million, primarily due to AFUDC equity related to the completion of the Columbia environmental project. Unit 2 and Unit 1 were placed into service in April and July 2014, respectively.

## 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<br/>and average rate per therm of<br/>retail customer)</i> | Revenues   |            |             | Therms Delivered |         |             |
|---|------------|------------|-------------|------------------|---------|-------------|
|   | 2015       | 2014       | %<br>Change | 2015             | 2014    | %<br>Change |
| Residential   | \$ 85,438  | \$ 117,523 | (27.3)%     | 92,970           | 110,422 | (15.8)%     |
| Commercial/Industrial   | 53,161     | 100,338    | (47.0)%     | 88,489           | 138,151 | (35.9)%     |
| Total retail  | 138,599    | 217,861    | (36.4)%     | 181,459          | 248,573 | (27.0)%     |
| Gas transportation  | 4,652      | 3,373      | 37.9 %      | 75,572           | 46,905  | 61.1 %      |
| Other revenues  | 486        | 486        | -%          | -                | -       | -%          |
| Total   | \$ 143,737 | \$ 221,720 | (35.2)%     | 257,031          | 295,478 | (13.0)%     |
| Heating degree days (normal<br>7,080)   |            |            |             | 6,395            | 7,887   | (18.9)%     |
| Average rate per therm of<br>retail customer  | \$ 0.764   | \$ 0.876   | (12.8)%     |                  |         |             |

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Gas revenues decreased \$78.0 million or 35.2% for the year ended December 31, 2015. These changes are related to the following factors:

|                                  |           |
|----------------------------------|-----------|
| <i>(In millions)</i>             |           |
| Volume                           | \$ (58.8) |
| Rate/PGA changes                 | (20.5)    |
| Transportation and other effects | 1.3       |
| Total                            | \$ (78.0) |

*Volume.* For the year ended December 31, 2015, retail gas deliveries decreased 27.0% compared to the same period in the prior year, as a result of extremely cold weather experienced in the first quarter of 2014. The decrease was also attributable to a large commercial customer's decision to purchase gas from a third party supplier and to use MGE's facilities for the transport of that gas. While the shift affects revenues, the impact to gas income of this shift is not material as we do not earn margin on the natural gas commodity cost billed to customers.

*Rate/PGA changes.* In December 2014, the PSCW approved changes to customer rates and rate design for gas service. Rates were reduced by 2.0%, effective January 1, 2015. Gas rate design consists of a fixed monthly customer charge and a variable charge tied to actual usage, in addition to the separate charge for natural gas commodity costs that is recovered through the PGA. The change shifted more of the rate recovery to the monthly charge, reflecting the related fixed costs of providing gas services, and reduced the variable usage-based charge. Thus, gas net income was more evenly distributed during the year and less sensitive to weather.

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 year ended December 31, 2015, decreased 12.8% compared to the same period in 2014, reflecting a \$28.7 million decrease in natural gas commodity costs (PGA) offset by an \$8.2 million increase (comprised of a decrease in variable rate costs offset by an increase in fixed rate charges) related to rate design changes. As noted previously, as a result of the rate design changes, revenues in the first and fourth quarters, when usage is higher, were lower than in past years; and revenues in the second and third quarters, when usage is lower, were higher than in past years.

*Transportation and other effects.* During the year ended December 31, 2015, transportation and other effects increased \$1.3 million primarily attributable to a large commercial customer's decision to purchase gas from a third party supplier and to use MGE's facilities for the transport of that gas. The impact to gas income of this shift is not material.

***Cost of gas sold***

For the year ended December 31, 2015, cost of gas sold decreased by \$67.5 million, compared to the same period in the prior year. The volume of gas purchased decreased 26.8%, which resulted in \$38.5 million of decreased expense. The cost per therm of natural gas decreased 27.6%, which resulted in \$29.0 million of decreased expense.

***Gas operating and maintenance expenses***

Gas operating and maintenance expenses decreased \$1.2 million for the year ended December 31, 2015, compared to the same period in 2014. The following changes contributed to the net change.

|  |          |
|--|----------|
| <i>(In millions)</i>                       |          |
| Decreased customer service costs           | \$ (1.0) |
| Decreased customer accounts costs          | (0.9)    |
| Increased administrative and general costs | 0.7      |
| Total                                      | \$ (1.2) |

For the year ended December 31, 2015, decreased customer service costs are due to lower Focus on Energy payments, Wisconsin's statewide energy efficiency and renewable resource program to promote energy efficiency on customer's premises. Decreased customer accounts costs are due to lower uncollectible accounts receivable. Increased administrative and general costs are primarily due to increased pension and other postretirement benefit costs predominantly driven by a reduction in the discount rate.

### **Nonregulated Energy Operations - MGE Energy and MGE**

For the years ended December 31, 2015 and 2014, net income at the nonregulated energy operations segment was \$20.1 million and \$19.3 million, respectively. 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.

### **Transmission Investment Operations - MGE Energy and MGE**

#### *Transmission investment other income*

For the years ended December 31, 2015 and 2014, other income at the transmission investment segment was \$7.7 million and \$9.2 million, respectively. The transmission investment segment holds our interest in ATC, and its income reflects our equity in the earnings of ATC. See Footnote 4.b. of the Notes to Consolidated Financial Statements and Other Matters below for additional information concerning ATC and summarized financial information regarding ATC.

### **All Other Operations - MGE Energy and MGE**

#### *Other income*

The increase in all other income primarily results from a decrease in voluntary contributions.

### **Consolidated Income Taxes - MGE Energy and MGE**

Both MGE Energy's and MGE's effective income tax rate for the years ended December 31, 2015 and 2014, was 36.7% and 37.5%, respectively. The decrease in the effective tax rate is due in part to a higher estimated domestic manufacturing deduction, offset by lower AFUDC equity earnings in 2015.

### **Noncontrolling Interest, Net of Tax - MGE**

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

| <i>(In millions)</i>       | Year Ended December 31, |         |
|----------------------------|-------------------------|---------|
|                            | 2015                    | 2014    |
| MGE Power Elm Road         | \$ 16.6                 | \$ 16.2 |
| MGE Power West Campus      | \$ 7.3                  | \$ 7.7  |
| MGE Transco <sup>(a)</sup> | \$ 2.2                  | \$ 2.4  |

(a)

In mid-2016, MGE is no longer expected to be the majority owner of MGE Transco. The change will have no effect on MGE Energy's consolidated financial statements; however, MGE Energy's proportionate share of the equity and net income of MGE Transco will be deconsolidated from MGE's financial statements. See further discussion in Footnote 8 of the Consolidated Financial Statements.

**Results of Operations****Year Ended December 31, 2014, Versus the Year Ended December 31, 2013****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:

|   | Revenues   |            |             | Sales (kWh) |           |             |
|---|------------|------------|-------------|-------------|-----------|-------------|
|   | 2014       | 2013       | %<br>Change | 2014        | 2013      | %<br>Change |
| <i>(In thousands, except cooling degree days)</i> |            |            |             |             |           |             |
| Residential                                       | \$ 132,359 | \$ 135,597 | (2.4)%      | 807,265     | 819,012   | (1.4)%      |
| Commercial  | 210,141    | 214,033    | (1.8)%      | 1,834,473   | 1,821,966 | 0.7 %       |
| Industrial  | 19,163     | 19,872     | (3.6)%      | 246,267     | 250,229   | (1.6)%      |
| Other-retail/municipal                            | 36,281     | 39,143     | (7.3)%      | 409,737     | 423,261   | (3.2)%      |
| Total retail                                      | 397,944    | 408,645    | (2.6)%      | 3,297,742   | 3,314,468 | (0.5)%      |
| Sales to the market                               | 2,547      | 1,134      | 124.6 %     | 68,727      | 50,606    | 35.8 %      |
| Other revenues                                    | 1,489      | 1,312      | 13.5 %      | -           | -         | -%          |
| Adjustments to revenues                           | (7,131)    | (7,134)    | -%          | -           | -         | -%          |
| Total   | \$ 394,849 | \$ 403,957 | (2.3)%      | 3,366,469   | 3,365,074 | -%          |
| Cooling degree days<br>(normal 665)               |            |            |             | 620         | 709       | (12.6)%     |

Electric operating revenues decreased \$9.1 million or 2.3% for the year ended December 31, 2014, due to the following:

|                      |          |
|----------------------|----------|
| <i>(In millions)</i> |          |
| Fuel credit          | \$ (6.5) |
| Other                | (2.2)    |
| Volume               | (1.8)    |
| Sales to the market  | 1.4      |
| Total                | \$ (9.1) |

In July 2013, the PSCW authorized MGE to freeze 2014 rates at 2013 levels for retail electric customers.

*Fuel Credit.* During the year ended December 31, 2014, customers received a fuel credit on their bill related to the 2013 fuel savings of \$6.5 million, which decreased electric revenues when compared to the same period in the prior year.

*Other.* During the year ended December 31, 2014, other items affecting electric operating revenues decreased \$2.2 million primarily attributable to a decrease in demand charges, lower monthly on-peak sales, and a shift in commercial customer rate classes.

*Volume.* During the year ended December 31, 2014, there was a 0.5% decrease in total retail sales volumes compared to the same period in the prior year driven by cooler than normal weather.

*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 year ended December 31, 2014, market volumes increased compared to the same period in the prior year, reflecting increased opportunities for sales. In addition, market settlement resulted in higher revenue per kWh for the year ended December 31, 2014, reflecting higher market prices.

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

Electric fuel and purchased power costs reflect a decrease in internal generation volumes partially 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, moderated the effects of that increased volume. These items are explained below.



Fuel for electric generation

The expense for fuel for internal electric generation decreased \$3.2 million during the year ended December 31, 2014, compared to the same period in the prior year, due to the following:

|                           |          |
|---------------------------|----------|
| <i>(In millions)</i>      |          |
| Decrease in volume        | \$ (6.8) |
| Increase in per-unit cost | 3.6      |
| Total                     | \$ (3.2) |

This decrease in expense reflects a 13.7% decrease in internal generated volume delivered to the system primarily as a result of reduced generation at Columbia to reduce coal use in order to maintain inventory levels, partially offset by a 7.7% increase in per-unit cost of internal electric generation.

Purchased power

Purchased power expense decreased \$7.6 million during the year ended December 31, 2014, compared to the same period in the prior year, due to the following:

|  |          |
|--|----------|
| <i>(In millions)</i>                   |          |
| Increase in volume                     | \$ 17.3  |
| Decrease in per-unit cost              | (5.4)    |
| Fuel Rules Adjustments                 |          |
| Decrease in recorded fuel rule credit  | (6.7)    |
| Amortization of 2012 fuel rule credits | (6.3)    |
| Return of 2013 fuel rule credits       | (6.5)    |
| Total                                  | \$ (7.6) |

The decrease in expense reflects a 5.9% decrease in the per-unit cost of purchased power and a 23.4% increase in the volume of power purchased from third parties primarily as a result of the reduced generation at Columbia.

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. Any over/under recovery of the deferred costs is determined on an annual basis and adjusted in future billings to customers. During the year ended December 31, 2014, as part of its rate freeze, MGE was allowed to amortize \$6.3 million of the 2012 fuel rule credit as a reduction of purchased power costs. In addition, MGE returned \$6.5 million on customer bills in October 2014 related to the 2013 fuel rules credit.

***Electric operating and maintenance expenses***

Electric operating and maintenance expenses decreased \$8.1 million during the year ended December 31, 2014, compared to the same period in 2013. The following changes contributed to the net change:

*(In millions)*

|  |    |       |
|--|----|-------|
| Decreased administrative and general costs | \$ | (5.9) |
| Decreased customer service costs           |    | (0.8) |
| Decreased distribution costs               |    | (0.7) |
| Decreased production costs                 |    | (0.4) |
| Decreased customer accounts costs          |    | (0.2) |
| Decreased transmission costs               |    | (0.1) |
| Total                                      | \$ | (8.1) |

For the year ended December 31, 2014, decreased administrative and general costs are primarily due to decreased pension and other postretirement benefits costs predominantly driven by an increase in the discount rate, which has the effect of reducing the related costs.

***Electric depreciation expense***

Electric depreciation expense increased \$1.2 million for the year ended December 31, 2014, compared to the same period in the prior year. This increase was a result of Columbia assets going in to service in April and July 2014.

**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 |         |          |
|---|------------|------------|----------|------------------|---------|----------|
|   | 2014       | 2013       | % Change | 2014             | 2013    | % Change |
| Residential   | \$ 117,523 | \$ 98,578  | 19.2 %   | 110,422          | 102,599 | 7.6 %    |
| Commercial/Industrial   | 100,338    | 79,344     | 26.5 %   | 138,151          | 134,619 | 2.6 %    |
| Total retail  | 217,861    | 177,922    | 22.4 %   | 248,573          | 237,218 | 4.8 %    |
| Gas transportation  | 3,373      | 3,025      | 11.5 %   | 46,905           | 37,778  | 24.2 %   |
| Other revenues  | 486        | 515        | (5.6)%   | -                | -       | -%       |
| Total   | \$ 221,720 | \$ 181,462 | 22.2 %   | 295,478          | 274,996 | 7.4 %    |
| Heating degree days (normal 7,047)  |            |            |          | 7,887            | 7,628   | 3.4 %    |
| Average rate per therm of retail customer                                       | \$ 0.876   | \$ 0.750   | 16.8 %   |                  |         |          |

Gas revenues increased \$40.3 million or 22.2% for the year ended December 31, 2014. These changes are related to the following factors:

| <i>(In millions)</i>             |         |
|----------------------------------|---------|
| Rate/PGA changes                 | \$ 31.4 |
| Volume                           | 8.5     |
| Transportation and other effects | 0.4     |
| Total                            | \$ 40.3 |

*Rate/PGA changes.* The average retail rate per therm for the year ended December 31, 2014, increased 16.8% compared to the same period in 2013, reflecting higher natural gas commodity costs. 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.

*Volume.* For the year ended December 31, 2014, retail gas deliveries increased 4.8% compared to the same period in 2013, as a result of colder weather during the winter months compared to milder weather in the prior year.

***Cost of gas sold***

For the year ended December 31, 2014, cost of gas sold increased by \$36.3 million, compared to the same period in the prior year. The cost per therm of natural gas increased 27.5%, which resulted in \$31.0 million of increased expense. In addition, the volume of purchased gas increased 5.0%, which resulted in \$5.3 million of increased expense.

***Gas operating and maintenance expenses***

Gas operating and maintenance expenses decreased \$1.6 million for the year ended December 31, 2014, compared to the same period in 2013. The following changes contributed to the net change.

|  |          |
|--|----------|
| <i>(In millions)</i>                       |          |
| Decreased administrative and general costs | \$ (2.5) |
| Decreased customer service costs           | (0.4)    |
| Increased distribution costs               | 0.7      |
| Increased customer accounts costs          | 0.6      |
| Total                                      | \$ (1.6) |

For the year ended December 31, 2014, decreased administrative and general costs are primarily due to decreased pension and other postretirement benefit costs predominantly driven by an increase in the discount rate.

### **Nonregulated Energy Operations - MGE Energy and MGE**

For the years ended December 31, 2014 and 2013, net income at the nonregulated energy operations segment was \$19.3 million and \$20.7 million, respectively. The nonregulated energy operations are conducted through MGE Energy's subsidiaries: MGE Power Elm Road and MGE Power West Campus, which have been formed to own and lease electric generating capacity to assist MGE.

In December 2012, as part of WEPCO's (the operator and primary owner of the Elm Road Units) 2013 Wisconsin rate case, the PSCW determined that 100% of the construction costs for the Elm Road Units were prudently incurred, and approved the recovery in rates of more than 99.5% of the force majeure costs. The recovery of the force majeure costs began in 2013, including a one-time cumulative adjustment pertaining to affected periods prior to the PSCW order. The portion pertaining to prior periods was fully reflected in 2013 results.

### **Transmission Investment Operations - MGE Energy and MGE**

#### *Transmission investment other income*

For the years ended December 31, 2014 and 2013, other income at the transmission investment segment was \$9.2 million and \$9.4 million, respectively. The transmission investment segment holds our interest in ATC, and its income reflects our equity in the earnings of ATC. See Footnote 4.b. of the Notes to Consolidated Financial Statements and Other Matters below for additional information concerning ATC and summarized financial information regarding ATC.

### **Consolidated Income Taxes - MGE Energy and MGE**

Both MGE Energy's and MGE's effective income tax rate for the years ended December 31, 2014 and 2013, was 37.5%.

### **Consolidated Other General Taxes**

MGE Energy's and MGE's other general taxes increased \$1.0 million or 5.6% for the year ended December 31, 2014, when compared to the same period in 2013, due in part to increased Wisconsin license fee tax. The annual license fee tax expense is based on the prior year's adjusted operating revenues. Tax rates have not changed.

**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 and their results are consolidated with those of MGE, the primary beneficiary of the VIEs. Also included in noncontrolling interest, net of tax, is MGE Energy's interest in MGE Transco, which holds our investment in ATC. The following table shows MGE Energy's noncontrolling interest, net of tax, reflected on MGE's consolidated statements of income:

| <i>(In millions)</i>  | Year Ended December 31, |         |
|-----------------------|-------------------------|---------|
|                       | 2014                    | 2013    |
| MGE Power Elm Road    | \$ 16.2                 | \$ 17.4 |
| MGE Power West Campus | \$ 7.7                  | \$ 7.7  |
| MGE Transco           | \$ 2.4                  | \$ 2.4  |

***Liquidity and Capital Resources***

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

**Cash Flows**

The following summarizes cash flows for MGE Energy and MGE during the years ended 2015, 2014, and 2013:

| <i>(In thousands)</i>               | 2015         | MGE Energy<br>2014 | 2013      | 2015         | MGE<br>2014 | 2013      |
|-------------------------------------|--------------|--------------------|-----------|--------------|-------------|-----------|
| <b>Cash provided by/(used for):</b> |              |                    |           |              |             |           |
| Operating activities                | \$ 141,185\$ | 128,762\$          | 140,267   | \$ 148,460\$ | 128,538\$   | 138,684   |
| Investing activities                | (73,313)     | (96,158)           | (121,922) | (72,920)     | (95,597)    | (120,597) |
| Financing activities                | (52,243)     | (35,662)           | 4,111     | (53,342)     | (43,187)    | (9,629)   |

**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.

***2015 vs. 2014***

Cash provided by operating activities for the year ended December 31, 2015, was \$141.2 million, an increase of \$12.4 million when compared to the same period in the prior year.

MGE Energy's net income decreased \$9.0 million for the year ended December 31, 2015, when compared to the same period in the prior year.

In 2015, MGE received a \$10.0 million refund from the IRS for the 2014 tax year. Excluding the 2015 refund, MGE Energy's federal and state taxes paid increased \$4.7 million during the year ended December 31, 2015, when compared to the same period in the prior year. In December 2014, bonus depreciation was extended for the year ended December 31, 2014. Tax payments were made earlier in 2014 before the additional depreciation deduction was known.

Working capital accounts (excluding prepaid and accrued taxes) resulted in \$5.0 million in cash provided by operating activities for the year ended December 31, 2015, primarily due to decreased receivables and decreased unbilled revenues, partially offset by increased inventories, decreased accounts payable, and decreased current liabilities. The decrease in current liabilities includes a fuel credit of \$2.6 million that customers received on their bill in the period September through December 2015 related to the 2015 fuel savings and \$11.4 million of deferred fuel related cost savings to be returned to customers.

Working capital accounts (excluding prepaid and accrued taxes) resulted in \$14.8 million in cash used for operating activities for the year ended December 31, 2014, primarily due to increased gas inventories, increased other current assets, and decreased current liabilities, partially offset by increased accounts payable. The decrease in current liabilities includes a fuel credit of \$6.5 million that customers received on their bill in October 2014 related to the 2013 fuel savings.

An increase in pension contribution resulted in an additional \$10.4 million in cash used for operating activities for the year ended December 31, 2015, when compared to the same period in the prior year. Pension contributions reflect amounts required by law and discretionary amounts. See Footnote 13 of Notes to Consolidated Financial Statements for further discussion of MGE Energy's pension and other postretirement benefits.

#### *2014 vs. 2013*

Cash provided by operating activities for the year ended December 31, 2014, was \$128.8 million, a decrease of \$11.5 million when compared to the same period in the prior year, primarily related to increased taxes paid.

MGE Energy's net income increased \$5.4 million for the year ended December 31, 2014, when compared to the same period in the prior year.

MGE Energy's federal and state taxes paid increased \$12.2 million during the year ended December 31, 2014, when compared to the same period in the prior year, primarily due to federal tax payments made in 2014. In December 2014, bonus depreciation was extended for the year ended December 31, 2014. Tax payments were made earlier in 2014 before the additional depreciation deduction was known. In 2013, the NOL from a prior year was fully utilized.

Working capital accounts (excluding prepaid and accrued taxes) resulted in \$14.8 million in cash used for operating activities for the year ended December 31, 2014, primarily due to increased gas inventories, increased other current assets, and decreased current liabilities, partially offset by increased accounts payable. The decrease in current liabilities includes a fuel credit of \$6.5 million that customers received on their bill in October 2014 related to the 2013 fuel savings. Working capital accounts (excluding prepaid and accrued taxes) resulted in \$4.5 million in cash provided by operating activities for the year ended December 31, 2013, primarily due to increased other current liabilities, decreased gas inventories, and decreased receivable margin account, partially offset by increased receivables and increased unbilled revenues.

A decrease in pension contribution resulted in an additional \$31.4 million in cash provided by operating activities for the year ended December 31, 2014, when compared to the same period in the prior year. Pension contributions reflect amounts required by law and discretionary amounts. See Footnote 13 of Notes to Consolidated Financial Statements for further discussion of MGE's pension and other postretirement benefits.

For the year ended December 31, 2013, MGE paid a make-whole premium equal to \$6.8 million related to the redemption of \$40 million of long-term debt.

## ***MGE***

### *2015 vs. 2014*

Cash provided by operating activities for the year ended December 31, 2015, was \$148.5 million, an increase of \$19.9 million when compared to the same period in the prior year.

Net income decreased \$10.5 million for the year ended December 31, 2015, when compared to the same period in the prior year.

In 2015, MGE received a \$10.0 million refund from the IRS for the 2014 tax year. Excluding the 2015 refund, MGE's federal and state taxes paid to MGE Energy decreased \$3.3 million during the year ended December 31, 2015, when

compared to the same period in the prior year. In December 2014, bonus depreciation was extended for the year ended December 31, 2014. Tax payments were made earlier in 2014 before the additional depreciation deduction was known.

Working capital accounts (excluding prepaid and accrued taxes) resulted in \$14.0 million in cash provided by operating activities for the year ended December 31, 2015, primarily due to decreased receivables and decreased unbilled revenues, partially offset by increased gas inventories, decreased accounts payable, and decreased other current liabilities. The decrease in current liabilities includes a fuel credit of \$2.6 million that customers received on their bill in the period September through December 2015 related to the 2015 fuel savings and \$11.4 million of deferred fuel related cost savings to be returned to customers.

Working capital accounts (excluding prepaid and accrued taxes) resulted in \$20.9 million in cash used for operating activities for the year ended December 31, 2014, primarily due to increased gas inventories, increased receivables, and decreased current liabilities, partially offset by increased accounts payable. The decrease in current liabilities includes a fuel credit of \$6.5 million that customers received on their bill in October 2014 related to the 2013 fuel savings.

An increase in pension contribution resulted in an additional \$10.4 million in cash used for operating activities for the year ended December 31, 2015, when compared to the same period in the prior year. These contributions reflect amounts required by law and discretionary amounts. See Footnote 13 of Notes to Consolidated Financial Statements for further discussion of MGE's pension and other postretirement benefits.

*2014 vs. 2013*

Cash provided by operating activities for the year ended December 31, 2014, was \$128.5 million, a decrease of \$10.1 million when compared to the same period in the prior year, primarily related to increased taxes paid.

Net income increased \$5.5 million for the year ended December 31, 2014, when compared to the same period in the prior year.

MGE's federal and state taxes paid increased \$13.8 million during the year ended December 31, 2014, when compared to the same period in the prior year, primarily due to federal tax payments made in 2014. In December 2014, bonus depreciation was extended for the year ended December 31, 2014. Tax payments were made earlier in 2014 before the additional depreciation deduction was known. In 2013, the NOL from a prior year was fully utilized.

Working capital accounts (excluding prepaid and accrued taxes) resulted in \$20.9 million in cash used for operating activities for the year ended December 31, 2014, primarily due to increased gas inventories, increased receivables, and decreased current liabilities, partially offset by increased accounts payable. The decrease in current liabilities includes a fuel credit of \$6.5 million that customers received on their bill in October 2014 related to the 2013 fuel savings. Working capital accounts (excluding prepaid and accrued taxes) resulted in \$2.0 million in cash provided by operating activities for the year ended December 31, 2013, primarily due to increased other current liabilities, decreased gas inventories, and decreased receivable margin account, partially offset by increased receivables and increased unbilled revenues.

A decrease in pension contribution resulted in an additional \$31.4 million in cash provided by operating activities for the year ended December 31, 2014, when compared to the same period in the prior year. These contributions reflect amounts required by law and discretionary amounts. See Footnote 13 of Notes to Consolidated Financial Statements for further discussion of MGE's pension and other postretirement benefits.

For the year ended December 31, 2013, MGE paid a make-whole premium equal to \$6.8 million related to the redemption of \$40.0 million of long-term debt.

## **Capital Requirements and Investing Activities**

### ***MGE Energy***

#### *2015 vs. 2014*

MGE Energy's cash used for investing activities decreased \$22.8 million for the year ended December 31, 2015, when compared to the same period in the prior year.

Capital expenditures for the year ended December 31, 2015, were \$72.0 million. This amount represents a decrease of \$20.6 million from the expenditures made in the same period in the prior year. The decrease primarily reflects \$16.2 million of lower expenditures on the Columbia environmental project in 2015 versus 2014 and decreased expenditures in electric and gas distribution assets.

*2014 vs. 2013*

MGE Energy's cash used for investing activities decreased \$25.8 million for the year ended December 31, 2014, when compared to the same period in the prior year.

Capital expenditures for the year ended December 31, 2014, were \$92.7 million. This amount represents a decrease of \$26.4 million from the expenditures made in the same period in the prior year. The decrease primarily reflects \$45.0 million of lower expenditures on the Columbia environmental project in 2014 versus 2013, offset by increased expenditures in electric and gas distribution assets.

***MGE***

*2015 vs. 2014*

MGE's cash used for investing activities decreased \$22.7 million for the year ended December 31, 2015, when compared to the same period in the prior year.

Capital expenditures for the year ended December 31, 2015, were \$72.0 million. This amount represents a decrease of \$20.6 million from the expenditures made in the same period in the prior year. The decrease primarily reflects \$16.2 million of lower expenditures on the Columbia environmental project in 2015 versus 2014 and decreased expenditures in electric and gas distribution assets.

2014 vs. 2013

MGE's cash used for investing activities decreased \$25.0 million for the year ended December 31, 2014, when compared to the same period in the prior year.

Capital expenditures for the year ended December 31, 2014, were \$92.7 million. This amount represents a decrease of \$26.4 million from the expenditures made in the same period in the prior year. The decrease primarily reflects \$45.0 million of lower expenditures on the Columbia environmental project in 2014 versus 2013, offset by increased expenditures in electric and gas distribution assets.

### *Capital expenditures*

The following table shows MGE Energy's actual capital expenditures for both 2015 and 2014, forecasted capital expenditures for 2016, and annual average forecasted capital expenditures for the years 2017 through 2019:

|                            | Actual    |           | Forecasted |                  |
|----------------------------|-----------|-----------|------------|------------------|
|                            |           |           |            | (Annual Average) |
| <i>(In thousands)</i>      |           |           |            |                  |
| <b>For the years ended</b> |           |           |            |                  |
| <b>December 31,</b>        | 2014      | 2015      | 2016       | 2017-2019        |
| Electric                   | \$ 68,067 | \$ 49,370 | \$ 63,070  | \$ 68,027        |
| Gas                        | 22,104    | 18,787    | 24,690     | 29,532           |
| Utility plant total        | 90,171    | 68,157    | 87,760     | 97,559           |
| Nonregulated               | 2,505     | 3,873     | 3,484      | 3,662            |
| MGE Energy total           | \$ 92,676 | \$ 72,030 | \$ 91,244  | \$ 101,221       |

The forecasted capital expenditures are based upon management's assumptions with respect to future events, including the timing and amount of expenditures associated with compliance with environmental compliance initiatives, load growth, and the timing and adequacy of rate recovery. Actual events may differ materially from those assumptions and result in material changes to those forecasted amounts.

MGE Energy used funds received as dividend payments from MGE Power West Campus and MGE Power Elm Road, internally generated cash, and short-term external financing to meet its 2015 capital requirements and cash obligations, including dividend payments. External financing included short-term financing under existing lines of credit.

## Financing Activities

### *MGE Energy*

#### *2015 vs. 2014*

Cash used for MGE Energy's financing activities was \$52.2 million for the year ended December 31, 2015, compared to \$35.7 million of cash used for the year ended December 31, 2014.

For the year ended December 31, 2015, dividends paid were \$40.0 million compared to \$38.4 million in the prior year. This increase was a result of a higher dividend per share (\$1.16 vs. \$1.11).

For the year ended December 31, 2015, net short-term debt repayments were \$7.0 million. There were no short-term debt repayments for the same period in the prior year.

#### *2014 vs. 2013*

Cash used for MGE Energy's financing activities was \$35.7 million for the year ended December 31, 2014, compared to \$4.1 million of cash provided by the year ended December 31, 2013.

For the year ended December 31, 2014, dividends paid were \$38.4 million compared to \$37.1 million in the prior year. This increase was a result of a higher dividend per share (\$1.11 vs. \$1.07).

During the year ended December 31, 2013, MGE issued \$85.0 million of long-term debt, which was used to retire \$40.0 million of long-term debt and to assist with the funding for the Columbia environmental project.

For the year ended December 31, 2014, short-term borrowings were \$7.0 million.



***MGE***

*2015 vs. 2014*

During the year ended December 31, 2015, cash used for MGE's financing activities was \$53.3 million compared to \$43.2 million of cash used for MGE's financing activities in the prior year.

Dividends paid from MGE to MGE Energy were \$30.0 million for the year ended December 31, 2015, compared to \$26.5 million in the prior year.

Distributions to parent from noncontrolling interest, which represent distributions from MGE Power Elm Road and MGE Power West Campus, were \$14.7 million for the year ended December 31, 2015, compared to \$21.4 million in the prior year.

For the year ended December 31, 2015, net short-term debt repayments were \$7.0 million. There were no short-term debt repayments for the same period in the prior year.

*2014 vs. 2013*

During the year ended December 31, 2014, cash used for MGE's financing activities was \$43.2 million compared to \$9.6 million of cash used for MGE's financing activities in the prior year.

Dividends paid from MGE to MGE Energy were \$26.5 million for the year ended December 31, 2014, compared to \$25.0 million in the prior year.

During the year ended December 31, 2013, MGE issued \$85.0 million of long-term debt, which was used to retire \$40.0 million of long-term debt and to assist with the funding for the Columbia environmental project.

Distributions to parent from noncontrolling interest, which represent distributions from MGE Power Elm Road and MGE Power West Campus, were \$21.4 million for the year ended December 31, 2014, compared to \$27.4 million in the prior year.

For the year ended December 31, 2014, short-term borrowings were \$7.0 million.

### **Dividend Restrictions**

Dividend payments by MGE to MGE Energy are subject to restrictions arising under a PSCW rate order and, to a lesser degree, MGE's first mortgage bonds. The PSCW order restricts any dividends, above the PSCW authorized amount of \$43 million, that MGE may pay MGE Energy if its common equity ratio, calculated in the manner used in the rate proceeding, is less than 55%. MGE's thirteen month rolling average common equity ratio at December 31, 2015, is 59.7% as determined under the calculation used in the rate proceeding. MGE was not restricted from paying cash dividends in 2015. Cash dividends of \$30.0 million and \$26.5 million were paid by MGE to MGE Energy in 2015 and 2014, respectively. The rate proceeding calculation includes as indebtedness imputed amounts for MGE's outstanding purchase power capacity payments and other PSCW adjustments, but does not include the indebtedness associated with MGE Power Elm Road and MGE Power West Campus, which are consolidated into MGE's financial statements but are not direct obligations of MGE.

MGE has covenanted with the holders of its first mortgage bonds not to declare or pay any dividend or make any other distribution on or purchase any shares of its common stock unless, after giving effect thereto, the aggregate amount of all such dividends and distributions and all amounts applied to such purchases, after December 31, 1945, shall not exceed the earned surplus (retained earnings) accumulated subsequent to December 31, 1945. As of December 31, 2015, approximately \$353.0 million was available for the payment of dividends under this covenant.

***Credit Facilities***

At December 31, 2015, MGE Energy and MGE had the following aggregate bank commitments and available capacity under their credit agreements and the indicated amounts of outstanding commercial paper:

| Borrower   | Aggregate<br>Bank<br>Commitments | Outstanding<br>Commercial<br>Paper<br><i>(Dollars in millions)</i> | Outstanding<br>Borrowings | Available<br>Capacity | Expiration Date |
|------------|----------------------------------|--|---------------------------|-----------------------|-----------------|
| MGE Energy | \$ 50.0                          | \$ -   | \$ -                      | \$ 50.0               | June 1, 2020    |
| MGE        | \$ 100.0                         | \$ -   | \$ -                      | \$ 100.0              | June 1, 2020    |

Borrowings under the Credit Agreements may bear interest at a rate based upon either a "floating rate" or a "Eurodollar Rate" adjusted for statutory reserve requirements, plus an adder based upon the credit ratings assigned to MGE's senior unsecured long-term debt securities. The "floating rate" is calculated on a daily basis as the highest of a prime rate, a Federal Funds effective rate plus 0.5% per annum, or a Eurodollar Rate for a one-month interest period plus 1%. The "floating rate" adder ranges from zero to 0.125%. The "Eurodollar Rate" is calculated as provided in the Credit Agreements. The "Eurodollar Rate" adder ranges from 0.625% to 1.125%.

The agreements require the borrower to maintain a ratio of consolidated debt to consolidated total capitalization not to exceed a maximum of 65%. The ratio calculation excludes assets, liabilities, revenues, and expenses included in MGE's financial statements as a result of the consolidation of VIEs, such as MGE Power Elm Road and MGE Power West Campus. At December 31, 2015, the ratio of consolidated debt to consolidated total capitalization for each of MGE Energy and MGE, as calculated under the credit agreements' covenant, were 36.4% and 36.1%, respectively. See Footnote 10 of Notes to Consolidated Financial Statements for additional information regarding the credit facilities.

***Capitalization Ratios***

MGE Energy's capitalization ratios were as follows:

|                             | MGE Energy |        |
|-----------------------------|------------|--------|
|                             | 2015       | 2014   |
| Common shareholders' equity | 63.6 %     | 61.9 % |
| Long-term debt*             | 36.4 %     | 37.5 % |
| Short-term debt             | -%         | 0.6 %  |

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

*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 borrowing is 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.

**Contractual Obligations and Commercial Commitments for MGE Energy and MGE**

MGE Energy's and MGE's contractual obligations as of December 31, 2015, representing cash obligations that are considered to be firm commitments, are as follows:

| <i>(In thousands)</i>                                      | Total        | 1 Year     | Payment Due Within: |            | Due After  |
|--|--------------|------------|---------------------|------------|------------|
|  |              |            | 2-3 Years           | 4-5 Years  | 5 Years    |
| <b>MGE Energy</b>  |              |            |                     |            |            |
| Long-term debt <sup>(a)</sup>                              | \$ 395,508   | \$ 4,266   | \$ 58,810           | \$ 24,212  | \$ 308,220 |
| Repurchase-to-maturity transactions - loans <sup>(b)</sup> | 3,671        | 706        | 984                 | 922        | 1,059      |
| Interest expense <sup>(c)</sup>                            | 277,558      | 19,394     | 34,689              | 31,791     | 191,684    |
| Operating leases <sup>(d)</sup>                            | 12,441       | 1,615      | 1,956               | 587        | 8,283      |
| Purchase obligations <sup>(e)</sup>                        | 543,850      | 144,987    | 159,184             | 104,715    | 134,964    |
| Other obligations <sup>(f)</sup>                           | 23,833       | 13,138     | 3,098               | 1,510      | 6,087      |
| Total MGE Energy contractual obligations                   | \$ 1,256,861 | \$ 184,106 | \$ 258,721          | \$ 163,737 | \$ 650,297 |
| <b>MGE</b>   |              |            |                     |            |            |
| Long-term debt <sup>(a)</sup>                              | \$ 395,508   | \$ 4,266   | \$ 58,810           | \$ 24,212  | \$ 308,220 |
| Repurchase-to-maturity transactions - loans <sup>(b)</sup> | 3,671        | 706        | 984                 | 922        | 1,059      |
| Interest expense <sup>(c)</sup>                            | 277,558      | 19,394     | 34,689              | 31,791     | 191,684    |
| Operating leases <sup>(d)</sup>                            | 12,441       | 1,615      | 1,956               | 587        | 8,283      |
| Purchase obligations <sup>(e)</sup>                        | 543,850      | 144,987    | 159,184             | 104,715    | 134,964    |
| Other obligations <sup>(f)</sup>                           | 21,516       | 10,821     | 3,098               | 1,510      | 6,087      |
| Total MGE contractual obligations                          | \$ 1,254,544 | \$ 181,789 | \$ 258,721          | \$ 163,737 | \$ 650,297 |

(a)

Long-term debt consisting of secured first mortgage bonds, unsecured medium-term notes, Industrial Development Revenue Bonds issued by MGE, and private placement debt issued by MGE, MGE Power Elm Road, and MGE Power West Campus.

(b)

Chattel paper agreements. See Footnote 1.h. of the Notes to Consolidated Financial Statements.

(c)

Amount represents interest expense on long-term debt. See Footnote 9 of the Notes to Consolidated Financial Statements for further discussion of the long-term debt outstanding at December 31, 2015.

(d)

Operating leases. See Footnote 18.b. of the Notes to Consolidated Financial Statements.

(e)

Purchase obligations for MGE Energy and MGE consist primarily of the purchase of electricity and natural gas, electric transmission, natural gas storage capacity, natural gas pipeline transportation, and the purchase and transport of coal. See Footnote 18.a. of the Notes to Consolidated Financial Statements.

(f)

Other obligations are primarily related to investment commitments, easements, green energy projects, environmental projects, fuel credit, and uncertain tax positions.

The above amounts do not include any contributions for MGE's pension and postretirement plans. Voluntary contributions to the qualified plans for 2016 are expected to be \$10.0 million, which was paid in January 2016. MGE does not expect to make contributions to the plans for 2017. The contributions for years after 2017 are not yet currently estimated. Due to uncertainties in the future economic performance of plan assets, discount rates, and other key assumptions, estimated contributions are subject to change. MGE may also elect to make additional discretionary contributions.

The above amounts do not include future capital calls by ATC. On January 29, 2016, MGE Transco made a \$0.5 million capital contribution to ATC. The amount and timing of future capital calls is uncertain and primarily dependent on the operations and expansion of ATC.

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MGE Energy's and MGE's commercial commitments as of December 31, 2015, representing commitments triggered by future events and including financing arrangements to secure obligations of MGE Energy and MGE, are as follows:

| <i>(In thousands)</i>                    |    | Total      | 1 Year | Expiration Within: |      | 4-5 Years  | Due After |
|--|----|------------|--------|--------------------|------|------------|-----------|
|  |    |            |        | 2-3 Years          |      |            | 5 Years   |
| <b>MGE Energy</b>                        |    |            |        |                    |      |            |           |
| Available lines of credit <sup>(a)</sup> | \$ | 150,000 \$ | -      | \$ -               | \$ - | 150,000 \$ | -         |
| <b>MGE</b>                               |    |            |        |                    |      |            |           |
| Available lines of credit <sup>(b)</sup> | \$ | 100,000 \$ | -      | \$ -               | \$ - | 100,000 \$ | -         |

(a)

Amount includes the facility discussed in (b) plus an additional line of credit. MGE Energy has available at any time a \$50 million committed revolving credit agreement, expiring in June 2020. At December 31, 2015, MGE Energy had no borrowings outstanding under this credit facility.

(b)

Amount includes two committed revolving credit agreements totaling \$100 million expiring in June 2020. These credit facilities are used to support commercial paper issuances. At December 31, 2015, MGE had no borrowings outstanding under these facilities, and MGE had no commercial paper outstanding.

***Other Matters***

**ATC**

In 2013, several parties filed a complaint with the FERC seeking to reduce the base return on equity (ROE) used by MISO transmission owners, including ATC, "due to changes in the capital markets." The complaint alleges that the MISO ROE should not exceed 9.15%, the equity components of hypothetical capital structures should be restricted to 50%, and the relevant incentive ROE adders should be discontinued. MISO's base ROE is 12.38% and ATC's base ROE is 12.2%. In December 2015, an administrative law judge issued an initial decision that would reduce the transmission owners' base ROE to 10.32%. That initial decision will be reviewed by FERC and it is anticipated FERC will issue an order on this issue by October 2016. In February 2015, a second complaint was filed with the FERC requesting a reduction in the base ROE used by MISO transmission owners, including ATC, to 8.67%, with a refund effective date retroactive to the filing date of the complaint. An initial decision from the administrative law judge is expected by June 30, 2016.

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

Any change to ATC's ROE could result in lower equity earnings and distributions from ATC in the future. Our share of ATC's earnings for 2015 reflects a charge recorded by ATC for this matter representing its estimate of its potential refund liability for the period of November 2013 through December 2015. We derived approximately 6.4% and 6.7% of our net income for the years ended December 31, 2015 and 2014, respectively, from our investment in ATC.

### **Rate Matters**

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

### **Annual Fuel Proceeding**

In August 2015, the PSCW approved a \$0.00256/kWh fuel credit to begin on September 1, 2015, and continue throughout 2016. The fuel credit established a mechanism to return fuel savings to electric customers as a bill credit. MGE returned \$2.6 million of electric fuel-related savings in customer bill credits during the period from September 1, 2015, through December 31, 2015. As of December 31, 2015, MGE has deferred \$9.5 million of 2015 electric fuel-related savings that are outside the range authorized by the PSCW. These costs are subject to PSCW's annual review, expected to be completed in 2016.

In January 2016, the PSCW lowered MGE's 2016 fuel rules monitored costs by \$14.8 million as a result of continued lower projected fuel costs in 2016. The PSCW will address the return of the 2016 fuel savings to customers as an update to the fuel credit or through another approved mechanism. The return of the fuel savings for 2016 will be addressed during the PSCW's annual review during 2016 of 2015 fuel costs. MGE will defer these fuel savings until a final determination is made by the PSCW.

### ***Critical Accounting Estimates - MGE Energy and MGE***

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

#### **Unbilled Revenues**

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

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The amount of electricity expected to be lost in the process of its transmission and distribution to customers (line loss) and the amount of electricity actually delivered to customers.

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The amount of gas expected to be lost in the process of its distribution to customers and the amount of gas actually delivered to customers.

The mix of sales between customer rate classes, which is based upon historical utilization assumptions.

MGE monitors the reasonableness of the unbilled revenue estimate through the review of ratios such as unbilled electric consumption compared to billed electric sales. In the case of unbilled gas, the estimated unbilled consumption is compared to various other statistics, including percent of gas available for sale, change in unbilled month to month and change in unbilled compared to the prior year in order to confirm its reasonableness.

### **Allowance for Doubtful Accounts**

MGE maintains allowances for doubtful accounts for estimated losses resulting from the inability of its customers to make required payments. It determines the allowance based on historical write-off experience, regional economic data, and review of the accounts receivable aging. MGE reviews its allowance for doubtful accounts monthly. Although management believes that the allowance for doubtful accounts is MGE's best estimate of the amount of probable credit losses, if the financial condition of MGE's customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

### **Pension and Other Postretirement Benefit Plans**

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

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

*Assumed return on assets.* This assumption represents the rate of return on plan assets reflecting the average rate of earnings expected on the funds invested (or to be invested) to provide for the benefits included in the projected benefit obligation. For 2015, MGE used an assumed return on assets of 7.80% for pension and 7.06% for other postretirement benefits. In 2016, the pension asset assumption will decrease from 7.80% to 7.65%. MGE will decrease the postretirement benefit assumption from 7.06% to 6.97% in 2016. The annual expected rate of return is based on projected long-term equity and bond returns, maturities and asset allocations. Holding other assumptions constant, for every 1% reduction in the expected rate of return on plan assets, annual pension and other postretirement cost would increase by approximately \$3.3 million, before taxes.

*Discount rate.* The discount rate represents the rate at which pension obligations could effectively be settled on a present-value basis. MGE uses high-grade bond yields as a benchmark for determining the appropriate discount rate. At December 31, 2015, MGE refined its methodology for using discount rates to measure the components of net periodic benefit cost. The refined methodology uses individual spot rates, instead of a weighted average of the yield curve spot rates, for measuring the service cost and interest cost components. The change in methodology does not alter the measurement of the related benefit obligation as of December 31, 2015. Holding other assumptions constant, a 0.5% reduction in the discount rate on the obligation balance at December 31, 2015, would increase annual pension and other postretirement cost by approximately \$2.8 million, before taxes.

*Medical trend assumptions.* The health care cost trend rate is the assumed rate of increase in per-capita health care charges.

*Mortality rate assumption.* Expected mortality rates are used in the valuation to determine the expected duration of future benefit payments to the plan participants. In October 2014, the Society of Actuaries released new mortality tables and projection scales. At December 31, 2014, the Company adopted a modified version of these tables that were developed by a third party actuary.

See Footnote 13 of the Notes to Consolidated Financial Statements for additional discussion of these plans.

## Income Tax Provision

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

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

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

Accounting for uncertainty in income taxes applies to all tax positions and requires a recognition threshold and measurement standard for the financial statement recognition and measurement of a tax position taken, or expected to be taken, in an income tax return. The threshold is defined for recognizing tax return positions in the financial statements as "more likely than not" that the position is sustainable, based on its merits. Subsequent recognition, derecognition, and measurement is based on management's best judgment given the facts, circumstances and information available at the reporting date.

## **Accounting for Derivative Instruments**

MGE accounts for derivative financial instruments, except those qualifying for the normal purchase normal sale exception, at their fair value on the balance sheet. Fair value is determined using current quoted market prices, except for the PPA which is valued utilizing an internally-developed pricing model. This model includes observable and unobservable inputs.

MGE received approval from the PSCW to establish a regulatory asset or liability for the deferral of the effects of mark-to-market accounting on contracts related to commodity hedging in MGE's regulated operations.

## **Regulatory Assets/Liabilities**

Regulatory assets represent costs that have been deferred to future periods when it is probable that the regulator will allow future recovery of those costs through rates. MGE bases its assessment of recovery on precedents established by the regulatory body. Regulatory liabilities represent previous collections from customers that are expected to be refunded to customers in future periods. Regulatory assets and regulatory liabilities typically include deferral of energy costs, the normalization of income taxes, the deferral of certain operating expenses, and non-ARO removal costs. The accounting for these regulatory assets and liabilities is in accordance with regulatory accounting standards.

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

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

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

See Footnote 20 of the Notes to Consolidated Financial Statements for discussion of new accounting pronouncements.

**Item 7A. Quantitative and Qualitative Disclosures About Market Risk.**

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

**Commodity Price Risk**

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

MGE's electric fuel costs are subject to fuel rules established by the PSCW. The fuel rules require the PSCW and Wisconsin utilities to defer electric fuel-related costs that fall outside a symmetrical cost tolerance band. Any over/under recovery of the actual costs is determined on an annual basis and is adjusted in future billings to electric retail customers. Under the electric fuel rules, MGE is required to defer the benefit of lower costs if the actual electric fuel costs fall outside the lower end of the range and is required to defer costs, less any excess revenues, if the actual electric fuel costs exceed the upper end of the range. Excess revenues are defined as revenues in the year in question that provide MGE with a greater return on common equity than authorized by the PSCW in MGE's latest rate order. The range is defined by the PSCW and has been modified throughout the years based on market conditions and other relevant factors. Currently, MGE is subject to a plus or minus 2% range. MGE assumes the risks and benefits of variances that are within the cost tolerance band. For 2016, fuel and purchased power costs included in MGE's base fuel rates are \$108.2 million. See Footnote 17 of the Notes to Consolidated Financial Statements for additional information.

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.

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 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 December 31, 2015, the cost basis of these instruments exceeded their fair value by \$0.8 million. Under the PGA clause and electric fuel rules, MGE may include in the costs of fuel (natural gas or power) the costs and benefits of the aforementioned fuel price risk management tools. Because these costs/benefits are recoverable, the related unrealized loss/gain has been deferred on the consolidated balance sheets as a regulatory asset/liability.

MGE has also entered into a purchased power agreement that provides MGE with firm capacity and energy that began on June 1, 2012, and ends on May 31, 2022 (the "base term"). The agreement also allows MGE an option to extend the contract after the base term. The agreement is considered a derivative contract and is recognized at its fair value on the consolidated balance sheet. However, the derivative qualifies for regulatory deferral and is recognized with a corresponding regulatory asset or liability depending on whether the fair value is in a loss or gain position. The fair value of the contract at December 31, 2015, reflects a loss position of \$53.3 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. Holding other assumptions

constant, for every 1% reduction in the expected rate of return on plan assets, annual pension and other postretirement cost would increase by approximately \$3.3 million, before taxes. MGE's risk of expense and annuity payments, as a result of changes in the market value of the trust funds, is mitigated in part through future rate actions by the PSCW. The value of employee benefit plans trusts' assets have increased in value by approximately 1.39% and 8.04% during the years ended December 31, 2015 and 2014, respectively.

### **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 December 31, 2015, no counterparties have defaulted.

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

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

**Item 8. Financial Statements and Supplementary Data.**

**MGE Energy**

***Management's Report on Internal Control Over Financial Reporting***

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an assessment of the effectiveness of our internal control over financial reporting based on the framework in the Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our assessment under the framework in the Internal Control - Integrated Framework (2013), our management concluded that our internal control over financial reporting was effective as of December 31, 2015.

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

The effectiveness of MGE Energy's internal control over financial reporting as of December 31, 2015, has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which appears herein.

February 25, 2016

**MGE**

***Management's Report on Internal Control Over Financial Reporting***

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an assessment of the effectiveness of our internal control over financial reporting based on the framework in the Internal Control -

Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our assessment under the framework in the Internal Control - Integrated Framework (2013), our management concluded that our internal control over financial reporting was effective as of December 31, 2015.

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

February 25, 2016

## Report of Independent Registered Public Accounting Firm

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

In our opinion, the consolidated financial statements listed in the index appearing under Item 15(a)(1) present fairly, in all material respects, the financial position of MGE Energy, Inc. and its subsidiaries at December 31, 2015 and 2014, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2015, in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedules listed in the index appearing under Item 15(a)(2) present fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2015, based on criteria established in the *Internal Control - Integrated Framework* (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements and financial statement schedules, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express opinions on these financial statements, on the financial statement schedules, and on the Company's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become

inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP

Chicago, Illinois

February 25, 2016

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**Report of Independent Registered Public Accounting Firm**

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

In our opinion, the consolidated financial statements listed in the index appearing under Item 15(a)(1) present fairly, in all material respects, the financial position of Madison Gas and Electric Company and its subsidiaries at December 31, 2015 and 2014, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2015, in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15(a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

/s/ PricewaterhouseCoopers LLP

Chicago, Illinois

February 25, 2016

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

|  | <b>For the Years Ended December 31,</b> |             |             |
|--|---|-------------|-------------|
|  | <b>2015</b>                             | <b>2014</b> | <b>2013</b> |
| <b>Operating Revenues:</b>                 |   |             |             |
| Regulated electric revenues                | \$ 412,528                              | \$ 394,849  | \$ 403,957  |
| Regulated gas revenues                     | 143,737                                 | 221,720     | 181,462     |
| Nonregulated revenues                      | 7,763                                   | 3,283       | 5,468       |
| <i>Total Operating Revenues</i>            | 564,028                                 | 619,852     | 590,887     |
| <b>Operating Expenses:</b>                 |   |             |             |
| Fuel for electric generation               | 53,858                                  | 42,828      | 46,062      |
| Purchased power                            | 81,224                                  | 73,232      | 80,830      |
| Cost of gas sold                           | 76,109                                  | 143,644     | 107,315     |
| Other operations and maintenance           | 164,478                                 | 161,703     | 171,248     |
| Depreciation and amortization              | 44,225                                  | 40,695      | 38,838      |
| Other general taxes                        | 19,879                                  | 19,652      | 18,607      |
| <i>Total Operating Expenses</i>            | 439,773                                 | 481,754     | 462,900     |
| <b>Operating Income</b>                    | 124,255                                 | 138,098     | 127,987     |
| Other income, net                          | 8,613                                   | 10,079      | 10,701      |
| Interest expense, net                      | (20,162)                                | (19,673)    | (18,924)    |
| Income before income taxes                 | 112,706                                 | 128,504     | 119,764     |
| Income tax provision                       | (41,363)                                | (48,185)    | (44,859)    |
| <b>Net Income</b>                          | \$ 71,343                               | \$ 80,319   | \$ 74,905   |
| <b>Earnings Per Share of Common Stock</b>  |   |             |             |
| (basic and diluted)                        | \$ 2.06                                 | \$ 2.32     | \$ 2.16     |
| Dividends per share of common stock        | \$ 1.16                                 | \$ 1.11     | \$ 1.07     |
| <b>Weighted Average Shares Outstanding</b> |   |             |             |
| (basic and diluted)                        | 34,668                                  | 34,668      | 34,668      |

*The accompanying notes are an integral part of the above consolidated financial statements.***MGE Energy, Inc.****Consolidated Statements of Comprehensive Income***(In thousands)*

|   | <b>For the Years Ended December 31,</b> |             |             |
|---|---|-------------|-------------|
|   | <b>2015</b>                             | <b>2014</b> | <b>2013</b> |
| Net Income  | \$ 71,343                               | \$ 80,319   | \$ 74,905   |
| Other comprehensive income, net of tax:   |   |             |             |
| Unrealized (loss) gain on available-for-sale securities, net of tax (\$67, (\$54), and (\$189)) | (101)                                   | 81          | 283         |
| <b>Comprehensive Income</b>   | \$ 71,242                               | \$ 80,400   | \$ 75,188   |

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

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

|   | <b>For the Years Ended December 31,</b> |             |             |
|---|---|-------------|-------------|
|   | <b>2015</b>                             | <b>2014</b> | <b>2013</b> |
| <b>Operating Activities:</b>                                    |   |             |             |
| Net income  | \$ 71,343                               | \$ 80,319   | \$ 74,905   |
| Items not affecting cash:                                       |   |             |             |
| Depreciation and amortization                                   | 44,225                                  | 40,695      | 38,838      |
| Deferred income taxes   | 21,927                                  | 49,884      | 38,365      |
| Provision for doubtful receivables                              | 596                                     | 1,898       | 2,448       |
| Employee benefit plan expenses                                  | 3,333                                   | (1,080)     | 13,303      |
| Equity earnings in ATC  | (7,728)                                 | (9,150)     | (9,434)     |
| Other items   | 721                                     | 729         | 117         |
| Changes in working capital items:                               |   |             |             |
| Trade and other receivables                                     | 4,508                                   | 2,115       | (3,827)     |
| Inventories   | (2,646)                                 | (10,399)    | 2,488       |
| Unbilled revenues   | 6,254                                   | 720         | (3,720)     |
| Prepaid taxes   | 3,658                                   | (19,804)    | 414         |
| Other current assets  | 978                                     | (5,693)     | 2,514       |
| Accounts payable  | (3,499)                                 | 2,756       | 858         |
| Other current liabilities                                       | (597)                                   | (4,195)     | 6,271       |
| Dividend income from ATC  | 6,645                                   | 7,740       | 7,404       |
| Cash contributions to pension and other<br>postretirement plans | (13,676)                                | (3,321)     | (34,765)    |
| Debt make-whole premium   | -                                       | -           | (6,757)     |
| Other noncurrent items, net                                     | 5,143                                   | (4,452)     | 10,845      |
| <i>Cash Provided by Operating Activities</i>                    | 141,185                                 | 128,762     | 140,267     |
| <b>Investing Activities:</b>                                    |   |             |             |
| Capital expenditures  | (72,030)                                | (92,676)    | (119,047)   |
| Capital contributions to investments                            | (1,053)                                 | (2,185)     | (1,660)     |
| Purchase of investment - land                                   | -                                       | -           | (10)        |
| Other   | (230)                                   | (1,297)     | (1,205)     |
| <i>Cash Used for Investing Activities</i>                       | (73,313)                                | (96,158)    | (121,922)   |
| <b>Financing Activities:</b>                                    |   |             |             |
| Cash dividends paid on common stock                             | (40,043)                                | (38,429)    | (37,107)    |
| Repayment of long-term debt                                     | (4,182)                                 | (4,103)     | (43,012)    |
| Issuance of long-term debt                                      | -                                       | -           | 85,000      |
| (Decrease) increase in short-term debt                          | (7,000)                                 | 7,000       | -           |
| Other   | (1,018)                                 | (130)       | (770)       |
| <i>Cash (Used for) Provided by<br/>Financing Activities</i>     | (52,243)                                | (35,662)    | 4,111       |
| Change in cash and cash equivalents:                            | 15,629                                  | (3,058)     | 22,456      |
|   | 65,755                                  | 68,813      | 46,357      |

Cash and cash equivalents at beginning of period

**Cash and cash equivalents at end of period**

|  |           |           |           |
|--|-----------|-----------|-----------|
|  | \$ 81,384 | \$ 65,755 | \$ 68,813 |
|--|-----------|-----------|-----------|

**Supplemental Disclosures of Cash Flow**

**Information:**

|               |           |           |           |
|---------------|-----------|-----------|-----------|
| Interest paid | \$ 19,636 | \$ 20,478 | \$ 17,991 |
|---------------|-----------|-----------|-----------|

|                   |           |           |          |
|-------------------|-----------|-----------|----------|
| Income taxes paid | \$ 23,800 | \$ 19,579 | \$ 8,046 |
|-------------------|-----------|-----------|----------|

|                       |             |          |            |
|-----------------------|-------------|----------|------------|
| Income taxes received | \$ (10,130) | \$ (644) | \$ (1,339) |
|-----------------------|-------------|----------|------------|

Significant noncash investing activities:

|                              |          |          |          |
|------------------------------|----------|----------|----------|
| Accrued capital expenditures | \$ 3,963 | \$ 1,569 | \$ 9,892 |
|------------------------------|----------|----------|----------|

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

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

|   | <b>At December 31,</b> |              |
|---|------------------------|--------------|
| <b>ASSETS</b>   | <b>2015</b>            | <b>2014</b>  |
| <b>Current Assets:</b>  |                        |              |
| Cash and cash equivalents   | \$ 81,384              | \$ 65,755    |
| Accounts receivable, less reserves of \$3,052 and \$4,329, respectively   | 37,112                 | 41,614       |
| Other accounts receivable, less reserves of \$642 and \$420, respectively | 7,477                  | 7,610        |
| Unbilled revenues   | 25,008                 | 31,262       |
| Materials and supplies, at average cost                                   | 19,155                 | 17,121       |
| Fossil fuel   | 13,110                 | 8,098        |
| Stored natural gas, at average cost                                       | 16,145                 | 21,036       |
| Prepaid taxes   | 35,252                 | 38,910       |
| Regulatory assets - current   | 9,538                  | 8,360        |
| Other current assets  | 10,570                 | 10,711       |
| <i>Total Current Assets</i>   | 254,751                | 250,477      |
| Other long-term receivables   | 5,045                  | 2,181        |
| Regulatory assets   | 148,199                | 156,823      |
| Other deferred assets and other   | 5,602                  | 4,837        |
| <b>Property, Plant, and Equipment:</b>                                    |                        |              |
| Property, plant, and equipment, net                                       | 1,217,094              | 1,189,077    |
| Construction work in progress   | 26,351                 | 19,029       |
| <i>Total Property, Plant, and Equipment</i>                               | 1,243,445              | 1,208,106    |
| <b>Investments</b>  | 73,631                 | 71,760       |
| <b>Total Assets</b>   | \$ 1,730,673           | \$ 1,694,184 |
| <b>LIABILITIES AND CAPITALIZATION</b>                                     |                        |              |
| <b>Current Liabilities:</b>   |                        |              |
| Long-term debt due within one year  | \$ 4,266               | \$ 4,182     |
| Short-term debt   | -                      | 7,000        |
| Accounts payable  | 40,830                 | 41,655       |
| Accrued interest and taxes  | 5,067                  | 5,086        |
| Accrued payroll related items   | 11,215                 | 11,241       |
| Regulatory liabilities - current  | 9,515                  | -            |
| Derivative liabilities  | 8,343                  | 6,901        |
| Other current liabilities   | 4,910                  | 13,931       |
| <i>Total Current Liabilities</i>  | 84,146                 | 89,996       |
| <b>Other Credits:</b>   |                        |              |
| Deferred income taxes   | 360,785                | 338,563      |
| Investment tax credit - deferred  | 1,050                  | 1,223        |
| Regulatory liabilities  | 20,785                 | 22,715       |

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|  |                     |                     |
|--|---------------------|---------------------|
| Accrued pension and other postretirement benefits        | 75,680              | 90,201              |
| Derivative liabilities                                   | 44,935              | 46,560              |
| Other deferred liabilities and other                     | 61,820              | 50,269              |
| <i>Total Other Credits</i>                               | 565,055             | 549,531             |
| <b>Capitalization:</b>                                   |                     |                     |
| Common shareholders' equity:                             |                     |                     |
| Common Stock - \$1 par value - 75,000 shares authorized; |                     |                     |
| 34,668 shares issued and outstanding                     | 34,668              | 34,668              |
| Additional paid-in capital                               | 316,268             | 316,268             |
| Retained earnings  | 339,165             | 308,007             |
| Accumulated other comprehensive income, net of tax       | 357                 | 458                 |
| <i>Total Common Shareholders' Equity</i>                 | 690,458             | 659,401             |
| Long-term debt   | 391,014             | 395,256             |
| <i>Total Capitalization</i>                              | 1,081,472           | 1,054,657           |
| Commitments and contingencies (see Footnote 18)          | -                   | -                   |
| <b>Total Liabilities and Capitalization</b>              | <b>\$ 1,730,673</b> | <b>\$ 1,694,184</b> |

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

**MGE Energy, Inc.****Consolidated Statements of Common Equity***(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>(Loss)/Income | Total      |
|--|------------------------|-----------------------|----------------------------------|----------------------|--|------------|
| <b>2013</b>  |                        |                       |                                  |                      |  |            |
| Beginning balance -<br>December 31, 2012                             | 34,668                 | \$ 34,668             | \$ 316,268                       | \$ 228,399           | \$ 94  | \$ 579,429 |
| Net income   |                        |                       |                                  | 74,905               |  | 74,905     |
| Other comprehensive<br>income  |                        |                       |                                  |                      | 283  | 283        |
| Common stock dividends<br>declared<br>(\$1.07 per share)             |                        |                       |                                  | (37,107)             |  | (37,107)   |
| Ending balance -<br>December 31, 2013                                | 34,668                 | \$ 34,668             | \$ 316,268                       | \$ 266,197           | \$ 377   | \$ 617,510 |
| <b>2014</b>  |                        |                       |                                  |                      |  |            |
| Net income   |                        |                       |                                  | 80,319               |  | 80,319     |
| Other comprehensive<br>income  |                        |                       |                                  |                      | 81   | 81         |
| Common stock dividends<br>declared<br>(\$1.11 per share)             |                        |                       |                                  | (38,429)             |  | (38,429)   |
| Cash in lieu of fractional<br>shares related to stock<br>split       |                        |                       |                                  | (80)                 |  | (80)       |
| Ending balance -<br>December 31, 2014                                | 34,668                 | \$ 34,668             | \$ 316,268                       | \$ 308,007           | \$ 458   | \$ 659,401 |
| <b>2015</b>  |                        |                       |                                  |                      |  |            |
| Beginning balance -<br>January 1, 2015                               | 34,668                 | \$ 34,668             | \$ 316,268                       | \$ 308,007           | \$ 458   | \$ 659,401 |
| Cumulative effect of new<br>accounting<br>principle (see Footnote 1) |                        |                       |                                  | (142)                |  | (142)      |
| Beginning balance -<br>Adjusted                                      |                        |                       |                                  | 307,865              |  | 659,259    |
| Net income   |                        |                       |                                  | 71,343               |  | 71,343     |
| Other comprehensive loss   |                        |                       |                                  |                      | (101)  | (101)      |
| Common stock dividends<br>declared                                   |                        |                       |                                  |                      |  |            |

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|                    |        |           |            |            |    |     |            |
|--------------------|--------|-----------|------------|------------|----|-----|------------|
| (\$1.16 per share) |        |           |            | (40,043)   |    |     | (40,043)   |
| Ending balance -   |        |           |            |            |    |     |            |
| December 31, 2015  | 34,668 | \$ 34,668 | \$ 316,268 | \$ 339,165 | \$ | 357 | \$ 690,458 |

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

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

|  | <b>For the Years Ended December 31,</b> |                  |                  |
|--|---|------------------|------------------|
|  | <b>2015</b>                             | <b>2014</b>      | <b>2013</b>      |
| <b>Operating Revenues:</b>   |   |                  |                  |
| Regulated electric revenues  | \$ 412,550                              | \$ 394,871       | \$ 403,980       |
| Regulated gas revenues   | 143,752                                 | 221,741          | 181,477          |
| Nonregulated revenues  | 7,763                                   | 3,283            | 5,468            |
| <i>Total Operating Revenues</i>  | 564,065                                 | 619,895          | 590,925          |
| <b>Operating Expenses:</b>   |   |                  |                  |
| Fuel for electric generation   | 53,866                                  | 42,836           | 46,070           |
| Purchased power  | 81,237                                  | 73,245           | 80,844           |
| Cost of gas sold   | 76,124                                  | 143,665          | 107,330          |
| Other operations and maintenance                                       | 163,622                                 | 160,831          | 170,498          |
| Depreciation and amortization  | 44,178                                  | 40,648           | 38,834           |
| Other general taxes  | 19,879                                  | 19,652           | 18,607           |
| Income tax provision   | 38,159                                  | 45,090           | 41,519           |
| <i>Total Operating Expenses</i>  | 477,065                                 | 525,967          | 503,702          |
| <b>Operating Income</b>  | <b>87,000</b>                           | <b>93,928</b>    | <b>87,223</b>    |
| <b>Other Income and Deductions:</b>                                    |   |                  |                  |
| AFUDC - equity funds   | 712                                     | 3,466            | 3,140            |
| Equity in earnings in ATC  | 7,728                                   | 9,150            | 9,434            |
| Income tax provision   | (3,247)                                 | (4,055)          | (4,303)          |
| Other deductions, net  | (345)                                   | (704)            | (18)             |
| <i>Total Other Income and Deductions</i>                               | 4,848                                   | 7,857            | 8,253            |
| Income before interest expense   | 91,848                                  | 101,785          | 95,476           |
| <b>Interest Expense:</b>   |   |                  |                  |
| Interest on long-term debt   | 20,520                                  | 20,927           | 20,087           |
| Other interest, net  | 94                                      | 62               | (21)             |
| AFUDC - borrowed funds   | (231)                                   | (1,142)          | (1,035)          |
| <i>Net Interest Expense</i>  | 20,383                                  | 19,847           | 19,031           |
| <b>Net Income</b>  | <b>\$ 71,465</b>                        | <b>\$ 81,938</b> | <b>\$ 76,445</b> |
| Less Net Income Attributable to<br>Noncontrolling Interest, net of tax | (26,097)                                | (26,310)         | (27,438)         |
| <b>Net Income Attributable to MGE</b>                                  | <b>\$ 45,368</b>                        | <b>\$ 55,628</b> | <b>\$ 49,007</b> |

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

**Consolidated Statements of Comprehensive Income***(In thousands)*

|   | <b>For the Years Ended December 31,</b> |                  |                  |
|---|---|------------------|------------------|
|   | <b>2015</b>                             | <b>2014</b>      | <b>2013</b>      |
| Net Income  | \$ 71,465                               | \$ 81,938        | \$ 76,445        |
| Other comprehensive income, net of tax:   |   |                  |                  |
| Unrealized (loss) gain on available-for-sale securities, net of tax (\$81, \$33, and (\$126)) | (121)                                   | (48)             | 188              |
| <b>Comprehensive Income</b>   | <b>\$ 71,344</b>                        | <b>\$ 81,890</b> | <b>\$ 76,633</b> |
| Less: Comprehensive Income Attributable to Noncontrolling Interest, net of tax                | (26,097)                                | (26,310)         | (27,438)         |
| <b>Comprehensive Income Attributable to MGE</b>   | <b>\$ 45,247</b>                        | <b>\$ 55,580</b> | <b>\$ 49,195</b> |

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

**Madison Gas and Electric Company**

**Consolidated Statements of Cash Flows**

(In thousands)

|   | <b>For the Years Ended December 31,</b> |             |             |
|---|---|-------------|-------------|
|   | <b>2015</b>                             | <b>2014</b> | <b>2013</b> |
| <b>Operating Activities:</b>                                    |   |             |             |
| Net income  | \$ 71,465                               | \$ 81,938   | \$ 76,445   |
| Items not affecting cash:                                       |   |             |             |
| Depreciation and amortization                                   | 44,178                                  | 40,648      | 38,834      |
| Deferred income taxes   | 18,843                                  | 49,603      | 37,462      |
| Provision for doubtful receivables                              | 596                                     | 1,898       | 2,448       |
| Employee benefit plan expenses                                  | 3,333                                   | (1,080)     | 13,303      |
| Equity earnings in ATC  | (7,728)                                 | (9,150)     | (9,434)     |
| Other items   | 1,223                                   | 1,280       | 651         |
| Changes in working capital items:                               |   |             |             |
| Trade and other receivables                                     | 11,079                                  | (4,455)     | (3,699)     |
| Inventories   | (2,647)                                 | (10,398)    | 2,488       |
| Unbilled revenues   | 6,254                                   | 720         | (3,720)     |
| Prepaid taxes   | 4,824                                   | (15,169)    | (373)       |
| Other current assets  | 976                                     | (5,693)     | 2,518       |
| Accounts payable  | (3,587)                                 | 2,741       | 126         |
| Accrued interest and taxes                                      | (18)                                    | (1,001)     | 2,065       |
| Other current liabilities                                       | 1,885                                   | (3,144)     | 2,975       |
| Dividend income from ATC  | 6,645                                   | 7,740       | 7,404       |
| Cash contributions to pension and other<br>postretirement plans | (13,677)                                | (3,321)     | (34,765)    |
| Debt make-whole premium   | -                                       | -           | (6,757)     |
| Other noncurrent items, net                                     | 4,816                                   | (4,619)     | 10,713      |
| <i>Cash Provided by Operating Activities</i>                    | 148,460                                 | 128,538     | 138,684     |
| <b>Investing Activities:</b>                                    |   |             |             |
| Capital expenditures  | (72,030)                                | (92,676)    | (119,047)   |
| Capital contributions to investments                            | (710)                                   | (1,775)     | (1,420)     |
| Other   | (180)                                   | (1,146)     | (130)       |
| <i>Cash Used for Investing Activities</i>                       | (72,920)                                | (95,597)    | (120,597)   |
| <b>Financing Activities:</b>                                    |   |             |             |
| Cash dividends paid to parent by MGE                            | (30,000)                                | (26,500)    | (25,000)    |
| Distributions to parent from noncontrolling<br>interest         | (14,708)                                | (21,359)    | (27,365)    |
| Equity contribution received by<br>noncontrolling interest      | 3,230                                   | 1,775       | 1,420       |
| Repayment of long-term debt                                     | (4,182)                                 | (4,103)     | (43,012)    |
| Issuance of long-term debt                                      | -                                       | -           | 85,000      |
| (Decrease) increase in short-term debt                          | (7,000)                                 | 7,000       | -           |
| Other   | (682)                                   | -           | (672)       |

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|   |                  |                 |                  |
|---|------------------|-----------------|------------------|
| <i>Cash Used for Financing Activities</i>                 | (53,342)         | (43,187)        | (9,629)          |
| Change in cash and cash equivalents:                      | 22,198           | (10,246)        | 8,458            |
| Cash and cash equivalents at beginning of period          | 4,562            | 14,808          | 6,350            |
| <b>Cash and cash equivalents at end of period</b>         | <b>\$ 26,760</b> | <b>\$ 4,562</b> | <b>\$ 14,808</b> |
| <b>Supplemental disclosures of cash flow information:</b> |                  |                 |                  |
| Interest paid   | \$ 19,636        | \$ 20,478       | \$ 17,991        |
| Income taxes paid   | \$ 29            | \$ 67           | \$ 144           |
| Income taxes received                                     | \$ -             | \$ (644)        | \$ -             |
| Significant noncash investing activities:                 |                  |                 |                  |
| Accrued capital expenditures                              | \$ 3,963         | \$ 1,569        | \$ 9,892         |

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

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

|   | <b>At December 31,</b> |              |
|---|------------------------|--------------|
|   | <b>2015</b>            | <b>2014</b>  |
| <b>ASSETS</b>   |                        |              |
| <b>Current Assets:</b>  |                        |              |
| Cash and cash equivalents   | \$ 26,760              | \$ 4,562     |
| Accounts receivable, less reserves of \$3,052 and \$4,329, respectively   | 37,112                 | 41,614       |
| Affiliate receivables   | 542                    | 7,112        |
| Other accounts receivable, less reserves of \$642 and \$420, respectively | 7,390                  | 7,524        |
| Unbilled revenues   | 25,008                 | 31,262       |
| Materials and supplies, at average cost                                   | 19,155                 | 17,121       |
| Fossil fuel   | 13,110                 | 8,098        |
| Stored natural gas, at average cost                                       | 16,145                 | 21,035       |
| Prepaid taxes   | 34,279                 | 39,103       |
| Regulatory assets - current   | 9,538                  | 8,360        |
| Other current assets  | 10,544                 | 10,683       |
| <i>Total Current Assets</i>   | 199,583                | 196,474      |
| Affiliate receivable long-term  | 4,766                  | 5,295        |
| Regulatory assets   | 148,199                | 156,823      |
| Other deferred assets and other   | 8,486                  | 4,977        |
| <b>Property, Plant, and Equipment:</b>                                    |                        |              |
| Property, plant, and equipment, net                                       | 1,216,415              | 1,188,351    |
| Construction work in progress   | 26,351                 | 19,029       |
| <i>Total Property, Plant, and Equipment</i>                               | 1,242,766              | 1,207,380    |
| <b>Investments</b>  | 69,984                 | 68,402       |
| <b>Total Assets</b>   | \$ 1,673,784           | \$ 1,639,351 |
| <b>LIABILITIES AND CAPITALIZATION</b>                                     |                        |              |
| <b>Current Liabilities:</b>   |                        |              |
| Long-term debt due within one year  | \$ 4,266               | \$ 4,182     |
| Short-term debt   | -                      | 7,000        |
| Accounts payable  | 40,742                 | 41,654       |
| Accrued interest and taxes  | 5,021                  | 5,039        |
| Accrued payroll related items   | 11,215                 | 11,241       |
| Regulatory liabilities - current  | 9,515                  | -            |
| Derivative liabilities  | 8,343                  | 6,901        |
| Other current liabilities   | 4,791                  | 11,350       |
| <i>Total Current Liabilities</i>  | 83,893                 | 87,367       |
| <b>Other Credits:</b>   |                        |              |
| Deferred income taxes   | 352,626                | 333,502      |
| Investment tax credit - deferred  | 1,050                  | 1,223        |

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|  |                     |                     |
|--|---------------------|---------------------|
| Regulatory liabilities   | 20,785              | 22,715              |
| Accrued pension and other postretirement benefits                                  | 75,680              | 90,201              |
| Derivative liabilities   | 44,935              | 46,560              |
| Other deferred liabilities and other   | 61,817              | 50,267              |
| <i>Total Other Credits</i>   | 556,893             | 544,468             |
| <b>Capitalization:</b>   |                     |                     |
| Common shareholder's equity:   |                     |                     |
| Common Stock - \$1 par value - 50,000 shares authorized; 17,348 shares outstanding | 17,348              | 17,348              |
| Additional paid-in capital   | 192,417             | 192,417             |
| Retained earnings  | 291,888             | 276,662             |
| Accumulated other comprehensive income, net of tax                                 | 23                  | 144                 |
| <i>Total Common Shareholder's Equity</i>   | 501,676             | 486,571             |
| Noncontrolling interest  | 140,308             | 125,689             |
| <i>Total Equity</i>  | 641,984             | 612,260             |
| Long-term debt   | 391,014             | 395,256             |
| <i>Total Capitalization</i>  | 1,032,998           | 1,007,516           |
| Commitments and contingencies (see Footnote 18)                                    | -                   | -                   |
| <b>Total Liabilities and Capitalization</b>  | <b>\$ 1,673,784</b> | <b>\$ 1,639,351</b> |

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

**Madison Gas and Electric Company****Consolidated Statements of Common Equity***(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>(Loss)/Income | Non-<br>Controlling<br>Interest | Total      |
|---|------------------------|-----------------------|----------------------------------|----------------------|--|---------------------------------|------------|
| <b>2013</b>   |                        |                       |                                  |                      |  |                                 |            |
| Beginning balance -<br>December 31, 2012                      | 17,348                 | \$ 17,348             | \$ 192,417                       | \$ 223,527           | \$ 4   | \$ 117,470                      | \$ 550,766 |
| Net income  |                        |                       |                                  | 49,007               |  | 27,438                          | 76,445     |
| Other comprehensive<br>income                                 |                        |                       |                                  |                      | 188  |                                 | 188        |
| Cash dividends paid to<br>parent by MGE                       |                        |                       |                                  | (25,000)             |  |                                 | (25,000)   |
| Equity contribution<br>received by<br>noncontrolling interest |                        |                       |                                  |                      |  | 1,420                           | 1,420      |
| Distributions to parent<br>from<br>noncontrolling interest    |                        |                       |                                  |                      |  | (27,365)                        | (27,365)   |
| Ending balance -<br>December 31, 2013                         | 17,348                 | \$ 17,348             | \$ 192,417                       | \$ 247,534           | \$ 192   | \$ 118,963                      | \$ 576,454 |
| <b>2014</b>   |                        |                       |                                  |                      |  |                                 |            |
| Net income  |                        |                       |                                  | 55,628               |  | 26,310                          | 81,938     |
| Other comprehensive<br>loss                                   |                        |                       |                                  |                      | (48)   |                                 | (48)       |
| Cash dividends paid to<br>parent by MGE                       |                        |                       |                                  | (26,500)             |  |                                 | (26,500)   |
| Equity contribution<br>received by<br>noncontrolling interest |                        |                       |                                  |                      |  | 1,775                           | 1,775      |
| Distributions to parent<br>from<br>noncontrolling interest    |                        |                       |                                  |                      |  | (21,359)                        | (21,359)   |
| Ending balance -<br>December 31, 2014                         | 17,348                 | \$ 17,348             | \$ 192,417                       | \$ 276,662           | \$ 144   | \$ 125,689                      | \$ 612,260 |
| <b>2015</b>   |                        |                       |                                  |                      |  |                                 |            |
| Beginning balance -<br>January 1, 2015                        | 17,348                 | \$ 17,348             | \$ 192,417                       | \$ 276,662           | \$ 144   | \$ 125,689                      | \$ 612,260 |
| Cumulative effect of<br>new accounting                        |                        |                       |                                  |                      |  |                                 |            |



## **Notes to Consolidated Financial Statements**

**December 31, 2015, 2014, and 2013**

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

**1.**

### **Summary of Significant Accounting Policies.**

**a.**

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

The consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States of America (GAAP), which give recognition to the rate making accounting policies for regulated operations prescribed by the regulatory authorities having jurisdiction, principally the PSCW and FERC. MGE's accounting records conform to the FERC uniform system of accounts.

**b.**

#### **Principles of Consolidation - MGE Energy and MGE.**

MGE, a wholly owned subsidiary of MGE Energy, is a regulated electric and gas utility headquartered in Madison, Wisconsin. MGE Energy and MGE consolidate all majority owned subsidiaries in which it has controlling influence. MGE is the majority owner of MGE Transco. MGE Transco is a nonregulated entity formed to manage the investment in ATC.

Wholly owned subsidiaries of MGE Energy include CWDC, MAGAEL, MGE Power, MGE State Energy Services, MGE Services, and NGV Fueling Services. MGE Power owns 100% of MGE Power Elm Road and MGE Power West Campus. MGE Power and its subsidiaries are part of MGE Energy's nonregulated energy operations, which were formed to own and lease electric generation projects to assist MGE.

MGE Energy and MGE consolidate variable interest entities (VIEs) for which it is the primary beneficiary. Variable interest entities are legal entities that possess any of the following characteristics: equity investors who have an insufficient amount of equity at risk to finance their activities, equity owners who do not have the power to direct the significant activities of the entity (or have voting rights that are disproportionate to their ownership interest), or equity holders who do not receive expected losses or returns significant to the VIE. If MGE Energy or MGE is not the primary beneficiary and an ownership interest is held, the VIE is accounted for under the equity method of accounting. When assessing the determination of the primary beneficiary, all relevant facts and circumstances are considered, including: the power, through voting or similar rights, to direct the activities of the VIE that most significantly impact the VIE's economic performance and the obligation to absorb the expected losses and/or the right to receive the expected returns of the VIE. Ongoing reassessments of all VIEs are performed to determine if the primary beneficiary status has changed. MGE has consolidated MGE Power Elm Road and MGE Power West Campus. Both entities are VIEs. MGE is considered the primary beneficiary of these entities as a result of contractual agreements. See Footnote 2 for more discussion of these entities.

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

**c.**

**Use of Estimates - MGE Energy and MGE.**

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

**d.**

**Cash Equivalents and Restricted Cash - MGE Energy and MGE.**

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

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

included in "Other current assets" on the consolidated balance sheets.

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e.

**Receivable Margin Account - MGE Energy and MGE.**

Cash amounts held by counterparties as margin for certain financial transactions are recorded as receivable margin account in "Other current assets" on the consolidated balance sheets. As of December 31, 2015 and 2014, the receivable margin account balance of \$2.3 million and \$2.2 million, respectively, is shown net of any collateral posted against derivative positions. As of December 31, 2015 and 2014, there was \$1.0 million and \$2.2 million, respectively, of collateral posted against derivative positions. Changes in this cash account are considered cash flows from operating activities to match with the costs being hedged. The costs being hedged are fuel for electric generation, purchased power, and cost of gas sold.

f.

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

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

g.

**Inventories - MGE Energy and MGE.**

Inventories consist of natural gas in storage, fossil fuels, materials and supplies, and renewable energy credits (RECs). MGE values natural gas in storage, fossil fuels, and materials and supplies using average cost.

REC allowances are included in "Materials and supplies" on the consolidated balance sheets and are recorded based on specific identification. These allowances are charged to purchase power expense as they are used in operations. MGE's REC allowance balances as of December 31, 2015 and 2014, were \$0.3 million and \$0.8 million, respectively.

h.

**Chattel Paper Agreements - MGE Energy and MGE.**

MGE makes available to qualifying customers a financing program for the purchase and installation of energy-related equipment that will provide more efficient use of utility service at the customer's property. The energy-related equipment installed at the customer sites is used to secure the customer loans. MGE is a party to a chattel paper purchase agreement with a financial institution under which it can sell or finance an undivided interest with recourse, in up to \$10.0 million of the financing program receivables, until July 31, 2016. The length of the MGE guarantee to the financial institution varies from one to ten years depending on the term of the underlying customer loan. The loan balances outstanding at December 31, 2015, approximate the fair value of the energy-related equipment acting as collateral. MGE accounts for these agreements as secured borrowings.

Prior to the Transfers and Servicing Asset authoritative accounting guidance that became effective in 2015, these agreements were treated as off-balance sheet arrangements. Beginning January 1, 2015, these agreements are included as assets and liabilities in the consolidated balance sheets. As of December 31, 2015, assets ("Other accounts receivable" and "Other deferred assets") and liabilities ("Accounts payable" and "Other deferred liabilities") increased approximately \$3.7 million as a cumulative result of the guidance. In addition, the cumulative effect of this guidance resulted in a \$0.1 million reduction in retained earnings.

As of December 31, 2015, the remaining contractual maturities of the chattel paper agreements were as follows:

| <i>(In thousands)</i>                | 2016     | 2017  | 2018  | 2019  | 2020  | Thereafter |
|--------------------------------------|----------|-------|-------|-------|-------|------------|
| Repurchase-to-Maturity Transactions: |          |       |       |       |       |            |
| Loans                                | \$ 706\$ | 476\$ | 508\$ | 477\$ | 445\$ | 1,059      |

i.

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

Regulatory assets and regulatory liabilities are recorded consistent with regulatory treatment. Regulatory assets represent costs which are deferred due to the probable future recovery from customers through regulated rates. Regulatory liabilities represent the excess recovery of costs or accrued credits which were deferred because MGE believes it is probable such amounts will be returned to customers through future regulated rates. Regulatory assets and liabilities are amortized in the consolidated statements of income consistent with the recovery or refund included in customer rates. MGE believes that it is probable that its recorded regulatory assets and liabilities will be recovered and refunded, respectively, in future rates. See Footnote 6 for further information.

j.

**Debt Issuance Costs - MGE Energy and MGE.**

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

k.

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

Property, plant, and equipment is recorded at original cost. Cost includes indirect costs consisting of payroll taxes, pensions, postretirement benefits, other fringe benefits, and administrative and general costs. Also, included in the cost is AFUDC for utility property and capitalized interest for nonregulated property. Additions for significant replacements of property are charged to property, plant, and equipment at cost; and minor items are charged to maintenance expense. Depreciation rates on utility property are approved by the PSCW, based on the estimated economic lives of property, and include estimates for salvage value and removal costs. Removal costs of utility property, less any salvage value, are adjusted through regulatory liabilities. Depreciation rates on nonregulated property are based on the estimated economic lives of the property. See Footnote 3 for further information.

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

|              | 2015  | 2014  | 2013  |
|--------------|-------|-------|-------|
| Electric     | 2.6 % | 2.6 % | 2.7 % |
| Gas          | 1.7 % | 1.7 % | 1.7 % |
| Nonregulated | 2.4 % | 2.4 % | 2.3 % |

**l.**

**Asset Retirement Obligations - MGE Energy and MGE.**

MGE Energy and MGE are required to record a liability for the fair value of an ARO to be recognized in the period in which it is incurred if it can be reasonably estimated. The offsetting associated asset retirement costs are capitalized as a long-lived asset and depreciated over the asset's useful life. The expected present value technique used to calculate the fair value of ARO liabilities includes assumptions about costs, probabilities, settlement dates, interest accretion, and inflation. Revisions to the assumptions, including the timing or amount of expected asset retirement costs, could result in increases or decreases to the AROs. All asset retirement obligations are recorded as "Other long-term liabilities" on our consolidated balance sheets. MGE has regulatory treatment and recognizes regulatory assets or liabilities for the timing differences between when we recover legal AROs in rates and when we would recognize these costs. See Footnote 19 for further information.

**m.**

**Repairs and Maintenance Expense - MGE Energy and MGE.**

MGE utilizes the direct expensing method for planned major maintenance projects. Under this method, MGE expenses all costs associated with major planned maintenance activities as incurred.

**n.**

**Purchased Gas Adjustment Clause - MGE Energy and MGE.**

MGE's natural gas rates are subject to a fuel adjustment clause designed to recover or refund the difference between the actual cost of purchased gas and the amount included in rates. Differences between the amounts billed to customers and the actual costs recoverable are deferred and recovered or refunded in future periods



by means of prospective monthly adjustments to rates. At December 31, 2015 and 2014, MGE had over collected \$0.8 million and \$1.2 million, respectively. These amounts are included in "Other current liabilities" on the consolidated balance sheets.

**o.**

**Revenue Recognition - MGE Energy and MGE.**

Operating revenues are recorded as service is rendered or energy is delivered to customers. Meters are read on a systematic basis throughout the month based on established meter-reading schedules. At the end of the month, MGE accrues an estimate for the unbilled amount of energy delivered to customers. The unbilled revenue estimate is based on daily system demand volumes, weather factors, estimated line losses, estimated customer usage by class, and applicable customer rates.

**p.**

**Utility Cost Recovery - MGE Energy and MGE.**

MGE's rates include a provision for fuel costs. The PSCW allows Wisconsin utilities to defer electric fuel-related costs, less excess revenues, that fall outside a symmetrical cost tolerance band. Any over/under recovery of the actual costs is determined on an annual basis and will be adjusted in future billings to electric retail customers. Such deferred amounts will be recognized in "Purchased power" expense in MGE Energy's and MGE's consolidated income statements each period. The cumulative effects of these deferred amounts will be recorded in "Regulatory assets" or "Regulatory liabilities" on MGE Energy's and MGE's consolidated balance sheets until they are reflected in future billings to customers. See Footnote 17.b. for further information regarding the regulatory rules applicable to the recovery of electric fuel costs.

**q.**

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

Allowance for funds used during construction is included in utility plant accounts and represents the cost of borrowed funds used during plant construction and a return on shareholder's capital used for construction purposes. In the consolidated income statements, the cost of borrowed funds (AFUDC-debt) is presented as an offset to "Interest expense" and the return on shareholder's capital (AFUDC-equity funds) is shown as an item within "Other income." For 2015, as approved by the PSCW, MGE capitalized AFUDC-debt and equity on 50% of applicable average

construction work in progress at 7.93%. For both 2014 and 2013, MGE capitalized AFUDC-debt and equity on 50% of applicable average construction work in progress at 8.21%. For 2015 and 2014, MGE received specific approval to recover 100% AFUDC on certain environmental costs for Columbia and 50% in 2013. Although the allowance does not represent current cash income, it is recovered under the ratemaking process over the service lives of the related properties.

r.

#### **Investments - MGE Energy and MGE.**

Investments in limited liability companies that have specific ownership accounts in which MGE Energy or MGE's ownership interest is more than minor and are considered to have significant influence are accounted for using the equity method. All other investments are carried at fair value or at cost, as appropriate. See Footnote 4 for further information.

s.

#### **Capitalized Software Costs - MGE Energy and MGE.**

Property, plant, and equipment includes the net book value of capitalized costs of internal use software totaling \$12.0 million and \$8.4 million at December 31, 2015 and 2014, respectively. During 2015, 2014, and 2013, MGE recorded \$2.2 million, \$1.6 million, and \$1.5 million, respectively, of amortization expense related to these costs. These costs are amortized on a straight-line basis over the estimated useful lives of the assets. For internal use software, the useful lives range from five to ten years.

t.

#### **Impairment of Long-Lived Assets - MGE Energy and MGE.**

MGE reviews plant and equipment and other property for impairment when events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. MGE's policy for determining when long-lived assets are impaired is to recognize an impairment loss if the sum of the expected future cash flows (undiscounted and without interest charges) from an asset are less than the carrying amount of that asset. If an impairment loss is recognized, the amount that will be recorded will be measured as the amount by which the carrying amount of the asset exceeds the fair value of the asset. There is no impairment of long-lived assets at December 31, 2015, 2014, and 2013.



u.

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

*Income taxes*

Under the liability method, income taxes are deferred for all temporary differences between pretax financial and taxable income and between the book and tax basis of assets and liabilities using the tax rates scheduled by law to be in effect when the temporary differences reverse. Future tax benefits are recognized to the extent that realization of such benefits is more likely than not. A valuation allowance is recorded for those benefits that do not meet this criterion.

Accounting for uncertainty in income taxes applies to all tax positions and requires a recognition threshold and measurement standard for the financial statement recognition and measurement of a tax position taken, or expected to be taken, in an income tax return. The threshold is defined for recognizing tax return positions in the financial statements as "more likely than not" that the position is sustainable, based on its merits. Subsequent recognition, derecognition, and measurement is based on management's best judgment given the facts, circumstances, and information available at the reporting date.

Regulatory and accounting principles have resulted in a regulatory liability related to income taxes. Excess deferred income taxes result from past taxes provided at rates higher than current rates. The income tax regulatory liability and deferred investment tax credit reflect the revenue requirement associated with the return of these tax benefits to customers.

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

*Excise taxes*

MGE Energy, through its utility operations, pays a state license fee tax in lieu of property taxes on property used in utility operations. License fee tax is calculated as a percentage of adjusted operating revenues of the prior year. The electric tax rate is 3.19% for retail sales and 1.59% for sales of electricity for resale by the purchaser. The tax rate on sales of natural gas is 0.97%. The tax is required to be estimated and prepaid in the year prior to its computation and expensing. License fee tax expense, included in "Other general taxes," was \$14.7 million, \$14.6 million, and \$13.8 million for the years ended December 31, 2015, 2014, and 2013, respectively.

Operating income taxes, including tax credits and license fee tax, are included in rates for utility related items.

v.

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

Under two separate incentive plans, eligible participants, including employees and non-employee directors, may receive performance units that entitle the holder to receive a cash payment equal to the value of a designated number of shares of MGE Energy's common stock, plus dividend equivalent payments thereon, at the end of the set performance period. Under the plans, these awards are subject to a prescribed vesting schedule and must be settled in cash. Accordingly, no new shares of common stock are issued in connection with the plans.

MGE Energy and MGE initially measure the cost of the employee or director 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 award is subsequently re-measured at each reporting date through the settlement date. Changes in fair value during the requisite period are recognized as compensation cost over that period.

See Footnote 14 for additional information regarding the plans.

w.

**Comprehensive Income - MGE Energy and MGE.**

Total comprehensive income includes all changes in equity during a period except those resulting from investments by and distributions to shareholders. Comprehensive income is reflected in the consolidated statements of comprehensive income.

x.

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

As part of regular operations, MGE enters into contracts, including options, swaps, futures, forwards, and other contractual commitments, to manage its exposure to commodity prices. MGE recognizes all derivatives

in the consolidated balance sheets at fair value, with changes in the fair value of derivative instruments to be recorded in current earnings or deferred in accumulated other comprehensive income (loss), depending on whether a derivative is designated as, and is effective as, a hedge and on the type of hedge transaction. Derivative activities are in accordance with the company's risk management policy.

If the derivative qualifies for regulatory deferral, the derivatives are marked to fair value and are offset with a corresponding regulatory asset or liability. Cash flows from such derivative instruments are classified on a basis consistent with the nature of the underlying hedged item.

2.

**Variable Interest Entities - MGE Energy and MGE.**

a.

**MGE Power Elm Road.**

MGE Power Elm Road is not a subsidiary of MGE; however, it has been consolidated in the financial statements of MGE. MGE Power Elm Road was created for the purpose of owning new generating assets. Its sole principal assets are an undivided ownership interest in two coal-fired generating plants located in Oak Creek, Wisconsin, which it leases to MGE pursuant to long-term leases. Based on the nature and terms of the contractual agreements, MGE is expected to absorb a majority of the expected losses, residual value, or both, associated with the ownership of MGE Power Elm Road and therefore holds a variable interest in MGE Power Elm Road, even though it has no equity interest in MGE Power Elm Road. MGE Energy and MGE consolidate VIEs for which they are the primary beneficiary. MGE has the power to direct the activities that most significantly impact the Elm Road Units' economic performance and is also the party most closely associated with MGE Power Elm Road. As a result, MGE is the primary beneficiary. At December 31, MGE has included the following significant accounts on its consolidated balance sheets related to its interest in this VIE:

| <i>(In thousands)</i>               | 2015       | 2014       |
|-------------------------------------|------------|------------|
| Property, plant, and equipment, net | \$ 177,904 | \$ 179,620 |
| Construction work in progress       | 2,400      | 1,976      |

|                         |        |        |
|-------------------------|--------|--------|
| Affiliate receivables   | -      | 1,742  |
| Deferred income taxes   | 40,865 | 40,044 |
| Long-term debt          | 65,305 | 67,972 |
| Noncontrolling interest | 79,113 | 72,537 |

Long-term debt consists of \$65.3 million of senior secured notes that require that MGE Power Elm Road maintain a projected and actual debt service coverage ratio at the end of any calendar quarter of not less than 1.25 to 1.00 for the trailing 12-month period. The debt is secured by a collateral assignment of lease payments that MGE is making to MGE Power Elm Road for use of the Elm Road Units pursuant to the related long-term leases. As of December 31, 2015, MGE Power Elm Road is in compliance with the covenant requirements.

MGE has been and will continue to recover in rates the lease payments made to MGE Power Elm Road. MGE received approval from the PSCW to collect in rates the carrying costs incurred by MGE Power Elm Road. The total carrying costs on the Elm Road Units is \$62.5 million. MGE is collecting carrying costs in rates over a six year period that began in 2010. Of these costs, \$17.0 million relates to the capitalized interest and the debt portion of the units. These costs will be recognized over the period in which the generating units will be depreciated. The remaining \$45.5 million represents the equity portion and was recognized over the period allowed for recovery in rates which ended in 2015.

**b.**

**MGE Power West Campus.**

MGE Power West Campus is not a subsidiary of MGE; however, it has been consolidated in the financial statements of MGE. MGE Power West Campus was created for the purpose of owning new generating assets. Its sole principal asset is the WCCF, which it leases to MGE pursuant to a long-term lease. MGE is responsible for operation of the plant during the term of the lease. Based on the nature and terms of these contractual relationships, MGE absorbs a majority of the expected losses, residual value, or both, associated with the ownership and operation of the WCCF and therefore holds a variable interest in MGE Power West

Campus, even though it has no equity interest in MGE Power West Campus. MGE has the power to direct the activities that most significantly impact WCCF's economic performance and is also the party most closely associated with MGE Power West Campus. As a result, MGE is the primary beneficiary. At December 31, MGE has included the following significant accounts on its consolidated balance sheets related to its interest in this VIE:

| <i>(In thousands)</i>               | 2015      | 2014      |
|-------------------------------------|-----------|-----------|
| Property, plant, and equipment, net | \$ 84,403 | \$ 86,763 |
| Affiliate receivables               | 5,295     | 5,862     |
| Deferred income taxes               | 19,612    | 23,813    |
| Long-term debt                      | 46,703    | 48,218    |
| Noncontrolling interest             | 37,603    | 30,755    |

Long-term debt consists of \$46.7 million of senior secured notes that require that MGE Power West Campus maintain a projected debt service coverage ratio of not less than 1.25 to 1.00 and debt to total capitalization ratio of not more than 0.65 to 1.00. The debt is secured by a collateral assignment of lease payments that MGE is making to MGE Power West Campus for use of the cogeneration facility pursuant to the long-term lease. As of December 31, 2015, MGE Power West Campus is in compliance with the covenant requirements.

MGE has been and will continue to recover lease payments made to MGE Power West Campus in rates. Also, MGE received approval from the PSCW to collect approximately \$12.1 million in carrying costs incurred by MGE Power West Campus during construction of the facility. The carrying costs were recovered in rates over a 10 year period that started in 2005 and ended in 2015.

c.

#### **Other Variable Interest Entities.**

MGE has a variable interest in entities through purchase power agreements relating to purchased energy from the facilities. As of December 31, 2015 and 2014, MGE had 61 megawatts of capacity available under these agreements. MGE evaluated the variable interest entities for possible consolidation. The interest holder is considered the primary beneficiary of the entity and is required to consolidate the entity if the interest holder has the power to direct the activities that most significantly impact the economics of the variable interest entity. MGE examined qualitative factors such as the length of the remaining term of the contracts compared with the remaining lives of the plants, who has the power to direct the operations and maintenance of the facilities, and other factors, and determined MGE is not the primary beneficiary of the variable interest entities. There is not a significant potential exposure to loss as a result of involvement with these variable interest entities.

3.

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

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

| <i>(In thousands)</i>                           | MGE Energy   |              | MGE          |              |
|---|--------------|--------------|--------------|--------------|
|   | 2015         | 2014         | 2015         | 2014         |
| <b><i>Utility:</i></b>                          |              |              |              |              |
| Electric  | \$ 1,147,701 | \$ 1,110,953 | \$ 1,147,718 | \$ 1,110,970 |
| Gas   | 384,163      | 369,975      | 384,175      | 369,987      |
| Total utility plant                             | 1,531,864    | 1,480,928    | 1,531,893    | 1,480,957    |
| Less: Accumulated depreciation and amortization | 578,410      | 559,615      | 578,410      | 559,615      |
| In-service utility plant, net                   | 953,454      | 921,313      | 953,483      | 921,342      |
| <b><i>Nonregulated:</i></b>                     |              |              |              |              |
| Nonregulated                                    | 315,589      | 313,152      | 314,750      | 312,314      |
| Less: Accumulated depreciation and amortization | 51,949       | 45,388       | 51,818       | 45,305       |
| In-service nonregulated plant, net              | 263,640      | 267,764      | 262,932      | 267,009      |
| <b><i>Construction work in progress:</i></b>    |              |              |              |              |
| Utility construction work in progress           | 23,837       | 16,988       | 23,837       | 16,988       |
| Nonregulated construction work in progress      | 2,514        | 2,041        | 2,514        | 2,041        |
| Total property, plant, and equipment            | \$ 1,243,445 | \$ 1,208,106 | \$ 1,242,766 | \$ 1,207,380 |

MGE's utility plant is subject to the lien of its Indenture of Mortgage and Deed of Trust. As of December 31, 2015 and 2014, there was \$1.2 million of bonds outstanding under that indenture. See Footnote 9 for further discussion of the mortgage indenture.

**4.****Investments - MGE Energy and MGE.****a.****Equity Method Investments, Available for Sale Securities, and Other Investments.**

| <i>(In thousands)</i>           | MGE Energy |           | MGE       |           |
|---------------------------------|------------|-----------|-----------|-----------|
|                                 | 2015       | 2014      | 2015      | 2014      |
| Available for sale securities:  |            |           |           |           |
| Cost basis                      | \$ 2,225   | \$ 1,964  | \$ 480    | \$ 489    |
| Gross unrealized gains          | 599        | 765       | 40        | 240       |
| Gross unrealized losses         | (2)        | -         | (2)       | -         |
| Fair value                      | 2,822      | 2,729     | 518       | 729       |
| Equity method investments:      |            |           |           |           |
| ATC                             | 69,466     | 67,673    | 69,466    | 67,673    |
| Other                           | 1,184      | 1,199     | -         | -         |
| Total equity method investments | 70,650     | 68,872    | 69,466    | 67,673    |
| Other investments               | 159        | 159       | -         | -         |
| Total                           | \$ 73,631  | \$ 71,760 | \$ 69,984 | \$ 68,402 |

MGE Energy's and MGE's available for sale securities represent publicly traded securities and private equity investments in common stock of companies in various industries.

During the years ended December 31, 2015, 2014, and 2013, certain investments were liquidated. As a result of these liquidations, MGE Energy and MGE received the following:

| <i>(In thousands)</i> | 2015  | MGE Energy |       | 2015  | MGE  |       |
|-----------------------|-------|------------|-------|-------|------|-------|
|                       |       | 2014       | 2013  |       | 2014 | 2013  |
| Cash proceeds         | \$ 19 | \$ 38      | \$ 39 | \$ 19 | \$ - | \$ 16 |
| Gain (loss) on sale   | 10    | 21         | 2     | 10    | -    | (3)   |

**b.****ATC.**

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

MGE Transco has accounted for its investment in ATC under the equity method of accounting. For the years ended December 31, 2015, 2014, and 2013, MGE Transco recorded the following:

| <i>(In thousands)</i>                     |    | 2015     | 2014     | 2013  |
|---|----|----------|----------|-------|
| Equity in earnings from investment in ATC | \$ | 7,728 \$ | 9,150 \$ | 9,434 |
| Dividends received from ATC               |    | 6,645    | 7,740    | 7,404 |
| Capital contributions to ATC              |    | 710      | 1,775    | 1,420 |

At December 31, 2015 and 2014, MGE Transco held a 3.6% ownership interest in ATC. MGE Transco's investment balance is different from the amount of the underlying equity in the net assets of ATC. This difference is attributable to the allocation of certain tax impacts related to the initial asset transfer. On January 29, 2016, MGE Transco made a \$0.5 million capital contribution to ATC.

At December 31, 2015 and 2014, MGE is the majority owner, and MGE Energy, the holding company, is the minority owner of MGE Transco. MGE Energy's proportionate share of the equity and net income of MGE Transco is classified within the MGE consolidated financial statements as noncontrolling interest.

In mid-2016, MGE is no longer expected to be the majority owner of MGE Transco. The change will have no effect on MGE Energy's consolidated financial statements; however, MGE Energy's proportionate share of the equity and net income of MGE Transco will be deconsolidated from MGE's financial statements. See further discussion in Footnote 8.

ATC's summarized financial data for the years ended December 31, 2015, 2014, and 2013 is as follows:

*(In thousands)*

**Income statement data for the year ended**

| <b>December 31,</b>                   | 2015       | 2014       | 2013       |
|---------------------------------------|------------|------------|------------|
| Operating revenues                    | \$ 615,836 | \$ 635,033 | \$ 626,336 |
| Operating expenses                    | (319,321)  | (307,451)  | (295,069)  |
| Other income                          | 1,176      | 117        | 831        |
| Interest expense, net                 | (97,250)   | (88,970)   | (84,484)   |
| Earnings before members' income taxes | \$ 200,441 | \$ 238,729 | \$ 247,614 |

**Balance sheet data as of December 31,**

|                                       | 2015         | 2014         | 2013         |
|---------------------------------------|--------------|--------------|--------------|
| Current assets                        | \$ 80,520    | \$ 66,410    | \$ 80,715    |
| Noncurrent assets                     | 3,957,576    | 3,728,675    | 3,509,517    |
| Total assets                          | \$ 4,038,096 | \$ 3,795,085 | \$ 3,590,232 |
| Current liabilities                   | \$ 330,248   | \$ 313,065   | \$ 381,467   |
| Long-term debt                        | 1,800,029    | 1,701,000    | 1,550,000    |
| Other noncurrent liabilities          | 244,991      | 163,818      | 126,167      |
| Members' equity                       | 1,662,828    | 1,617,202    | 1,532,598    |
| Total members' equity and liabilities | \$ 4,038,096 | \$ 3,795,085 | \$ 3,590,232 |

**5.**

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

**a.**

**Columbia.**

MGE and two other utilities jointly own Columbia, a coal-fired generating facility located in Portage, Wisconsin, which accounts for 31% (242 MW) of MGE's net summer rated capacity. Power from this facility is shared in proportion to each company's ownership interest. MGE has a 22% ownership interest in Columbia. The other owners are WPL, which operates Columbia, and WPSC. MGE's share of fuel, operating, and maintenance expenses for Columbia was \$38.2 million, \$28.1 million, and \$37.5 million for the years ended December 31, 2015, 2014, and 2013, respectively.

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

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| <i>(In thousands)</i>                | 2015          | 2014     |
|--------------------------------------|---------------|----------|
| Utility plant                        | \$ 273,762 \$ | 268,597  |
| Accumulated depreciation             | (84,864)      | (80,645) |
| Property, plant, and equipment, net  | 188,898       | 187,952  |
| Construction work in progress        | 17,110        | 6,941    |
| Total property, plant, and equipment | \$ 206,008 \$ | 194,893  |

**b.**

**Elm Road.**

MGE Power Elm Road owns an 8.33% ownership interest in each of two 615 MW coal-fired generating units in Oak Creek, Wisconsin, which accounts for 14% (106 MW) of MGE's net summer rated capacity. Unit 1 entered commercial operation on February 2, 2010. Unit 2 entered commercial operation on January 12, 2011. MGE Power Elm Road's sole principal asset is that ownership interest in those generating units. MGE Power Elm Road's interest in the Elm Road Units is leased to MGE pursuant to long-term leases.

The remainder of the ownership interest in the Elm Road Units is held by two other entities, one of which is also responsible for the Units' operation. Each owner provides its own financing and reflects its respective portion of the facility and costs in its financial statements. MGE's share of fuel, operating, and maintenance expenses for the Elm Road Units was \$20.9 million, \$20.3 million, and \$13.4 million for the years ended December 31, 2015, 2014, and 2013, respectively.

MGE Power Elm Road's interest in the portion of the Elm Road Units in-service and the related accumulated depreciation reserves at December 31 were as follows:

| <i>(In thousands)</i>                | 2015          | 2014     |
|--------------------------------------|---------------|----------|
| Nonregulated plant                   | \$ 202,326 \$ | 199,582  |
| Accumulated depreciation             | (24,422)      | (19,962) |
| Property, plant, and equipment, net  | 177,904       | 179,620  |
| Construction work in progress        | 2,400         | 1,976    |
| Total property, plant, and equipment | \$ 180,304 \$ | 181,596  |

c.

**WCCF.**

MGE Power West Campus and the UW jointly own the West Campus Cogeneration Facility located on the UW campus in Madison, Wisconsin. MGE Power West Campus owns 55% of the facility and the UW owns 45% of the facility. The UW owns a controlling interest in the chilled-water and steam plants, which are used to meet the growing needs for air-conditioning and steam-heat capacity for the UW campus. MGE Power West Campus owns a controlling interest in the electric generation plant, which is leased and operated by MGE.

Each owner provides its own financing and reflects its respective portion of the facility and operating costs in its financial statements. MGE Power West Campus' interest in WCCF and the related accumulated depreciation reserves at December 31 were as follows:

| <i>(In thousands)</i>               | 2015          | 2014     |
|-------------------------------------|---------------|----------|
| Nonregulated plant                  | \$ 111,141 \$ | 111,453  |
| Accumulated depreciation            | (26,738)      | (24,691) |
| Property, plant, and equipment, net | \$ 84,403 \$  | 86,762   |

Operating charges are allocated to the UW based on formulas contained in the operating agreement. Under the provisions of this arrangement, the UW is required to reimburse MGE for their allocated portion of fuel and operating expenses. For the years ended December 31, 2015, 2014, and 2013, the UW allocated share of fuel and operating costs was \$3.7 million, \$2.8 million, and \$4.9 million, respectively.

6.

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

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

| <i>(In thousands)</i>                               | 2015       | 2014       |
|---|------------|------------|
| <b>Regulatory Assets</b>                            |            |            |
| Asset retirement obligation                         | \$ 4,849   | \$ 4,532   |
| Debt related costs                                  | 10,672     | 11,133     |
| Derivatives   | 54,083     | 54,998     |
| Environmental costs                                 | 368        | 700        |
| Tax recovery related to AFUDC equity                | 8,950      | 8,821      |
| Unfunded pension and other postretirement liability | 78,181     | 84,551     |
| Other   | 634        | 448        |
| <i>Total Regulatory Assets</i>                      | \$ 157,737 | \$ 165,183 |
| <b>Regulatory Liabilities</b>                       |            |            |
| Conservation costs                                  | \$ 231     | \$ 680     |
| Deferred fuel savings                               | 9,515      | 755        |
| Elm Road  | 643        | 1,497      |
| Income taxes  | 1,559      | 1,794      |
| Non-ARO removal costs                               | 17,137     | 16,129     |
| Renewable energy credits                            | 327        | 753        |
| Other   | 888        | 1,107      |
| <i>Total Regulatory Liabilities</i>                 | \$ 30,300  | \$ 22,715  |

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

### ***Asset Retirement Obligation***

See Footnote 19 for further discussion.

### ***Debt Related Costs***

This balance includes debt issuance costs of extinguished debt and other debt related expenses. The PSCW has allowed rate recovery on unamortized issuance costs for extinguished debt facilities. When the facility replacing the old facility is deemed by the PSCW to be more favorable for the ratepayers, the PSCW will allow rate recovery of any unamortized issuance costs related to the old facility. These amounts are recovered over the term of the new facility.

In 2013, MGE issued long-term debt and used the net proceeds to redeem Medium-Term Notes and partially redeem Senior Notes. Included in the redemption prices were make-whole premiums totalling \$6.8 million. The make-whole premiums are treated as a regulatory asset and will be amortized over the life of the long-term debt issued.

### ***Derivatives***

MGE has physical and financial contracts that are defined as derivatives. The amounts recorded for the net mark-to-market value of the commodity based contracts is offset with a corresponding regulatory asset or liability because these transactions are part of the PGA or fuel rules clause authorized by the PSCW. A significant portion of the recorded amount is related 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. This agreement is accounted for as a derivative contract. See Footnote 16 for further discussion.

### ***Environmental Costs***

MGE has been allowed to defer actual costs on certain environmental matters, including clean up of two landfill sites and legal expenditures pertaining to the response to the EPA Clean Air Act enforcement matter at Columbia. For further discussion of the Columbia Clean Air Act litigation, see Footnote 18.c.

### ***Tax Recovery Related to AFUDC Equity***

AFUDC equity represents the after-tax equity cost associated with utility plant construction and results in a temporary difference between the book and tax basis of such plant. It is probable under PSCW regulation that MGE will recover in future rates the future increase in taxes payable represented by the deferred income tax liability. The amounts will be recovered in rates over the depreciable life of the asset for which AFUDC was applied. Tax recovery related to AFUDC equity represents the revenue requirement related to recovery of these future taxes payable, calculated at current statutory tax rates.

#### ***Unfunded Pension and Other Postretirement Liability***

MGE is required to recognize the unfunded status of defined benefit pension and other postretirement pension plans as a net liability or asset on the balance sheet with an offset to a regulatory asset. The unfunded status represents future expenses that are expected to be recovered in rates. See Footnote 13 for further discussion.

#### ***Conservation Costs***

MGE has received regulatory treatment for certain conservation expenditures. The expenditures are used for Focus on Energy programs, Wisconsin's statewide energy efficiency and renewable resource program, to promote energy efficiency on the customer's premises. Costs for Focus on Energy programs are estimated in MGE's rates utilizing escrow accounting. The escrow accounting allows the utility to true-up its actual costs incurred and reflect the amount of the true-up in its next rate case filing.

#### ***Deferred Fuel Savings***

The fuel rules require the PSCW and Wisconsin utilities to defer electric fuel-related costs that fall outside a symmetrical cost tolerance band. Any over/under recovery of the actual costs is determined on an annual basis and is adjusted in future billings to electric retail customers. Under the electric fuel rules, MGE is required to defer the benefit of lower costs if the actual electric fuel costs fall outside the lower end of the range and is

required to defer costs, less any excess revenues, if the actual electric fuel costs exceed the upper end of the range. Excess revenues are defined as revenues in the year in question that provide MGE with a greater return on common equity than authorized by the PSCW in MGE's latest rate order. See Footnote 17.b. for further discussion.

### ***Elm Road***

Costs associated with Elm Road are estimated in MGE's rates utilizing escrow accounting and include costs for lease payments, management fees, community impact mitigation, and operating costs. Also, MGE has deferred payments made to MGE Power Elm Road for carrying costs during construction of the facility. MGE has collected the carrying costs in rates over a six year period that ended in 2015. All other costs are collected in rates over a one to two year period.

### ***Income Taxes***

Excess deferred income taxes result from past taxes provided at rates higher than current rates. The regulatory liability and deferred investment tax credit reflects the revenue requirement associated with the return of these tax benefits to customers.

### ***Non-ARO Removal Costs***

In connection with accounting for asset retirement obligations, companies are required to reclassify cumulative collections for non-ARO removal costs as a regulatory liability, with an offsetting entry to accumulated depreciation. Under the current rate structure, these removal costs are being recovered as a component of depreciation expense.

### ***Renewable Energy Credits***

MGE receives renewable energy credits from certain purchase power agreements. The value of the credits are recorded as inventory and expensed when the credit is redeemed or expired. A regulatory liability has been established for the value of the renewable energy credits included in inventory. In Wisconsin, renewable energy credits expire four years after the year of acquisition.

7.

### **Common Equity.**

a.

### **Common Stock - MGE Energy and MGE.**

On December 20, 2013, MGE Energy's Board of Directors declared a three-for-two stock split of MGE Energy's outstanding shares of common stock, effective in the form of a stock dividend. Shareholders of record at the close of business on January 24, 2014, received one additional share of MGE Energy common stock for every two shares of common stock owned on that date. The additional shares were distributed on February 7, 2014. Shareholders received cash in lieu of any fractional shares of common stock they otherwise would have received in connection with the dividend. All share and per share data provided in this report give effect to this stock split.

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 the years ended December 31, 2015 and 2014, MGE Energy did not issue any new shares of common stock under the Stock Plan.

MGE Energy purchases shares on the open market 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 specific maximum number of shares to be repurchased and no specified termination date for the repurchases.

During the years ended December 31, 2015 and 2014, MGE Energy paid \$40.0 million (or \$1.16 per share) and \$38.4 million (or \$1.11 per share), respectively, in cash dividends on its common stock. Dividends on common stock at MGE are subject to restrictions imposed by the PSCW and the covenants of MGE's outstanding first mortgage bonds. See Footnote 9 for further discussion of these covenants. During the years ended December 31, 2015 and 2014, MGE paid \$30.0 million and \$26.5 million, respectively, in cash dividends to MGE Energy.

b.

**Dilutive Shares Calculation - MGE Energy.**

MGE Energy does not hold any dilutive securities.

8.

**Noncontrolling Interest - MGE.**

The noncontrolling interest on MGE's consolidated balance sheets at December 31 was as follows:

| <i>(In thousands)</i>                | 2015       | 2014       |
|--------------------------------------|------------|------------|
| MGE Power Elm Road <sup>(a)</sup>    | \$ 79,113  | \$ 72,537  |
| MGE Power West Campus <sup>(a)</sup> | 37,603     | 30,755     |
| MGE Transco <sup>(b)</sup>           | 23,592     | 22,397     |
| Total Noncontrolling Interest        | \$ 140,308 | \$ 125,689 |

The net income attributable to noncontrolling interest, net of tax, for the years ended December 31, 2015, 2014, and 2013 was as follows:

| <i>(In thousands)</i>  | 2015      | 2014      | 2013      |
|--|-----------|-----------|-----------|
| MGE Power Elm Road <sup>(a)</sup>                              | \$ 16,577 | \$ 16,160 | \$ 17,373 |
| MGE Power West Campus <sup>(a)</sup>                           | 7,348     | 7,666     | 7,657     |
| MGE Transco <sup>(b)</sup>                                     | 2,172     | 2,484     | 2,408     |
| Net Income Attributable to Noncontrolling Interest, Net of Tax | \$ 26,097 | \$ 26,310 | \$ 27,438 |

(a)

MGE Power Elm Road and MGE Power West Campus are not subsidiaries of MGE; however, they have been consolidated in the consolidated financial statements of MGE (see Footnote 2). MGE Power Elm Road and MGE Power West Campus are 100% owned by MGE Power, and MGE Power is 100% owned by MGE Energy. MGE Energy's proportionate share of the equity and net income (through its wholly owned subsidiary MGE Power) of MGE Power Elm Road and MGE Power West Campus is classified within the MGE consolidated financial statements as noncontrolling interest.

(b)

At December 31, 2015, MGE is the majority owner, and MGE Energy is the minority owner, of MGE Transco. MGE Energy's proportionate share of the equity and net income of MGE Transco is classified within the MGE consolidated financial statements as noncontrolling interest. In mid-2016, MGE is no longer expected to be the majority owner of MGE Transco. The change will have no effect on MGE Energy's consolidated financial statements; however, MGE Energy's proportionate share of the equity and net income of MGE Transco will be deconsolidated from MGE's financial statements. No gain or loss is expected to be recognized on the date MGE ceases to have a controlling financial interest.

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## 9.

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

## a.

**Long-Term Debt.**

| <i>(In thousands)</i>                                       | 2015          |            | 2014          |            |
|---|---------------|------------|---------------|------------|
|   | MGE<br>Energy | MGE        | MGE<br>Energy | MGE        |
| <b>First Mortgage Bonds:</b> <sup>(a)</sup>                 |               |            |               |            |
| 7.70%, 2028 Series  | \$ 1,200      | \$ 1,200   | \$ 1,200      | \$ 1,200   |
| <b>Tax Exempt Debt:</b>                                     |               |            |               |            |
| 3.45%, 2027 Series,<br>Industrial Development Revenue Bonds | 19,300        | 19,300     | 19,300        | 19,300     |
| <b>Medium-Term Notes:</b> <sup>(b)</sup>                    |               |            |               |            |
| 5.25%, due 2017   | 30,000        | 30,000     | 30,000        | 30,000     |
| 6.12%, due 2028   | 20,000        | 20,000     | 20,000        | 20,000     |
| 7.12%, due 2032   | 25,000        | 25,000     | 25,000        | 25,000     |
| 6.247%, due 2037  | 25,000        | 25,000     | 25,000        | 25,000     |
| <i>Total Medium-Term Notes</i>                              | 100,000       | 100,000    | 100,000       | 100,000    |
| <b>Other Long-Term Debt:</b> <sup>(c)</sup>                 |               |            |               |            |
| 5.59%, due 2018 <sup>(d)</sup>                              | 20,000        | 20,000     | 20,000        | 20,000     |
| 3.38%, due 2020 <sup>(d)</sup>                              | 15,000        | 15,000     | 15,000        | 15,000     |
| 3.09%, due 2023 <sup>(d)</sup>                              | 30,000        | 30,000     | 30,000        | 30,000     |
| 3.29%, due 2026 <sup>(d)</sup>                              | 15,000        | 15,000     | 15,000        | 15,000     |
| 5.68%, due 2033 <sup>(e)</sup>                              | 28,063        | 28,063     | 28,954        | 28,954     |
| 5.19%, due 2033 <sup>(e)</sup>                              | 18,640        | 18,640     | 19,264        | 19,264     |
| 5.26%, due 2040 <sup>(d)</sup>                              | 15,000        | 15,000     | 15,000        | 15,000     |
| 5.04%, due 2040 <sup>(f)</sup>                              | 40,138        | 40,138     | 41,805        | 41,805     |
| 4.74%, due 2041 <sup>(f)</sup>                              | 25,167        | 25,167     | 26,167        | 26,167     |
| 4.38%, due 2042 <sup>(d)</sup>                              | 28,000        | 28,000     | 28,000        | 28,000     |
| 4.42%, due 2043 <sup>(d)</sup>                              | 20,000        | 20,000     | 20,000        | 20,000     |
| 4.47%, due 2048 <sup>(d)</sup>                              | 20,000        | 20,000     | 20,000        | 20,000     |
| <i>Total Other Long-Term Debt</i>                           | 275,008       | 275,008    | 279,190       | 279,190    |
| Long-term debt due within one year                          | (4,266)       | (4,266)    | (4,182)       | (4,182)    |
| Unamortized discount  | (228)         | (228)      | (252)         | (252)      |
| <i>Total Long-Term Debt</i>                                 | \$ 391,014    | \$ 391,014 | \$ 395,256    | \$ 395,256 |

(a)

MGE's utility plant is subject to the lien of its Indenture of Mortgage and Deed of Trust, under which its first mortgage bonds are issued. The Mortgage Indenture provides that dividends or any other distribution or purchase of shares may not be made if the aggregate amount thereof since December 31, 1945 would exceed the earned surplus

(retained earnings) accumulated subsequent to December 31, 1945. As of December 31, 2015, approximately \$353.0 million was available for the payment of dividends under this covenant.

(b)

The indenture under which MGE's Medium-Term notes are issued provides that those notes will be entitled to be equally and ratably secured in the event that MGE issues any additional first mortgage bonds.

(c)

Unsecured notes issued pursuant to various Note Purchase Agreements with one or more purchasers. The notes are not issued under, or governed by, MGE's Indenture dated as of September 1, 1998, which governs MGE's Medium-Term Notes.

(d)

Issued by MGE. Under that Note Purchase Agreement: (i) note holders have the right to require MGE to repurchase their notes at par in the event of an acquisition of beneficial ownership of 30% or more of the outstanding voting stock of MGE Energy, (ii) MGE must maintain a ratio of its consolidated indebtedness to consolidated total capitalization not to exceed a maximum of 65%, and (iii) MGE cannot issue "Priority Debt" in an amount exceeding 20% of its consolidated assets. Priority Debt is defined as any indebtedness of MGE secured by liens other than specified liens permitted by the Note Purchase Agreement and certain unsecured indebtedness of certain subsidiaries. As of December 31, 2015, MGE was in compliance with the covenant requirements.

(e)

Issued by MGE Power West Campus. The Note Purchase Agreements require it to maintain a projected debt service coverage ratio of not less than 1.25 to 1.00, and debt to total capitalization ratio of not more than 0.65 to 1.00. The notes are secured by a collateral assignment of lease payments that MGE is making to MGE Power West Campus for use of its ownership interest in the West Campus Cogeneration Facility pursuant to a long-term lease. As of December 31, 2015, MGE Power West Campus was in compliance with the covenant requirements.

(f)

Issued by MGE Power Elm Road. The Note Purchase Agreement requires MGE Power Elm Road to maintain a projected and actual debt service coverage ratio at the end of any calendar quarter of not less than 1.25 to 1.00 for the trailing 12-month period. The notes are secured by a collateral assignment of lease payments that MGE is making to MGE Power Elm Road for use of its ownership interest in the Elm Road Units pursuant to long-term leases. As of December 31, 2015, MGE Power Elm Road was in compliance with the covenant requirements.

**b.****Long-Term Debt Maturities.**

Below is MGE Energy's and MGE's aggregate maturities for all long-term debt for years following the December 31, 2015, consolidated balance sheets.

| <i>(In thousands)</i> | MGE        |            |
|-----------------------|------------|------------|
|                       | Energy     | MGE *      |
| 2016                  | \$ 4,266   | \$ 4,266   |
| 2017                  | 34,358     | 34,358     |
| 2018                  | 24,452     | 24,452     |
| 2019                  | 4,553      | 4,553      |
| 2020                  | 19,659     | 19,659     |
| Future years          | 308,220    | 308,220    |
| Total                 | \$ 395,508 | \$ 395,508 |

*\*Includes \$46.7 million for MGE Power West Campus and \$65.3 million for MGE Power Elm Road, all of which are consolidated with MGE's debt (see Footnote 2 for further information).*

**10.**

**Notes Payable to Banks, Commercial Paper, and Lines of Credit.**

**a.**

**MGE Energy.**

At December 31, 2015, MGE Energy had an unsecured, committed revolving line of credit of \$50 million expiring June 1, 2020. At December 31, 2015, no borrowings were outstanding under this facility.

The agreement requires MGE Energy to maintain a ratio of its consolidated indebtedness to consolidated total capitalization not to exceed a maximum of 65%. A change in control constitutes a default under the agreement. Change in control events are defined as (i) a failure by MGE Energy to hold 100% of the outstanding voting equity interest in MGE or (ii) the acquisition of beneficial ownership of 30% or more of the outstanding voting stock of MGE Energy by one person or two or more persons acting in concert. As of December 31, 2015, MGE Energy was in compliance with the covenant requirements.

**b.**

**MGE.**

For short-term borrowings, MGE generally issues commercial paper (issued at the prevailing discount rate at the time of issuance), which is supported by unused committed bank lines of credit. At December 31, 2015, MGE had two unsecured, committed revolving lines of credit for a total of \$100 million expiring June 1, 2020. At December 31, 2015, no borrowings were outstanding under these facilities, and MGE had no commercial paper outstanding.

The agreements require MGE to maintain a ratio of consolidated debt to consolidated total capitalization not to exceed a maximum of 65%. The ratio calculation excludes assets, liabilities, revenues, and expenses included in MGE's financial statements as the result of the consolidation of VIEs, such as MGE Power West Campus and MGE Power Elm Road. A change in control constitutes a default under the agreement. Change in control events are defined as (i) a failure by MGE Energy to hold 100% of the outstanding voting equity interest in MGE or (ii) the acquisition of beneficial ownership of 30% or more of the outstanding voting stock of MGE Energy by one person or two or more persons acting in concert. As of December 31, 2015, MGE was in compliance with the covenant requirements.



c.

**MGE Energy and MGE.**

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

| <i>(In thousands)</i>           | As of December 31, |            |            |
|---------------------------------|--------------------|------------|------------|
|                                 | 2015               | 2014       | 2013       |
| <b>MGE Energy<sup>(a)</sup></b> |                    |            |            |
| Available lines of credit       | \$ 150,000         | \$ 150,000 | \$ 150,000 |
| Short-term debt outstanding     | \$ -               | \$ 7,000   | \$ -       |
| Weighted-average interest rate  | -%                 | 0.20%      | -%         |
| <i>During the year:</i>         |                    |            |            |
| Maximum short-term borrowings   | \$ 17,500          | \$ 9,000   | \$ 32,000  |
| Average short-term borrowings   | \$ 1,511           | \$ 182     | \$ 6,992   |
| Weighted-average interest rate  | 0.17%              | 0.24%      | 0.18%      |
| <b>MGE</b>                      |                    |            |            |
| Available lines of credit       | \$ 100,000         | \$ 100,000 | \$ 100,000 |
| Commercial paper outstanding    | \$ -               | \$ 7,000   | \$ -       |
| Weighted-average interest rate  | -%                 | 0.20%      | -%         |
| <i>During the year:</i>         |                    |            |            |
| Maximum short-term borrowings   | \$ 17,500          | \$ 9,000   | \$ 32,000  |
| Average short-term borrowings   | \$ 1,511           | \$ 182     | \$ 6,992   |
| Weighted-average interest rate  | 0.17%              | 0.24%      | 0.18%      |

(a)

MGE Energy short-term borrowings include MGE Energy and MGE lines of credit and MGE commercial paper.

**11.****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 December 31, 2015 and 2014, the carrying amount of cash, cash equivalents, and outstanding commercial paper approximates fair market value due to the short maturity of those investments and obligations. The estimated fair market value of MGE Energy's and MGE's long-term debt is based on quoted market prices for similar financial instruments at December 31. Since long-term debt is not traded in an active market, it is classified as Level 2.

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The estimated fair market value of MGE Energy's and MGE's financial instruments are as follows:

| <i>(In thousands)</i>              | 2015            |            | 2014            |            |
|------------------------------------|-----------------|------------|-----------------|------------|
|                                    | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| <b>MGE Energy</b>                  |                 |            |                 |            |
| <i>Assets:</i>                     |                 |            |                 |            |
| Cash and cash equivalents          | \$ 81,384       | \$ 81,384  | \$ 65,755       | \$ 65,755  |
| <i>Liabilities:</i>                |                 |            |                 |            |
| Short-term debt - commercial paper | -               | -          | 7,000           | 7,000      |
| Long-term debt*                    | 395,508         | 435,767    | 399,690         | 457,420    |
| <b>MGE</b>                         |                 |            |                 |            |
| <i>Assets:</i>                     |                 |            |                 |            |
| Cash and cash equivalents          | \$ 26,760       | \$ 26,760  | \$ 4,562        | \$ 4,562   |
| <i>Liabilities:</i>                |                 |            |                 |            |
| Short-term debt - commercial paper | -               | -          | 7,000           | 7,000      |
| Long-term debt*                    | 395,508         | 435,767    | 399,690         | 457,420    |

\*Includes long-term debt due within one year.

b.

**Recurring Fair Value Measurements.**

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

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

**MGE**

## Assets:

|                             |    |     |    |     |    |   |    |     |
|-----------------------------|----|-----|----|-----|----|---|----|-----|
| Derivatives, net            | \$ | 234 | \$ | -   | \$ | - | \$ | 234 |
| Exchange-traded investments |    | 148 |    | 148 |    | - |    | -   |
| Total Assets                | \$ | 382 | \$ | 148 | \$ | - | \$ | 234 |

## Liabilities:

|                                 |    |        |    |     |    |       |    |        |
|---------------------------------|----|--------|----|-----|----|-------|----|--------|
| Derivatives, net <sup>(a)</sup> | \$ | 54,316 | \$ | 581 | \$ | -     | \$ | 53,735 |
| Deferred compensation           |    | 3,145  |    | -   |    | 3,145 |    | -      |
| Total Liabilities               | \$ | 57,461 | \$ | 581 | \$ | 3,145 | \$ | 53,735 |

| (In thousands)                  | Fair Value as of December 31, 2014 |          |          |           |
|---------------------------------|------------------------------------|----------|----------|-----------|
|                                 | Total                              | Level 1  | Level 2  | Level 3   |
| <b>MGE Energy</b>               |                                    |          |          |           |
| Assets:                         |                                    |          |          |           |
| Derivatives, net                | \$ 642                             | \$ -     | \$ -     | \$ 642    |
| Exchange-traded investments     | 927                                | 927      | -        | -         |
| Total Assets                    | \$ 1,569                           | \$ 927   | \$ -     | \$ 642    |
| Liabilities:                    |                                    |          |          |           |
| Derivatives, net <sup>(a)</sup> | \$ 55,640                          | \$ 1,012 | \$ -     | \$ 54,628 |
| Deferred compensation           | 2,832                              | -        | 2,832    | -         |
| Total Liabilities               | \$ 58,472                          | \$ 1,012 | \$ 2,832 | \$ 54,628 |
| <b>MGE</b>                      |                                    |          |          |           |
| Assets:                         |                                    |          |          |           |
| Derivatives, net                | \$ 642                             | \$ -     | \$ -     | \$ 642    |
| Exchange-traded investments     | 350                                | 350      | -        | -         |
| Total Assets                    | \$ 992                             | \$ 350   | \$ -     | \$ 642    |
| Liabilities:                    |                                    |          |          |           |
| Derivatives, net <sup>(a)</sup> | \$ 55,640                          | \$ 1,012 | \$ -     | \$ 54,628 |
| Deferred compensation           | 2,832                              | -        | 2,832    | -         |
| Total Liabilities               | \$ 58,472                          | \$ 1,012 | \$ 2,832 | \$ 54,628 |

(a)

These amounts are shown gross and exclude \$1.0 million and \$2.2 million of collateral that was posted against derivative positions with counterparties as of December 31, 2015 and 2014, respectively.

No transfers were made in or out of Level 1 or Level 2 for the year ended December 31, 2015.

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

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

liquidity, volatility, and contract duration. The fair value model uses a discount rate that incorporates discounting, credit, and model risks.

This model is prepared by members of MGE's Energy Accounting department. On a quarterly basis, management in the Energy Supply and Finance departments review the assumptions, inputs, and fair value measurements.

The following table presents the significant unobservable inputs used in the pricing model as of December 31:

| Significant Unobservable Inputs | Model Input |         |
|---------------------------------|-------------|---------|
|                                 | 2015        | 2014    |
| Basis adjustment:               |             |         |
| On peak                         | 96.9%       | 98.1%   |
| Off peak                        | 95.1%       | 95.0%   |
| Counterparty fuel mix:          |             |         |
| Internal generation             | 60%-75%     | 50%-70% |
| Purchased power                 | 40%-25%     | 50%-30% |

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

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

| <i>(In thousands)</i>                   | 2015        | 2014        | 2013        |
|---|-------------|-------------|-------------|
| Balance as of January 1,                | \$ (53,986) | \$ (64,628) | \$ (72,346) |
| Realized and unrealized gains (losses): |             |             |             |
| Included in regulatory liabilities      | 484         | 10,642      | 7,718       |
| Included in other comprehensive income  | -           | -           | -           |
| Included in earnings                    | (6,635)     | 5,129       | (2,618)     |
| Included in current assets              | -           | -           | (108)       |
| Purchases                               | 23,052      | 26,382      | 23,726      |
| Sales                                   | 35          | (125)       | (2)         |
| Issuances                               | -           | -           | -           |

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|   |             |             |             |
|---|-------------|-------------|-------------|
| Settlements   | (16,451)    | (31,386)    | (20,998)    |
| Transfers in and/or out of Level 3  | -           | -           | -           |
| Balance as of December 31,  | \$ (53,501) | \$ (53,986) | \$ (64,628) |
| Total gains (losses) included in earnings attributed to the change in unrealized gains (losses) related to assets and liabilities held at December 31, <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 for both MGE Energy and MGE (b).

*(In thousands)*

| <b>Year Ended December 31,</b> | 2015       | 2014     | 2013       |
|--------------------------------|------------|----------|------------|
| Purchased power expense        | \$ (6,663) | \$ 5,137 | \$ (2,618) |
| Cost of gas sold expense       | 28         | (8)      | -          |
| Total                          | \$ (6,635) | \$ 5,129 | \$ (2,618) |

(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.

12.

**Income Taxes.**

a.

**MGE Energy and MGE Income Taxes.**

MGE Energy files a consolidated federal income tax return that includes the operations of all subsidiary companies. The subsidiaries calculate their respective federal income tax provisions as if they were separate taxable entities.

On a consolidated and separate company basis, MGE Energy's and MGE's income tax provision consists of the following provision (benefit) components for the years ended December 31:

| <i>(In thousands)</i>            | MGE Energy |           |            | MGE       |           |           |
|----------------------------------|------------|-----------|------------|-----------|-----------|-----------|
|                                  | 2015       | 2014      | 2013       | 2015      | 2014      | 2013      |
| Current payable:                 |            |           |            |           |           |           |
| Federal                          | \$ 16,837  | \$ (891)  | \$ (1,508) | \$ 19,295 | \$ 637    | \$ (448)  |
| State                            | 2,774      | (589)     | 8,213      | 3,443     | (451)     | 8,322     |
| Net-deferred:                    |            |           |            |           |           |           |
| Federal                          | 15,951     | 39,284    | 37,203     | 13,538    | 38,553    | 36,937    |
| State                            | 5,976      | 10,600    | 1,163      | 5,305     | 10,625    | 1,223     |
| Amortized investment tax credits | (175)      | (219)     | (212)      | (175)     | (219)     | (212)     |
| Total income tax provision       | \$ 41,363  | \$ 48,185 | \$ 44,859  | \$ 41,406 | \$ 49,145 | \$ 45,822 |

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

|  | MGE Energy |        |        | MGE    |        |        |
|--|------------|--------|--------|--------|--------|--------|
|  | 2015       | 2014   | 2013   | 2015   | 2014   | 2013   |
| Statutory federal income tax rate          | 35.0 %     | 35.0 % | 35.0 % | 35.0 % | 35.0 % | 35.0 % |
| State income taxes, net of federal benefit | 5.2 %      | 5.1 %  | 5.1 %  | 5.2 %  | 5.1 %  | 5.1 %  |
| Amortized investment tax credits           | (0.2)%     | (0.2)% | (0.2)% | (0.2)% | (0.2)% | (0.2)% |
| Credit for electricity from wind energy    | (1.8)%     | (1.7)% | (1.5)% | (1.8)% | (1.7)% | (1.5)% |
|  | (1.4)%     | -%     | (0.2)% | (1.4)% | -%     | (0.2)% |

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|  |        |        |        |        |        |        |
|--|--------|--------|--------|--------|--------|--------|
| Domestic manufacturing deduction       |        |        |        |        |        |        |
| AFUDC equity, net                      | (0.1)% | (0.8)% | (0.7)% | (0.1)% | (0.8)% | (0.7)% |
| Other, net, individually insignificant | -%     | 0.1 %  | -%     | -%     | 0.1 %  | -%     |
| Effective income tax rate              | 36.7 % | 37.5 % | 37.5 % | 36.7 % | 37.5 % | 37.5 % |

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

| <i>(In thousands)</i>                     | MGE Energy |            | MGE        |            |
|---|------------|------------|------------|------------|
|   | 2015       | 2014       | 2015       | 2014       |
| Property-related                          | \$ 327,918 | \$ 312,903 | \$ 327,822 | \$ 312,807 |
| Investment in ATC                         | 38,213     | 36,140     | 30,382     | 29,156     |
| Bond transactions                         | 1,422      | 1,420      | 1,422      | 1,420      |
| Pension and other postretirement benefits | 57,697     | 57,847     | 57,697     | 57,847     |
| Derivatives                               | 21,660     | 22,331     | 21,660     | 22,331     |
| Tax deductible prepayments                | 8,011      | 8,077      | 8,011      | 8,077      |
| Other                                     | 14,997     | 10,451     | 14,831     | 10,259     |
| Gross deferred income tax liabilities     | 469,918    | 449,169    | 461,825    | 441,897    |
| Future tax benefit                        | -          | (4,092)    | -          | (4,092)    |
| Accrued expenses                          | (21,391)   | (32,091)   | (21,391)   | (32,091)   |
| Pension and other postretirement benefits | (46,582)   | (44,994)   | (46,582)   | (44,994)   |
| Deferred tax regulatory account           | (1,047)    | (1,211)    | (1,047)    | (1,211)    |
| Derivatives                               | (21,660)   | (22,331)   | (21,660)   | (22,331)   |
| Other                                     | (18,523)   | (5,957)    | (18,589)   | (3,746)    |
| Gross deferred income tax assets          | (109,203)  | (110,676)  | (109,269)  | (108,465)  |
| Less valuation allowance                  | 70         | 70         | 70         | 70         |
| Net deferred income tax assets            | (109,133)  | (110,606)  | (109,199)  | (108,395)  |
| Deferred income taxes                     | \$ 360,785 | \$ 338,563 | \$ 352,626 | \$ 333,502 |

As of December 31, 2015, MGE Energy and MGE did not have federal net operating losses or federal tax credit carryforwards. As of December 31, 2014, MGE Energy and MGE had approximately \$16.5 million and \$5.4 million of state net operating loss and federal tax credit carryforwards, respectively. The net operating loss and tax credit carryforwards resulted in deferred tax assets of \$0.8 million and \$5.4 million, respectively, as of December 31, 2014, that are shown net of \$2.0 million of unrecognized tax benefits and reflected in deferred tax liabilities on the consolidated balance sheets.

Our state valuation allowance reduces MGE Energy's and MGE's deferred tax assets for state carryforward losses to estimated realizable value due to the uncertainty of future income estimates in various state tax jurisdictions. For tax purposes, as of December 31, 2015, both MGE Energy and MGE had approximately \$1.4 million of state tax net operating loss deductions subject to a valuation allowance that expire between 2020 and 2023 if unused.

In November 2015, the FASB issued authoritative accounting guidance on the presentation of deferred taxes in the financial statements. Prior to the authoritative guidance, deferred taxes were presented as a net current asset or liability and net noncurrent asset or liability. As a result of the Accounting Standard Update (ASU), all deferred tax assets and liabilities, along with any related valuation allowance, will be classified as noncurrent on the consolidated balance sheets. The authoritative guidance states that early adoption of the ASU is permitted using either prospective or retrospective application. MGE Energy and MGE have adopted this standard early by retrospectively applying the guidance to all prior periods presented in addition to the current year ended December 31, 2015. For MGE Energy and MGE, as of December 31, 2014, current assets ("Deferred income taxes") decreased by approximately \$3.5 million and \$1.3 million, respectively, and noncurrent liabilities ("Deferred income taxes") decreased by approximately \$3.5 million and \$1.3 million, respectively, as a cumulative result of the guidance.

**b.**

**Accounting for Uncertainty in Income Taxes - MGE Energy and MGE.**

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

A tabular reconciliation of unrecognized tax benefits and interest from January 1, 2013, to December 31, 2015, is as follows:

*(In thousands)*

| <b>Unrecognized Tax Benefits:</b>                             | 2015     | 2014     | 2013     |
|---|----------|----------|----------|
| Unrecognized tax benefits, January 1,                         | \$ 2,365 | \$ 2,363 | \$ 3,204 |
| Additions based on tax positions related to the current year  | 488      | 610      | 377      |
| Additions based on tax positions related to the prior years   | 520      | 618      | 424      |
| Reductions based on tax positions related to the current year | -        | -        | (40)     |
| Reductions based on tax positions related to the prior years  | (845)    | (1,226)  | (1,602)  |
| Unrecognized tax benefits, December 31,                       | \$ 2,528 | \$ 2,365 | \$ 2,363 |

*(In thousands)*

| <b>Interest on Unrecognized Tax Benefits:</b>               | 2015   | 2014   | 2013   |
|---|--------|--------|--------|
| Accrued interest on unrecognized tax benefits, January 1,   | \$ 92  | \$ 101 | \$ 314 |
| Reduction in interest expense on uncertain tax positions    | (102)  | (97)   | (275)  |
| Interest expense on uncertain tax positions                 | 321    | 88     | 62     |
| Accrued interest on unrecognized tax benefits, December 31, | \$ 311 | \$ 92  | \$ 101 |

Unrecognized tax benefits of \$2.5 million and \$0.4 million are liabilities shown with "Other deferred liabilities" on the December 31, 2015 and 2014, consolidated balance sheets, respectively. At December 31, 2014, \$2.0 million of unrecognized tax benefits are netted with deferred tax liabilities on the consolidated balance sheet. The interest component is offset by a regulatory asset.

During 2013, the IRS issued guidance on the treatment of electric generation repairs. This guidance prompted the reversal of the unrecognized tax benefits for these repairs in 2013. With the adoption of this new guidance in 2014 unrecognized tax benefits related to electric generation were added. At December 31, 2015 and 2014, MGE Energy and MGE have an unrecognized tax benefit primarily related to temporary tax differences associated with the change in income tax method of accounting for electric generation and

electric and gas distribution repairs. At December 31, 2013, MGE Energy and MGE had an unrecognized tax benefit primarily related to temporary tax differences associated with the change in income tax method of accounting for electric and gas distribution repairs. There were no unrecognized tax benefits at December 31, 2015, 2014, or 2013 related to federal permanent differences and tax credits.

The unrecognized tax benefits at December 31, 2015, are not expected to significantly increase or decrease within the next twelve months. In addition, statutes of limitations will expire for MGE Energy and MGE tax returns. The impact of the statutes of limitations expiring is not anticipated to be material. The following table shows tax years that remain subject to examination by major jurisdiction:

| <b>Taxpayer</b>  | <b>Open Years</b> |
|--|-------------------|
| MGE Energy and consolidated subsidiaries in federal return | 2012 through 2015 |
| MGE Energy Wisconsin combined reporting corporation return | 2011 through 2015 |

### 13.

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

MGE maintains qualified and nonqualified pension plans, health care, and life insurance benefits, and defined contribution 401(k) benefit plans for its employees and retirees. MGE's costs for the 401(k) plans were \$2.8 million, \$2.5 million, and \$2.3 million in 2015, 2014, and 2013, respectively. A measurement date of December 31 is utilized for all pension and postretirement benefit plans.

All employees hired after December 31, 2006, have been enrolled in the defined contribution pension plan, rather than the defined benefit pension plan previously in place.

#### **a.**

#### **Benefit Obligations and Plan Assets.**

| <i>(In thousands)</i>                       | Pension Benefits |            | Other Postretirement Benefits |           |
|---|------------------|------------|-------------------------------|-----------|
| <b>Change in Benefit Obligations:</b>       | 2015             | 2014       | 2015                          | 2014      |
| Net benefit obligation at beginning of year | \$ 340,233       | \$ 283,958 | \$ 78,478                     | \$ 66,100 |
| Service cost                                | 7,263            | 6,179      | 1,559                         | 1,339     |
| Interest cost                               | 13,766           | 13,574     | 3,075                         | 3,166     |
| Plan participants' contributions            | -                | -          | 741                           | 708       |

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|   |            |            |           |           |
|---|------------|------------|-----------|-----------|
| Actuarial (gain) loss <sup>(a)</sup>                  | (17,576)   | 48,162     | (5,828)   | 10,090    |
| Gross benefits paid                                   | (11,121)   | (11,640)   | (3,280)   | (3,113)   |
| Less: federal subsidy on benefits paid <sup>(b)</sup> | -          | -          | 190       | 188       |
| Benefit obligation at end of year                     | \$ 332,565 | \$ 340,233 | \$ 74,935 | \$ 78,478 |

**Change in Plan Assets:**

|  |             |             |             |             |
|--|-------------|-------------|-------------|-------------|
| Fair value of plan assets at beginning of year | \$ 288,548  | \$ 277,398  | \$ 38,952   | \$ 37,602   |
| Actual return on plan assets                   | 4,153       | 21,907      | 603         | 2,558       |
| Employer contributions                         | 9,136       | 883         | 3,154       | 1,197       |
| Plan participants' contributions               | -           | -           | 741         | 708         |
| Gross benefits paid                            | (11,121)    | (11,640)    | (3,280)     | (3,113)     |
| Fair value of plan assets at end of year       | \$ 290,716  | \$ 288,548  | \$ 40,170   | \$ 38,952   |
| Funded Status at December 31                   | \$ (41,849) | \$ (51,685) | \$ (34,765) | \$ (39,526) |

(a)

In 2014, lower discount rates and mortality table updates were the main drivers to the actuarial loss.

(b)

In 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 was signed into law authorizing Medicare to provide prescription drug benefits to retirees. For the years ended December 31, 2015 and 2014, the subsidy due to MGE was \$0.2 million.

The accumulated benefit obligation for the defined benefit pension plans at the end of 2015 and 2014 was \$302.5 million and \$304.0 million, respectively.

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The amounts recognized in the consolidated balance sheets to reflect the funded status of the plans at December 31 are as follows:

| <i>(In thousands)</i> | Other Postretirement |             |             |             |
|-----------------------|----------------------|-------------|-------------|-------------|
|                       | Pension Benefits     |             | Benefits    |             |
|                       | 2015                 | 2014        | 2015        | 2014        |
| Current liability     | \$ (966)             | \$ (1,025)  | \$ (52)     | \$ (65)     |
| Long-term liability   | (40,883)             | (50,660)    | (34,713)    | (39,461)    |
| Net liability         | \$ (41,849)          | \$ (51,685) | \$ (34,765) | \$ (39,526) |

The following table shows the amounts that have not yet been recognized in our net periodic benefit cost as of December 31 and are recorded as regulatory assets in our consolidated balance sheets:

| <i>(In thousands)</i> | Other Postretirement |           |            |           |
|-----------------------|----------------------|-----------|------------|-----------|
|                       | Pension Benefits     |           | Benefits   |           |
|                       | 2015                 | 2014      | 2015       | 2014      |
| Net actuarial loss    | \$ 80,660            | \$ 85,102 | \$ 13,086  | \$ 17,657 |
| Prior service benefit | (436)                | (413)     | (15,158)   | (17,827)  |
| Transition obligation | -                    | -         | 29         | 32        |
| Total                 | \$ 80,224            | \$ 84,689 | \$ (2,043) | \$ (138)  |

The projected benefit obligation and fair value of plan assets for pension plans with a projected benefit obligation in excess of plan assets were as follows:

| <i>(In thousands)</i>  | Pension Benefits |            |
|--|------------------|------------|
|  | 2015             | 2014       |
| <b>Projected Benefit Obligation in Excess of Plan Assets</b> |                  |            |
| Projected benefit obligation, end of year                    | \$ 332,565       | \$ 340,233 |
| Fair value of plan assets, end of year                       | 290,716          | 288,548    |

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

| <i>(In thousands)</i> | Pension Benefits |      |
|-----------------------|------------------|------|
|                       | 2015             | 2014 |

**Accumulated Benefit Obligation in Excess of Plan****Assets**

|   |            |            |
|---|------------|------------|
| Projected benefit obligation, end of year   | \$ 332,565 | \$ 340,233 |
| Accumulated benefit obligation, end of year | 302,471    | 304,023    |
| Fair value of plan assets, end of year      | 290,716    | 288,548    |

b.

**Net Periodic Cost.**

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

| <i>(In thousands)</i>                             | Pension Benefits |            |          | Other Postretirement Benefits |          |          |
|---|------------------|------------|----------|-------------------------------|----------|----------|
| <b>Components of Net Periodic Cost (Benefit):</b> | 2015             | 2014       | 2013     | 2015                          | 2014     | 2013     |
| Service cost                                      | \$ 7,263         | \$ 6,179   | \$ 7,705 | \$ 1,559                      | \$ 1,339 | \$ 2,380 |
| Interest cost                                     | 13,766           | 13,574     | 12,656   | 3,075                         | 3,166    | 3,871    |
| Expected return on assets                         | (22,682)         | (22,051)   | (19,027) | (2,812)                       | (2,615)  | (2,176)  |
| Amortization of:                                  |                  |            |          |                               |          |          |
| Transition obligation                             | -                | -          | -        | 3                             | 3        | 3        |
| Prior service cost (benefit)                      | 23               | 204        | 314      | (2,669)                       | (2,669)  | 110      |
| Actuarial loss                                    | 5,395            | 703        | 8,014    | 953                           | 252      | 1,236    |
| Net periodic cost (benefit)                       | \$ 3,765         | \$ (1,391) | \$ 9,662 | \$ 109                        | \$ (524) | \$ 5,424 |

c.

**Plan Assumptions.**

The weighted-average assumptions used to determine the benefit obligations were as follows for the years ended December 31:

|   | Pension Benefits |       | Other Postretirement Benefits |       |
|---|------------------|-------|-------------------------------|-------|
|   | 2015             | 2014  | 2015                          | 2014  |
| Discount rate <sup>(a)</sup>  | 4.51%            | 4.11% | 4.32%                         | 3.96% |
| Rate of compensation increase   | 3.78%            | 3.85% | N/A                           | N/A   |
| Assumed health care cost trend rates:   |                  |       |                               |       |
| Health care cost trend rate assumed for next year                                 | N/A              | N/A   | 6.5%                          | 6.5%  |
| Rate to which the cost trend rate is assumed to decline (the ultimate trend rate) | N/A              | N/A   | 5.0%                          | 5.0%  |
| Year that the rate reaches the ultimate trend rate                                | N/A              | N/A   | 2022                          | 2021  |

(a)

In 2015, MGE refined its methodology for using discount rates to measure the components of net periodic benefit cost. The refined methodology uses individual spot rates, instead of a weighted average of the yield curve spot rates, for measuring the service cost and interest cost components. The change in methodology does not alter the measurement of the related benefit obligation as of December 31, 2015.

The weighted-average assumptions used to determine the net periodic cost were as follows for the years ended December 31:

|  | Pension Benefits |       |       | Other Postretirement Benefits |       |       |
|--|------------------|-------|-------|-------------------------------|-------|-------|
|  | 2015             | 2014  | 2013  | 2015                          | 2014  | 2013  |
| Discount rate                          | 4.11%            | 4.88% | 4.09% | 3.96%                         | 4.69% | 4.14% |
| Expected rate of return on plan assets | 7.80%            | 8.10% | 8.10% | 7.06%                         | 7.07% | 6.79% |
| Rate of compensation increase          | 3.84%            | 3.93% | 4.60% | N/A                           | N/A   | N/A   |

The assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. The following table shows how an assumed 1% increase or 1% decrease in health care cost trends could impact postretirement benefits in 2015 dollars:

| <i>(In thousands)</i>                                | 1%<br>Increase | 1%<br>Decrease |
|--|----------------|----------------|
| Effect on other postretirement benefit obligation    | \$ 1,391       | \$ (1,753)     |
| Effect on total service and interest cost components | 80             | (92)           |

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

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

**d.**

**Investment Strategy.**

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



The asset allocation for MGE's pension plans at the end of 2015 and 2014, and the target allocation for 2016, by asset category, follows:

|                                  | Target<br>Allocation | Percentage of Plan<br>Assets at Year End |         |
|----------------------------------|----------------------|--|---------|
|                                  |                      | 2015                                     | 2014    |
| Equity securities <sup>(a)</sup> | 63.0 %               | 63.0 %                                   | 62.0 %  |
| Fixed income securities          | 30.0 %               | 29.0 %                                   | 31.0 %  |
| Real estate                      | 7.0 %                | 8.0 %                                    | 7.0 %   |
| Total                            | 100.0 %              | 100.0 %                                  | 100.0 % |

(a)

Target allocations for equity securities are broken out as follows: 45.5% United States equity, 17.5% non-United States equity.

The fair value of plan assets for the postretirement benefit plans is \$40.2 million and \$39.0 million at the end of 2015 and 2014, respectively. Of this amount, \$34.1 million and \$32.8 million at the end of 2015 and 2014, respectively, were held in the master pension trust and are allocable to postretirement health expenses. The target asset allocation and investment strategy for the portion of assets held in the master pension trust are the same as that explained for MGE's pension plans. The remainder of postretirement benefit assets is held either in an insurance continuance fund for the payment of retiree life benefits or a health benefit trust for payment of retiree health claims. There is no formal target asset allocation for these assets, but the intent is to seek interest income and maintain stability of principal.

e.

**Concentrations of Credit Risk.**

MGE evaluated its pension and other postretirement benefit plans' asset portfolios for the existence of significant concentrations of credit risk as of December 31, 2015. Types of concentrations that were evaluated include, but are not limited to, investment concentrations in a single entity, type of industry, and foreign country. As of December 31, 2015, there were no significant concentrations (defined as greater than 10 percent of plan assets) of risk in MGE pension and postretirement benefit plan assets.

f.

**Fair Value Measurements of Plan Assets.**

Pension and other postretirement benefit plan investments are recorded at fair value. See Footnote 11 for more information regarding the fair value hierarchy.

The following is a description of the valuation methodologies used for assets measured at fair value as of December 31, 2015:

Cash and Cash Equivalents This category includes highly liquid investments with maturities of less than three months which are traded in active markets.

Equity Securities These securities consist of U.S. and international stock funds. The U.S. stock funds are primarily invested in domestic equities. Securities in these funds are typically priced using the closing price from the applicable exchange, NYSE, Nasdaq, etc. The international funds are composed of international equities. Securities are priced using the closing price from the appropriate local stock exchange.

Fixed Income Securities These securities consist of U.S. bond funds and short-term funds. U.S. bond funds are priced by a pricing agent using inputs such as benchmark yields, reported trades, broker/dealer quotes, and issuer spreads. The short-term funds are valued initially at cost and adjusted for amortization of any discount or premium.

Real Estate The fair value of real estate properties is determined through an external appraisal process.

Insurance Continuance Fund (ICF) The fair value of the ICF is based on largely unobservable inputs, which are based on a commingled interest.

Fixed Rate Fund The fair value of the Fixed Rate fund is determined based on the type of assets held. Public market data and GAAP reported market values are used when available. For all other assets, discounted cash flows are calculated using treasury rates and spreads based on the cash flow timing and quality of assets.



The fair value of MGE's plan assets, by asset category are as follows:

| <i>(In thousands)</i>      | Fair Value as of December 31, 2015 |         |            |           |
|----------------------------|------------------------------------|---------|------------|-----------|
|                            | Total                              | Level 1 | Level 2    | Level 3   |
| Cash and Cash Equivalents  | \$ 300                             | \$ 300  | \$ -       | -         |
| Equity Securities:         |                                    |         |            |           |
| U.S. Large Cap             | 98,949                             | -       | 98,949     | -         |
| U.S. Mid Cap               | 22,446                             | -       | 22,446     | -         |
| U.S. Small Cap             | 27,561                             | -       | 27,561     | -         |
| International Blend        | 55,948                             | -       | 55,948     | -         |
| Fixed Income Securities:   |                                    |         |            |           |
| Short-Term Fund            | 3,388                              | -       | 3,388      | -         |
| High Yield Bond            | 16,225                             | -       | 16,225     | -         |
| Long Duration Bond         | 73,112                             | -       | 73,112     | -         |
| Real Estate                | 27,231                             | -       | -          | 27,231    |
| Insurance Continuance Fund | 1,518                              | -       | -          | 1,518     |
| Fixed Rate Fund            | 4,208                              | -       | -          | 4,208     |
| Total                      | \$ 330,886                         | \$ 300  | \$ 297,629 | \$ 32,957 |

| <i>(In thousands)</i>      | Fair Value as of December 31, 2014 |         |            |           |
|----------------------------|------------------------------------|---------|------------|-----------|
|                            | Total                              | Level 1 | Level 2    | Level 3   |
| Equity Securities:         |                                    |         |            |           |
| U.S. Large Cap             | 99,256                             | -       | 99,256     | -         |
| U.S. Mid Cap               | 22,926                             | -       | 22,926     | -         |
| U.S. Small Cap             | 29,353                             | -       | 29,353     | -         |
| International Blend        | 47,650                             | -       | 47,650     | -         |
| Fixed Income Securities:   |                                    |         |            |           |
| Short-Term Fund            | 3,776                              | -       | 3,776      | -         |
| High Yield Bond            | 15,492                             | -       | 15,492     | -         |
| Long Duration Bond         | 79,603                             | -       | 79,603     | -         |
| Real Estate                | 23,480                             | -       | -          | 23,480    |
| Insurance Continuance Fund | 1,518                              | -       | -          | 1,518     |
| Fixed Rate Fund            | 4,446                              | -       | -          | 4,446     |
| Total                      | \$ 327,500                         | \$ -    | \$ 298,056 | \$ 29,444 |

No transfers were made in or out of Level 1 or Level 2 for the year ended December 31, 2015.

The following table summarizes the changes in the fair value of the Level 3 plan assets.

| <i>(In thousands)</i>                               |           | Level 3 Assets<br>Insurance<br>Continuance<br>Fund | Fixed Rate<br>Fund |
|---|-----------|--|--------------------|
| Balance as of January 1, 2014                       | \$ 19,628 | \$ 1,428   | \$ -               |
| Actual return on plan assets:                       |           |  |                    |
| Relating to assets still held at the reporting date | 1,561     | 44   | 54                 |
| Purchases, sales, and settlements                   | 2,291     | 46   | 4,392              |
| Transfers in and/or out of Level 3                  | -         | -  | -                  |
| Balance as of December 31, 2014                     | 23,480    | 1,518  | 4,446              |
| Actual return on plan assets:                       |           |  |                    |
| Relating to assets still held at the reporting date | 2,749     | 46   | 103                |
| Purchases, sales, and settlements                   | 1,002     | (46)   | (341)              |
| Transfers in and/or out of Level 3                  | -         | -  | -                  |
| Balance as of December 31, 2015                     | \$ 27,231 | \$ 1,518   | \$ 4,208           |

g.

**Expected Cash Flows.**

Contributions to the qualified plans for 2016 are expected to be \$10.0 million, which was paid in January 2016. MGE does not expect to make contributions to the plans for 2017. The contributions for years after 2017 are not yet currently estimated. MGE has adopted the asset smoothing as permitted in accordance with the Pension Protection Act of 2006, including modifications made by WRERA.

Due to uncertainties in the future economic performance of plan assets, discount rates, and other key assumptions, estimated contributions are subject to change. MGE may also elect to make additional discretionary contributions.

In 2015, MGE made \$13.7 million in employer contributions to its pension and postretirement plans.

**h.**

**Benefit Payments.**

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

|                       | Pension   |                | Other Postretirement Benefits |                |                |
|-----------------------|-----------|----------------|-------------------------------|----------------|----------------|
|                       | Pension   | Gross          | Expected                      |                | Net            |
|                       | Benefits  | Postretirement | Medicare                      | Part D Subsidy | Postretirement |
| <i>(In thousands)</i> | Benefits  | Benefits       |                               |                | Benefits       |
| 2016                  | \$ 12,489 | \$ 3,119       | \$ (227)                      | \$             | 2,892          |
| 2017                  | 13,320    | 3,481          | (249)                         |                | 3,232          |
| 2018                  | 14,506    | 3,947          | (273)                         |                |                |