

MGE ENERGY INC
Form 10-Q
November 06, 2014

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

FORM 10-Q

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

For the quarterly period ended:

September 30, 2014

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

For the transition period from _____ to _____

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

Edgar Filing: MGE ENERGY INC - Form 10-Q

(a Wisconsin Corporation)

133 South Blair Street

Madison, Wisconsin 53788

(608) 252-7000

mge.com

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

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

Yes No

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

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

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

MGE Energy, Inc. and Madison Gas and Electric Company: Yes No

Number of Shares Outstanding of Each Class of Common Stock as of October 31, 2014

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

1

Table of Contents

PART I. FINANCIAL INFORMATION.

| | |
|---|----------|
| | <u>3</u> |
| <u>Filing Format</u> | <u>3</u> |
| <u>Forward-Looking Statements</u> | <u>3</u> |
| <u>Stock Split</u> | <u>3</u> |
| <u>Where to Find More Information</u> | <u>3</u> |
| <u>Definitions, Abbreviations, and Acronyms Used in the Text and Notes of this Report</u> | <u>4</u> |
| <u>Item 1. Financial Statements.</u> | <u>6</u> |
| <u>MGE Energy, Inc.</u> | <u>6</u> |
| <u>Consolidated Statements of Income (unaudited)</u> | <u>6</u> |
| <u>Consolidated Statements of Comprehensive Income (unaudited)</u> | <u>6</u> |
| <u>Consolidated Statements of Cash Flows (unaudited)</u> | <u>7</u> |
| <u>Consolidated Balance Sheets (unaudited)</u> | <u>8</u> |

| | |
|---|----|
| <u>Consolidated Statements of Common Equity (unaudited)</u> | 9 |
| <u>Madison Gas and Electric Company</u> | 10 |
| <u>Consolidated Statements of Income (unaudited)</u> | 10 |
| <u>Consolidated Statements of Comprehensive Income (unaudited)</u> | 10 |
| <u>Consolidated Statements of Cash Flows (unaudited)</u> | 11 |
| <u>Consolidated Balance Sheets (unaudited)</u> | 12 |
| <u>Consolidated Statements of Common Equity (unaudited)</u> | 13 |
| <u>MGE Energy, Inc., and Madison Gas and Electric Company</u> | 14 |
| <u>Notes to Consolidated Financial Statements (unaudited)</u> | 14 |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.</u> | 32 |
| <u>Item 3. Quantitative and Qualitative Disclosures About Market Risk.</u> | 48 |
| <u>Item 4. Controls and Procedures.</u> | 50 |
| <u>PART II. OTHER INFORMATION.</u> | 51 |

| | |
|---|-----------|
| <u>Item 1. Legal Proceedings.</u> | <u>51</u> |
| <u>Item 1A. Risk Factors.</u> | <u>51</u> |
| <u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.</u> | <u>51</u> |
| <u>Item 4. Mine Safety Disclosures.</u> | <u>52</u> |
| <u>Item 6. Exhibits.</u> | <u>52</u> |
| <u>Signatures - MGE Energy, Inc.</u> | <u>53</u> |
| <u>Signatures - Madison Gas and Electric Company</u> | <u>54</u> |

PART I. FINANCIAL INFORMATION.

Filing Format

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

Forward-Looking Statements

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

The factors that could cause actual results to differ materially from the forward-looking statements made by a registrant include (a) those factors discussed in the Registrants' 2013 Annual Report on Form 10-K: Item 1A. Risk Factors, as updated by Part II. Item 1A. Risk Factors in this Report, Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations, as updated by Part I, Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations in this report, and Item 8. Financial Statements and Supplementary Data Note 18, as updated by Part I, Item 1. Financial Statements Note 8 in this report, and (b) other factors discussed herein and in other filings made by that registrant with the SEC.

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

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. All share and per share data provided in this report give effect to this stock split.

Where to Find More Information

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

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

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

MGE Energy and Subsidiaries:

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

Other Defined Terms:

| | |
|---------------------------|--|
| AFUDC | Allowance for Funds Used During Construction |
| ATC | American Transmission Company LLC |
| Blount | Blount Station |
| CA | Certificate of Authority |
| CAA | Clean Air Act |
| CAIR | Clean Air Interstate Rule |
| CAVR | Clean Air Visibility Rule |
| CCC | Closed Cycle Cooling |
| CCR | Coal Combustion Residual |
| Codification | Financial Accounting Standards Board Accounting Standards Codification |
| Columbia | Columbia Energy Center |
| Cooling degree days | Measure of the extent to which the average daily temperature is above 65 degrees Fahrenheit, which is considered an indicator of possible increased demand for energy to provide cooling |
| CSAPR | Cross-State Air Pollution Rule |
| Dth | Dekatherms, a quantity measure used in respect of natural gas |
| EGUs | Electric Generating Units |
| Elm Road Units | Elm Road Generating Station |
| EPA | United States Environmental Protection Agency |
| FASB | Financial Accounting Standards Board |
| FTR | Financial Transmission Rights |
| GHG | Greenhouse Gas |
| Heating degree days (HDD) | |

Edgar Filing: MGE ENERGY INC - Form 10-Q

Measure of the extent to which the average daily temperature is below 65 degrees Fahrenheit, which is considered an indicator of possible increased demand for energy to provide heating

| | |
|-------|---|
| IRS | Internal Revenue Service |
| kWh | Kilowatt-hour, a measure of electric energy produced |
| MATS | Mercury and Air Toxics Standards |
| MISO | Midcontinent Independent System Operator (a regional transmission organization) |
| MW | Megawatt, a measure of electric energy generating capacity |
| MWh | Megawatt-hour, a measure of electric energy produced |
| NAAQS | National Ambient Air Quality Standards |
| NOL | Net Operating Loss |
| NOV | Notice of Violation |
| NOx | Nitrogen Oxides |
| NSPS | New Source Performance Standards |

| | |
|-----------------|--|
| PGA | Purchased Gas Adjustment clause, a regulatory mechanism used to reconcile natural gas costs recovered in rates to actual costs |
| PJM | PJM Interconnection, LLC (a regional transmission organization) |
| PPA | Purchased Power Agreement |
| PSCW | Public Service Commission of Wisconsin |
| PSD | Prevention of Significant Deterioration |
| ROE | Return on Equity |
| SCR | Selective Catalytic Reduction |
| SEC | Securities and Exchange Commission |
| SIP | State Implementation Plan |
| SO2 | 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 |
| WPL | Wisconsin Power and Light Company |
| WPSC | Wisconsin Public Service Corporation |
| XBRL | eXtensible Business Reporting Language |

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|---|-------------|--|-------------|
| | 2014 | 2013 | 2014 | 2013 |
| Operating Revenues: | | | | |
| Regulated electric revenues | \$ 112,869 | \$ 119,836 | \$ 308,418 | \$ 310,176 |
| Regulated gas revenues | 21,404 | 18,864 | 163,335 | 121,373 |
| Nonregulated revenues | 862 | 1,399 | 2,392 | 4,075 |
| <i>Total Operating Revenues</i> | 135,135 | 140,099 | 474,145 | 435,624 |
| Operating Expenses: | | | | |
| Fuel for electric generation | 9,838 | 13,950 | 35,836 | 34,520 |
| Purchased power | 21,303 | 21,981 | 58,779 | 61,237 |
| Cost of gas sold | 11,039 | 8,819 | 107,679 | 70,259 |
| Other operations and maintenance | 37,587 | 41,134 | 118,267 | 124,670 |
| Depreciation and amortization | 10,376 | 9,710 | 30,191 | 28,864 |
| Other general taxes | 4,872 | 4,605 | 14,861 | 14,049 |
| <i>Total Operating Expenses</i> | 95,015 | 100,199 | 365,613 | 333,599 |
| Operating Income | 40,120 | 39,900 | 108,532 | 102,025 |
| Other income, net | 2,636 | 3,750 | 10,736 | 9,770 |
| Interest expense, net | (5,141) | (4,605) | (14,550) | (13,937) |
| Income before income taxes | 37,615 | 39,045 | 104,718 | 97,858 |
| Income tax provision | (14,286) | (14,692) | (39,585) | (37,030) |
| Net Income | \$ 23,329 | \$ 24,353 | \$ 65,133 | \$ 60,828 |
| Earnings Per Share of Common Stock | | | | |
| (basic and diluted) | \$ 0.67 | \$ 0.70 | \$ 1.88 | \$ 1.75 |
| Dividends per share of common stock | | | | |
| | \$ 0.283 | \$ 0.272 | \$ 0.826 | \$ 0.799 |
| Weighted Average Shares Outstanding | | | | |
| (basic and diluted) | 34,668 | 34,668 | 34,668 | 34,668 |

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

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|---|------------------|--|------------------|
| | 2014 | 2013 | 2014 | 2013 |
| Net Income | \$ 23,329 | \$ 24,353 | \$ 65,133 | \$ 60,828 |
| Other comprehensive income, net of tax: | | | | |
| Unrealized gain on available-for-sale securities, net of tax (\$63 and \$24, and \$38 and \$117, respectively) | 95 | 36 | 56 | 176 |
| Comprehensive Income | \$ 23,424 | \$ 24,389 | \$ 65,189 | \$ 61,004 |

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

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

| | Nine Months Ended September 30, | |
|---|--|------------------|
| | 2014 | 2013 |
| Operating Activities: | | |
| Net income | \$ 65,133 | \$ 60,828 |
| Items not affecting cash: | | |
| Depreciation and amortization | 30,191 | 28,864 |
| Deferred income taxes | 24,376 | 32,706 |
| Provision for doubtful receivables | 1,001 | 1,551 |
| Employee benefit plan expenses | (814) | 9,908 |
| Equity earnings in ATC | (7,306) | (7,045) |
| Other items | (843) | 250 |
| Changes in working capital items: | | |
| Decrease in current assets | 13,318 | 15,053 |
| Decrease in current liabilities | (7,515) | (5,496) |
| Dividend income from ATC | 5,762 | 5,498 |
| Cash contributions to pension and other postretirement plans | (2,449) | (33,919) |
| Debt make-whole premium | - | (6,757) |
| Other noncurrent items, net | 118 | 7,159 |
| <i>Cash Provided by Operating Activities</i> | 120,972 | 108,600 |
| Investing Activities: | | |
| Capital expenditures | (66,138) | (92,092) |
| Capital contributions to investments | (1,830) | (1,305) |
| Other | (1,265) | (780) |
| <i>Cash Used for Investing Activities</i> | (69,233) | (94,177) |
| Financing Activities: | | |
| Cash dividends paid on common stock | (28,634) | (27,685) |
| Repayment of long-term debt | (3,069) | (42,000) |
| Issuance of long-term debt | - | 85,000 |
| Other | (130) | (765) |
| <i>Cash (Used for) Provided by Financing Activities</i> | (31,833) | 14,550 |
| Change in cash and cash equivalents | 19,906 | 28,973 |
| Cash and cash equivalents at beginning of period | 68,813 | 46,357 |
| Cash and Cash Equivalents at End of Period | \$ 88,719 | \$ 75,330 |

**Supplemental disclosures of cash flow
information:**

Significant noncash investing activities:

| | | | | |
|------------------------------|----|-------|----|--------|
| Accrued capital expenditures | \$ | 6,549 | \$ | 10,473 |
|------------------------------|----|-------|----|--------|

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

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

| | September 30, 2014 | December 31, 2013 |
|---|-------------------------------|------------------------------|
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 88,719 | \$ 68,813 |
| Accounts receivable, less reserves of \$4,056 and \$4,219, respectively | 35,251 | 44,890 |
| Other accounts receivable, less reserves of \$448 and \$750, respectively | 5,365 | 5,352 |
| Unbilled revenues | 19,929 | 31,982 |
| Materials and supplies, at average cost | 17,524 | 16,662 |
| Fossil fuel | 5,121 | 5,206 |
| Stored natural gas, at average cost | 23,292 | 13,988 |
| Prepaid taxes | 15,569 | 19,106 |
| Regulatory assets - current | 4,985 | 6,377 |
| Other current assets | 9,650 | 8,225 |
| <i>Total Current Assets</i> | 225,405 | 220,601 |
| Regulatory assets | 100,227 | 107,166 |
| Pension benefits | 17,942 | 15,071 |
| Other deferred assets and other | 7,029 | 8,046 |
| Property, Plant, and Equipment: | | |
| Property, plant, and equipment, net | 1,176,592 | 1,018,809 |
| Construction work in progress | 21,331 | 141,415 |
| <i>Total Property, Plant, and Equipment</i> | 1,197,923 | 1,160,224 |
| Investments | 71,370 | 67,952 |
| Total Assets | \$ 1,619,896 | \$ 1,579,060 |
| LIABILITIES AND CAPITALIZATION | | |
| Current Liabilities: | | |
| Long-term debt due within one year | \$ 4,162 | \$ 4,102 |
| Accounts payable | 41,871 | 43,684 |
| Accrued interest and taxes | 4,041 | 5,661 |
| Accrued payroll related items | 10,305 | 10,731 |
| Deferred income taxes | - | 1,711 |
| Regulatory liabilities - current | 8,822 | 13,538 |
| Derivative liabilities | 7,131 | 7,750 |
| Other current liabilities | 5,824 | 9,489 |
| <i>Total Current Liabilities</i> | 82,156 | 96,666 |
| Other Credits: | | |
| Deferred income taxes | 313,101 | 284,791 |
| Investment tax credit - deferred | 1,274 | 1,413 |
| Regulatory liabilities | 21,970 | 19,792 |

Edgar Filing: MGE ENERGY INC - Form 10-Q

| | | |
|---|--------------|--------------|
| Accrued pension and other postretirement benefits | 50,339 | 49,184 |
| Derivative liabilities | 47,820 | 57,930 |
| Other deferred liabilities and other | 52,947 | 52,360 |
| <i>Total Other Credits</i> | 487,451 | 465,470 |
| Capitalization: | | |
| Common shareholders' equity | 653,985 | 617,510 |
| Long-term debt | 396,304 | 399,414 |
| <i>Total Capitalization</i> | 1,050,289 | 1,016,924 |
| Commitments and contingencies (see Footnote 8) | - | - |
| Total Liabilities and Capitalization | \$ 1,619,896 | \$ 1,579,060 |

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

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

| | Common Stock Shares | Common Stock Value | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income | Total |
|---|------------------------|-----------------------|----------------------------------|----------------------|---|------------|
| 2013 | | | | | | |
| Beginning balance - December 31, 2012 | 34,668 | \$ 34,668 | \$ 316,268 | \$ 228,399 | \$ 94 | \$ 579,429 |
| Net income | | | | 60,828 | | 60,828 |
| Other comprehensive income | | | | | 176 | 176 |
| Common stock dividends declared (\$ 0.799 per share) | | | | (27,685) | | (27,685) |
| Ending balance - September 30, 2013 | 34,668 | \$ 34,668 | \$ 316,268 | \$ 261,542 | \$ 270 | \$ 612,748 |
| 2014 | | | | | | |
| Beginning balance - December 31, 2013 | 34,668 | \$ 34,668 | \$ 316,268 | \$ 266,197 | \$ 377 | \$ 617,510 |
| Net income | | | | 65,133 | | 65,133 |
| Other comprehensive income | | | | | 56 | 56 |
| Common stock dividends declared (\$0.826 per share) | | | | (28,634) | | (28,634) |
| Cash in lieu of fractional shares related to stock split | | | | (80) | | (80) |
| Ending balance - September 30, 2014 | 34,668 | \$ 34,668 | \$ 316,268 | \$ 302,616 | \$ 433 | \$ 653,985 |

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

Madison Gas and Electric Company

Consolidated Statements of Income (unaudited)

(In thousands)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|---|-------------|--|-------------|
| | 2014 | 2013 | 2014 | 2013 |
| Operating Revenues: | | | | |
| Regulated electric revenues | \$ 112,875 | \$ 119,836 | \$ 308,435 | \$ 310,176 |
| Regulated gas revenues | 21,410 | 18,864 | 163,351 | 121,373 |
| Nonregulated revenues | 862 | 1,399 | 2,392 | 4,075 |
| <i>Total Operating Revenues</i> | 135,147 | 140,099 | 474,178 | 435,624 |
| Operating Expenses: | | | | |
| Fuel for electric generation | 9,841 | 13,950 | 35,843 | 34,520 |
| Purchased power | 21,307 | 21,981 | 58,790 | 61,237 |
| Cost of gas sold | 11,045 | 8,819 | 107,695 | 70,259 |
| Other operations and maintenance | 37,309 | 40,990 | 117,593 | 124,133 |
| Depreciation and amortization | 10,364 | 9,710 | 30,156 | 28,864 |
| Other general taxes | 4,872 | 4,605 | 14,861 | 14,049 |
| Income tax provision | 13,338 | 13,798 | 36,180 | 34,237 |
| <i>Total Operating Expenses</i> | 108,076 | 113,853 | 401,118 | 367,299 |
| Operating Income | 27,071 | 26,246 | 73,060 | 68,325 |
| Other Income and Deductions: | | | | |
| AFUDC - equity funds | 255 | 852 | 3,306 | 2,178 |
| Equity in earnings in ATC | 2,423 | 2,340 | 7,306 | 7,045 |
| Income tax provision | (984) | (880) | (3,390) | (2,802) |
| Other income, net | (111) | 407 | (351) | 118 |
| <i>Total Other Income and Deductions</i> | 1,583 | 2,719 | 6,871 | 6,539 |
| Income before interest expense | 28,654 | 28,965 | 79,931 | 74,864 |
| Interest Expense: | | | | |
| Interest on long-term debt | 5,225 | 4,910 | 15,714 | 14,757 |
| Other interest, net | 44 | 5 | 52 | (31) |
| AFUDC - borrowed funds | (84) | (281) | (1,090) | (718) |
| <i>Net Interest Expense</i> | 5,185 | 4,634 | 14,676 | 14,008 |
| Net Income | \$ 23,469 | \$ 24,331 | \$ 65,255 | \$ 60,856 |
| Less: Net Income Attributable to Noncontrolling | | | | |
| Interest, net of tax | (6,653) | (6,861) | (19,784) | (20,547) |
| Net Income Attributable to MGE | \$ 16,816 | \$ 17,470 | \$ 45,471 | \$ 40,309 |

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

Madison Gas and Electric Company

Consolidated Statements of Comprehensive Income (unaudited)

(In thousands)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|----------|------------------------------------|----------|
| | 2014 | 2013 | 2014 | 2013 |
| Net Income | \$ 23,469\$ | 24,331\$ | 65,255\$ | 60,856 |
| Other comprehensive income (loss), net of tax: | | | | |
| Unrealized gain (loss) on available-for-sale securities, net of tax ((\$29) and (\$33), and \$36 and (\$52), respectively) | 43 | 49 | (54) | 77 |
| Comprehensive Income | \$ 23,512\$ | 24,380\$ | 65,201\$ | 60,933 |
| Less: Comprehensive Income Attributable to Noncontrolling Interest, net of tax | (6,653) | (6,861) | (19,784) | (20,547) |
| Comprehensive Income Attributable to MGE | \$ 16,859\$ | 17,519\$ | 45,417\$ | 40,386 |

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

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

| | Nine Months Ended September 30, | |
|---|--|-------------|
| | 2014 | 2013 |
| Operating Activities: | | |
| Net income | \$ 65,255 | \$ 60,856 |
| Items not affecting cash: | | |
| Depreciation and amortization | 30,156 | 28,864 |
| Deferred income taxes | 23,811 | 31,467 |
| Provision for doubtful receivables | 1,001 | 1,551 |
| Employee benefit plan expenses | (814) | 9,908 |
| Equity earnings in ATC | (7,306) | (7,045) |
| Other items | (446) | 652 |
| Changes in working capital items: | | |
| Decrease in current assets | 13,258 | 14,599 |
| Decrease in current liabilities | (5,457) | (4,911) |
| Dividend income from ATC | 5,762 | 5,498 |
| Cash contributions to pension and other postretirement plans | (2,449) | (33,919) |
| Debt make-whole premium | - | (6,757) |
| Other noncurrent items, net | (24) | 7,063 |
| <i>Cash Provided by Operating Activities</i> | 122,747 | 107,826 |
| Investing Activities: | | |
| Capital expenditures | (66,138) | (92,092) |
| Capital contributions to investments | (1,420) | (1,065) |
| Other | (1,087) | (678) |
| <i>Cash Used for Investing Activities</i> | (68,645) | (93,835) |
| Financing Activities: | | |
| Cash dividends paid to parent by MGE | (26,500) | - |
| Distributions to parent from noncontrolling interest | (17,778) | (21,148) |
| Equity contribution received by noncontrolling interest | 1,420 | 1,065 |
| Repayment of long-term debt | (3,069) | (42,000) |
| Issuance of long-term debt | - | 85,000 |
| Other | - | (668) |
| <i>Cash (Used for) Provided by Financing Activities</i> | (45,927) | 22,249 |
| Change in cash and cash equivalents | 8,175 | 36,240 |

| | | | | |
|---|----|--------|----|--------|
| Cash and cash equivalents at beginning of period | | 14,808 | | 6,350 |
| Cash and Cash Equivalents at End of Period | \$ | 22,983 | \$ | 42,590 |

Supplemental disclosures of cash flow information:

Significant noncash investing activities:

| | | | | |
|------------------------------|----|-------|----|--------|
| Accrued capital expenditures | \$ | 6,549 | \$ | 10,473 |
|------------------------------|----|-------|----|--------|

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

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

| | September 30, 2014 | December 31, 2013 |
|---|-------------------------------|------------------------------|
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 22,983 | \$ 14,808 |
| Accounts receivable, less reserves of \$4,056 and \$4,219, respectively | 35,251 | 44,890 |
| Affiliate receivables | 609 | 534 |
| Other accounts receivable, less reserves of \$448 and \$750, respectively | 5,290 | 5,274 |
| Unbilled revenues | 19,929 | 31,982 |
| Materials and supplies, at average cost | 17,524 | 16,662 |
| Fossil fuel | 5,121 | 5,206 |
| Stored natural gas, at average cost | 23,292 | 13,988 |
| Prepaid taxes | 20,390 | 23,934 |
| Regulatory assets - current | 4,985 | 6,377 |
| Other current assets | 9,546 | 8,197 |
| <i>Total Current Assets</i> | 164,920 | 171,852 |
| Affiliate receivable long-term | 5,428 | 5,825 |
| Regulatory assets | 100,227 | 107,166 |
| Pension benefits | 17,942 | 15,071 |
| Other deferred assets and other | 4,987 | 6,138 |
| Property, Plant, and Equipment: | | |
| Property, plant, and equipment, net | 1,175,695 | 1,017,877 |
| Construction work in progress | 21,331 | 141,415 |
| <i>Total Property, Plant, and Equipment</i> | 1,197,026 | 1,159,292 |
| Investments | 68,172 | 65,299 |
| Total Assets | \$ 1,558,702 | \$ 1,530,643 |
| LIABILITIES AND CAPITALIZATION | | |
| Current Liabilities: | | |
| Long-term debt due within one year | \$ 4,162 | \$ 4,102 |
| Accounts payable | 41,861 | 43,684 |
| Accrued interest and taxes | 3,774 | 6,040 |
| Accrued payroll related items | 10,305 | 10,731 |
| Deferred income taxes | 1,143 | 2,723 |
| Regulatory liabilities - current | 8,822 | 13,538 |
| Derivative liabilities | 7,131 | 7,750 |
| Other current liabilities | 5,495 | 6,446 |
| <i>Total Current Liabilities</i> | 82,693 | 95,014 |
| Other Credits: | | |
| Deferred income taxes | 306,559 | 279,085 |

Edgar Filing: MGE ENERGY INC - Form 10-Q

| | | |
|---|--------------|--------------|
| Investment tax credit - deferred | 1,274 | 1,413 |
| Regulatory liabilities | 21,970 | 19,792 |
| Accrued pension and other postretirement benefits | 50,338 | 49,184 |
| Derivative liabilities | 47,820 | 57,930 |
| Other deferred liabilities and other | 52,947 | 52,357 |
| <i>Total Other Credits</i> | 480,908 | 459,761 |
| Capitalization: | | |
| Common shareholder's equity | 476,408 | 457,491 |
| Noncontrolling interest | 122,389 | 118,963 |
| <i>Total Equity</i> | 598,797 | 576,454 |
| Long-term debt | 396,304 | 399,414 |
| <i>Total Capitalization</i> | 995,101 | 975,868 |
| Commitments and contingencies (see Footnote 8) | - | - |
| Total Liabilities and Capitalization | \$ 1,558,702 | \$ 1,530,643 |

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

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

| | Common Stock Shares | Stock Value | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income | Non- Controlling Interest | Total |
|---|------------------------|----------------|----------------------------------|----------------------|---|---------------------------------|----------|
| 2013 | | | | | | | |
| Beginning balance - Dec. 31, 2012 | 17,348\$ | 17,348\$ | 192,417\$ | 223,527\$ | 4\$ | 117,470\$ | 550,766 |
| Net income | | | | 40,309 | | 20,547 | 60,856 |
| Other comprehensive income (loss) | | | | | 77 | | 77 |
| Equity contribution received by noncontrolling interest | | | | | | 1,065 | 1,065 |
| Distributions to parent from noncontrolling interest | | | | | | (21,148) | (21,148) |
| Ending balance - September 30, 2013 | 17,348\$ | 17,348\$ | 192,417\$ | 263,836\$ | 81\$ | 117,934\$ | 591,616 |
| 2014 | | | | | | | |
| Beginning balance - Dec. 31, 2013 | 17,348\$ | 17,348\$ | 192,417\$ | 247,534\$ | 192\$ | 118,963\$ | 576,454 |
| Net income | | | | 45,471 | | 19,784 | 65,255 |
| Other comprehensive income (loss) | | | | | (54) | | (54) |
| Cash dividends paid to parent by MGE | | | | (26,500) | | | (26,500) |
| Equity contribution received by noncontrolling interest | | | | | | 1,420 | 1,420 |
| Distributions to parent from noncontrolling interest | | | | | | (17,778) | (17,778) |
| Ending balance - September 30, 2014 | 17,348\$ | 17,348\$ | 192,417\$ | 266,505\$ | 138\$ | 122,389\$ | 598,797 |

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

MGE Energy, Inc., and Madison Gas and Electric Company

Notes to Consolidated Financial Statements (unaudited)

September 30, 2014

1.

Basis of Presentation - MGE Energy and MGE.

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

MGE Power Elm Road and MGE Power West Campus own electric generating assets and lease those assets to MGE. Both entities are variable interest entities under applicable authoritative guidance. MGE is considered the primary beneficiary of these entities as a result of contractual agreements. As a result, MGE has consolidated MGE Power Elm Road and MGE Power West Campus. See Footnote 2 of Notes to Consolidated Financial Statements under Item 8, Financial Statements and Supplementary Data, of MGE Energy's and MGE's 2013 Annual Report on Form 10-K.

The accompanying consolidated financial statements as of September 30, 2014, and for the three and nine months ended, are unaudited, but include all adjustments that MGE Energy and MGE management consider necessary for a fair statement of their respective financial statements. All adjustments are of a normal, recurring nature except as otherwise disclosed. The year-end consolidated balance sheet information was derived from the audited balance sheet appearing in MGE Energy's and MGE's 2013 Annual Report on Form 10-K, but does not include all disclosures required by accounting principles generally accepted in the United States of America. These notes should be read in conjunction with the financial statements and the notes on pages 57 through 100 of the 2013 Annual Report on Form 10-K.

On December 20, 2013, MGE Energy's Board of Directors declared a three-for-two stock split of MGE Energy's common stock in the form of a stock dividend. The additional shares were distributed February 7, 2014, to all shareholders of record as of January 24, 2014. All shares and per share data provided in this report give effect to this stock split.

2.

Equity and Financing Arrangements.

a.

Common Stock - MGE Energy.

MGE Energy sells shares of its common stock through its Stock Plan. Those shares may be newly issued shares or shares that MGE Energy has purchased in the open market for resale to participants in the Stock Plan. All sales under the stock plan are covered by a shelf registration statement that MGE Energy filed with the SEC. For both the nine months ended September 30, 2014 and 2013, MGE Energy did not issue any new shares of common stock under the Stock Plan.

b.

Dilutive Shares Calculation - MGE Energy.

MGE Energy does not hold any dilutive securities.

3.

Investment in ATC - MGE Energy and MGE.

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

Edgar Filing: MGE ENERGY INC - Form 10-Q

MGE Transco has accounted for its investment in ATC under the equity method of accounting. For the nine months ended September 30, 2014 and 2013, MGE Transco recorded the following:

| <i>(In thousands)</i> | Nine Months Ended September 30, | |
|---|------------------------------------|----------|
| | 2014 | 2013 |
| Equity in earnings from investment in ATC | \$ 7,306 | \$ 7,045 |
| Dividends received from ATC | 5,762 | 5,498 |
| Capital contributions to ATC | 1,420 | 1,065 |

On October 31, 2014, MGE Transco made an additional \$0.4 million capital contribution to ATC.

MGE Transco's investment in ATC as of September 30, 2014, and December 31, 2013, was \$67.5 million and \$64.5 million, respectively.

At September 30, 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 financial statements as noncontrolling interest.

ATC's summarized financial data for the three and nine months ended September 30, 2014 and 2013, is as follows:

| <i>(In thousands)</i> | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---------------------------------------|-------------------------------------|------------|------------------------------------|------------|
| | 2014 | 2013 | 2014 | 2013 |
| Operating revenues | \$ 163,643 | \$ 160,480 | \$ 486,970 | \$ 464,345 |
| Operating expenses | (76,561) | (77,595) | (229,589) | (217,240) |
| Other income, net | 693 | 917 | 1,403 | 585 |
| Interest expense, net | (22,204) | (21,136) | (66,442) | (63,232) |
| Earnings before members' income taxes | \$ 65,571 | \$ 62,666 | \$ 192,342 | \$ 184,458 |

4.

Columbia Environmental Project Construction - MGE Energy and MGE.

MGE and two other utilities jointly own Columbia, a coal-fired generating facility. WPL is the plant operator and permit holder, and owns 46.2% of Columbia. WPSC owns a 31.8% interest, and MGE owns a 22% interest, in Columbia. In early 2011, the PSCW issued a *Certificate and Order* authorizing the construction of scrubbers and baghouses and associated equipment on Columbia Units 1 and 2 to reduce SO₂ and mercury emissions. The modifications to Unit 2 were placed into service in April 2014, and the modifications to Unit 1 were placed into service in July 2014. The scrubbers and baghouses are expected to support compliance obligations for current and anticipated air quality regulations, including CAIR, CSAPR, MATS, and the Wisconsin Mercury Rule. As of September 30, 2014, \$138.6 million of the capitalized project was transferred from Construction work in progress to Property, plant, and equipment on MGE's balance sheet related to Units 1 and 2 being placed into service. This total amount consisted of \$128.8 million of capital expenditures and \$9.8 million of AFUDC. MGE's share of various contractual commitments entered for the project as of September 30, 2014, is \$5.5 million. For the three months ended September 30, 2014 and 2013, MGE has recognized after tax \$0.1 million and \$0.8 million, respectively, in AFUDC equity related to this project. For the nine months ended September 30, 2014 and 2013, MGE has recognized after tax \$3.0 million and \$1.9 million, respectively, in AFUDC equity related to this project.

MGE expects that the costs pertaining to this project will be fully recoverable through rates. For 2014, the PSCW authorized MGE 100% AFUDC on this project during construction. For 2013, the PSCW authorized MGE a 50% current return (included in customer rates) and the remaining 50% as AFUDC.

5.

Taxes - MGE Energy and MGE.

MGE Energy's effective income tax rates for the three and nine months ended September 30, 2014, were 38.0% and 37.8%, respectively, compared to 37.6% and 37.8% for the same periods in 2013. MGE's effective income tax rates for the three and nine months ended September 30, 2014, were 37.9% and 37.8%, respectively, compared to 37.6% and 37.8% for the same periods in 2013. The net increase in the three month effective tax rate is attributable to less AFUDC equity earned during the three month period in 2014 compared to 2013.

6.

Pension and Other Postretirement Plans - MGE Energy and MGE.

MGE maintains qualified and nonqualified pension plans, health care, and life insurance benefits. Additionally, MGE has defined contribution 401(k) benefit plans.

The following table presents the components of MGE Energy's and MGE's net periodic benefit costs recognized for the three and nine months ended September 30, 2014 and 2013. A portion of the net periodic benefit cost is capitalized within the consolidated balance sheets.

| <i>(In thousands)</i> | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|----------|------------------------------------|----------|
| | 2014 | 2013 | 2014 | 2013 |
| Pension Benefits | | | | |
| Components of net periodic (benefit) cost: | | | | |
| Service cost | \$ 1,536 | \$ 1,924 | \$ 4,609 | \$ 5,764 |
| Interest cost | 3,367 | 3,178 | 10,102 | 9,521 |
| Expected return on assets | (5,467) | (4,764) | (16,402) | (14,273) |
| Amortization of: | | | | |
| Prior service cost | 51 | 79 | 152 | 237 |
| Actuarial loss | 180 | 2,011 | 539 | 6,023 |
| Net periodic (benefit) cost | \$ (333) | \$ 2,428 | \$ (1,000) | \$ 7,272 |
| Postretirement Benefits | | | | |
| Components of net periodic (benefit) cost: | | | | |
| Service cost | \$ 241 | \$ 594 | \$ 722 | \$ 1,781 |
| Interest cost | 564 | 966 | 1,691 | 2,898 |
| Expected return on assets | (478) | (542) | (1,432) | (1,626) |
| Amortization of: | | | | |
| Transition obligation | 1 | - | 2 | 2 |
| Prior service (benefit) cost | (487) | 28 | (1,462) | 83 |
| Actuarial loss | 28 | 310 | 86 | 930 |
| Net periodic (benefit) cost | \$ (131) | \$ 1,356 | \$ (393) | \$ 4,068 |

7.

Share-Based Compensation - MGE Energy and MGE.

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

In addition to units granted in 2009 through 2013, on February 21, 2014, 21,991 units were granted based on the MGE Energy closing stock price as of that date. These units are subject to a five-year graded vesting schedule and reflect the three-for-two stock split declared December 20, 2013. On the grant date, MGE Energy and MGE measure the cost of the employee services received in exchange for a performance unit award based on the current market value of MGE Energy common stock. The fair value of the awards has been subsequently re-measured at September 30, 2014, as required by applicable accounting standards. Changes in fair value have been recognized as compensation cost. Since this amount is re-measured quarterly throughout the vesting period, the compensation cost is subject to variability.

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

In December 2013, a Director Incentive Plan was approved for the non-employee members of the Board of Directors. This plan is similar to MGE Energy's Performance Unit Plan for eligible employees described above. Under the plan, a non-employee director can 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 payments, at the end of the set performance period. The units are subject to a three-year graded vesting schedule. In January 2014, unit awards of 4,683 (post-split) were granted to the non-employee Directors. For accounting purposes, the awards will be measured similarly to the employee unit awards.

During the nine months ended September 30, 2014 and 2013, MGE recorded \$0.9 million and \$1.1 million, respectively, in compensation expense as a result of the plans. In January 2014, cash payments of \$1.2 million were distributed relating to awards that were granted in 2009. No forfeitures occurred during the nine months ended September 30, 2014 or 2013. At September 30, 2014, \$3.7 million of outstanding awards are vested.

8.

Commitments and Contingencies - MGE Energy and MGE.

a.

Environmental.

MGE Energy and MGE are subject to frequently changing local, state, and federal regulations concerning air quality, water quality, land use, threatened and endangered species, hazardous materials handling, and solid waste disposal. These regulations affect the manner in which 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. These initiatives, proposed rules, and court challenges include:

.

The President's announced plan and directive to the EPA to regulate carbon pollution, or greenhouse gas (GHG) emissions, from new and existing electric power generation units, and the EPA's related proposed GHG New Source Performance Standards (NSPS) (see below for additional information on the NSPS rule).

.

Rules to regulate NO_x and SO₂ emissions, including the EPA's Cross State Air Pollution Rule (CSAPR) (see below for recent developments with CSAPR). An environmental group has sought federal appellate court review of the EPA's Clean Air Visibility Rule (CAVR) to address regional haze. Both the pending challenges to CSAPR and the appellate court review of CAVR make the nature of compliance requirements uncertain.

.

Rules to regulate mercury and similar emissions, including Wisconsin's adopted Mercury Rule and the EPA's adopted Mercury and Air Toxics Standards.

The EPA's cooling water intake rules. The EPA issued a final rule for existing facilities in May 2014. The final rule is discussed below.

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

The EPA's ongoing review of several National Ambient Air Quality Standards (NAAQS), including the potential lowering of the ozone NAAQS and its proposed requirements for air agencies to characterize sulfur dioxide air quality for purposes of implementing the 1-hour SO₂ NAAQS. This approach focuses on large sources of SO₂ emissions and proposes area designations to be made in two rounds (2017 and 2020). The proposed rule gives states broad discretion in its implementation. The final rule is expected late in 2014. MGE will be reviewing the rule for potential impacts on its operations.

The matters in the bullet points above are discussed further in Footnote 18.d. of Notes to Consolidated Financial Statements under Item 8, Financial Statements and Supplementary Data, of MGE Energy's and MGE's 2013 Annual Report on Form 10-K. In addition to the developments noted above, the following discussion is an update to the current status of environmental matters set forth in that Footnote.

EPA's Final 316(b) Rule Governing Water Intake Systems at Electric Generating Facilities

In August 2014, the EPA published its Phase II and III Rules pursuant to Section 316(b) of the Clean Water Act, which governs cooling water intake structures located at large existing power plant and industrial facilities. The 316(b) Rule requires these facilities to implement methods for reducing fish impingement by their water intakes using one of seven options, including closed cycle cooling (CCC) systems.

Our WCCF facility already employs a CCC system as defined under the Rule. The Columbia plant may need to address multiple intake structures. Our Blount plant has conducted studies regarding options for compliance with this rule. The exact requirements at Blount and Columbia, however, will not be known until those sites' permits are modified to account for this rule. Nonetheless, MGE expects that the 316(b) Rule will not have material effects on its existing plants.

EPA's Cross-State Air Pollution Rule (CSAPR) Upheld by the Supreme Court

On April 29, 2014, the US Supreme Court issued a decision reversing the D.C. Circuit Court's decision that had vacated CSAPR and remanding the matter back to the D.C. Circuit for further proceedings. At that time CSAPR remained subject to an order of the D.C. Circuit that stayed its implementation. On October 23, 2014, the D.C. Circuit lifted its stay of CSAPR and set a briefing schedule to resolve issues remaining in the lawsuit. The court also set the briefing schedule for ongoing litigation with oral arguments scheduled for March 2015. The State of Wisconsin has filed a motion with the D.C. Circuit Court reiterating its contention that Wisconsin be removed from CSAPR and may be a part of the court's briefing and oral argument schedule. With several issues undecided and court proceedings extending into 2015, there is remaining uncertainty as to whether MGE's facilities will be required to meet the CSAPR mandates and, if so, the deadline for achieving compliance. The Clean Air Interstate Rule (CAIR) remains in effect for the time being. See MGE Energy's and MGE's 2013 Annual Report on Form 10K for additional information on the legal proceedings associated with these environmental matters.

With CSAPR now reinstated, it will require (once implemented) that qualifying power plants meet SO₂ and NO_x allocations or purchase them on the market. MGE has been monitoring our overall compliance options, particularly at our Columbia power plant as we awaited installation and testing of SO₂ controls. With the 2014 installation of SO₂ pollution controls at Columbia, we will likely meet or exceed the allocations for Columbia based on the CSAPR allocations in the current rule (see Footnote 4 for information regarding the Columbia environmental construction project and below in this Footnote for information regarding our consent decree). MGE expects that the costs pertaining to meeting CSAPR and the consent decree requirements will be fully recoverable through rates. We will continue to monitor and evaluate the D.C. Circuit Court remand proceedings and the implementation of the rule by the EPA and WDNR.

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

On June 2, 2014, the EPA released proposed guidelines for states to use in developing plans to control GHG emissions from existing fossil fuel fired electric generating units (EGUs). The proposed rule was published in the Federal Register on June 17, 2014.

The EPA's proposal seeks to reduce GHG emissions from EGUs by a national average of 30% by 2030 as measured from a 2005 baseline. Each state is given its own emission reduction targets to meet this goal. These targets are expressed as a "rate-based" emission average to be achieved by the combined fleet of EGUs within the state. States would be expected to make "meaningful progress" towards these reductions by 2020 and to meet their respective targets by 2030.

The EPA's proposal establishes guidelines for states and encourages the use of four "building blocks" for achieving these reductions. These "building blocks" are: (1) increasing the efficiency of EGUs; (2) re-dispatching of gas-fired generation at the expense of coal; (3) expanding the use of low and no carbon power sources, such as wind, nuclear and solar; and (4) improving demand side energy efficiency to reduce electric use.

The EPA is taking comments on the proposed rule through December 1, 2014. The rule is expected to be finalized by June 2015. States will then have up to two years to prepare compliance plans. This rule could have significant impacts on EGUs. MGE is reviewing the proposal at this time.

Coal Combustion Residual Rule

The EPA's proposed Coal Combustion Residual (CCR) Rule is anticipated to be finalized in December 2014. The final CCR Rule will regulate disposal and management of ash and other coal combustion byproducts as a waste under the EPA's solid waste rules.

Columbia

Based upon current available information, compliance with various environmental requirements and initiatives is expected to result in significant additional operating and capital expenditures at Columbia as noted below.

Columbia Environmental Project

See Footnote 4 for information regarding the Columbia environmental construction project.

Columbia Clean Air Act Litigation

In December 2009, the EPA sent a notice of violation (NOV) to MGE and the other co-owners of Columbia. The NOV alleged that WPL, as owner-operator, and the other co-owners failed to comply with appropriate pre-construction review and permitting requirements and, as a result, violated the PSD program requirements, the Title V operating permit requirements of the CAA and the Wisconsin State Implementation Plan (SIP). In April 2013, the EPA filed a lawsuit against the co-owners of Columbia asserting similar allegations. In September 2010 and April 2013, Sierra Club filed lawsuits against WPL alleging violations of the CAA at Columbia and other WPL-operated Wisconsin facilities.

In April 2013, WPL, as owner-operator, along with the other owners of Columbia, entered into a consent decree with the EPA and the Sierra Club to resolve these claims, while admitting no liability. In June 2013, the consent decree was approved and entered by the Court. The consent decree requires installation of the following emission controls at Columbia: SO₂ scrubbers and baghouses at Columbia Units 1 and 2 by December 31, 2014, which have now been installed, and an SCR system at Columbia Unit 2 by December 31, 2018. In addition, the consent decree establishes emission rate limits for SO₂, NO_x, and particulate matter for Columbia Units 1 and 2. The consent decree also includes annual plant-wide emission caps for SO₂ and NO_x for Columbia. MGE also paid approximately \$0.2 million as its share of a civil penalty and will complete approximately \$0.6 million in environmental mitigation projects. MGE intends to seek recovery in rates of the costs associated with its compliance with the terms of the final consent decree and currently expects to recover any material compliance costs.

b.

Chattel Paper Agreement and Other Guarantees.

MGE makes available to qualifying customers a financing program for the purchase and installation of energy-related equipment that will provide more efficient use of utility service at the customer's property. MGE is party to a chattel paper purchase agreement with a financial institution under which it can sell or finance an undivided interest with recourse, in up to \$10.0 million of the financing program receivables, until July 31, 2015. At September 30, 2014, MGE had sold a \$4.1 million interest in these receivables. MGE retains the servicing responsibility for these receivables. As of September 30, 2014, the servicing asset recognized by MGE is \$0.2 million.

MGE accounts for servicing rights under the amortization method. Initial determination of the servicing asset fair value is based on the present value of the estimated future cash flows. The discount rate is based on the PSCW authorized weighted cost of capital.

MGE would be required to perform under its guarantee if a customer defaulted on its loan. The energy-related equipment installed at the customer sites is used to secure the customer loans. The loan balances outstanding at September 30, 2014, approximate the fair value of the energy-related equipment acting as collateral. 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. Principal payments for the remainder of 2014 and the next four years on the loans are:

| <i>(In thousands)</i> | 2014 | 2015 | 2016 | 2017 | 2018 |
|-----------------------|-------------|-------------|-------------|-------------|-------------|
| Chattel Paper | \$ 108 \$ | 921 \$ | 841 \$ | 438 \$ | 374 |

c.

Legal Matters.

MGE is involved in various legal matters that are being defended and handled in the normal course of business. MGE maintains accruals for such costs that are probable of being incurred and subject to reasonable estimation. The accrued amount for these matters is not material to the financial statements.

d.

Purchase Contracts.

MGE Energy and MGE have entered into various commodity supply, transportation, and storage contracts to meet their obligations to deliver electricity and natural gas to customers. As of September 30, 2014, the future commitments related to these purchase contracts were as follows:

| <i>(In thousands)</i> | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|-------------|-------------|-------------|-------------|-------------|
| Coal ^(a) | \$ 11,950 | \$ 18,439 | \$ 10,765 | \$ 5,073 | 2,710 |
| Natural gas | | | | | |
| Transportation & storage ^(b) | 5,234 | 18,073 | 9,937 | 272 | 191 |
| Supply ^(c) | 16,951 | 16,070 | - | - | - |
| Purchase power ^(d) | 12,665 | 48,964 | 49,633 | 50,132 | 51,153 |
| Other | 16,102 | - | - | - | - |
| | \$ 62,902 | \$ 101,546 | \$ 70,335 | \$ 55,477 | 54,054 |

(a)

Total coal commitments for the Columbia and Elm Road Units, including transportation. Fuel procurements for MGE's jointly owned Columbia and Elm Road Units are handled by WPL and WEPCO, respectively, who are the operators of those facilities. If any minimum purchase obligations must be paid under these contracts, management believes these obligations would be considered costs of service and recoverable in rates.

(b)

MGE's natural gas transportation and storage contracts require fixed monthly payments for firm supply pipeline transportation and storage capacity. The pricing components of the fixed monthly payments for the transportation and storage contracts are established by FERC but may be subject to change.

(c)

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

(d)

MGE has several purchase power agreements to help meet future electric supply requirements. Management expects to recover these costs in future customer rates.

e.

Elm Road - MGE Energy and MGE.

The warranty periods for both of the Elm Road Units have expired. During 2013, WEPCO and Bechtel (the construction contractor for the Elm Road Units) were working through the outstanding warranty claims. The warranty claim for the costs incurred to repair steam turbine corrosion damage identified on both units was resolved through a binding arbitration in June 2013. Final acceptance of the Elm Road Units occurred in June 2013 after all requirements stated in the contract with Bechtel were satisfied. In April 2014, an additional warranty claim was resolved that did not have a material impact on our financial statements. The parties continue to work through one potential remaining warranty claim.

9.

Derivative and Hedging Instruments - MGE Energy and MGE.

a.

Purpose.

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

b.

Notional Amounts.

The gross notional volume of open derivatives is as follows:

| | September 30, 2014 | December 31, 2013 |
|--------------------------------|--------------------|-------------------|
| Commodity derivative contracts | 447,570 MWh | 458,660 MWh |
| Commodity derivative contracts | 6,555,000 Dth | 3,750,000 Dth |
| FTRs | 3,104 MW | 1,984 MW |

c.

Financial Statement Presentation.

MGE purchases and sells exchange-traded and over-the-counter options, swaps, and future contracts. These arrangements are primarily entered into to help stabilize the price risk associated with gas or power purchases. These transactions are employed by both MGE's gas and electric segments. Additionally, as a result of the firm transmission agreements that MGE holds on electricity transmission paths in the MISO market, MGE holds FTRs. An FTR is a financial instrument that entitles the holder to a stream of revenues or charges based on the differences in hourly day-ahead energy prices between two points on the transmission grid. The fair values of these instruments are offset with a corresponding regulatory asset/liability depending on whether they are in a net loss/gain position. Depending on the nature of the instrument, the gain or loss associated with these transactions will be reflected as cost of gas sold, fuel for electric generation, or purchased power expense in the delivery month applicable to the instrument. At September 30, 2014, and December 31, 2013, the fair value of exchange traded derivatives and FTRs exceeded their cost basis by \$2.3 million and \$1.8 million, respectively.

MGE is a party to a ten-year purchased power agreement that provides MGE with firm capacity and energy during a base term from June 1, 2012, through May 31, 2022. The agreement also allows MGE an option to extend the contract after the base term. The agreement is accounted for as a derivative contract and is recognized at its fair value on the consolidated balance 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 September 30, 2014, and December 31, 2013, reflects a loss position of \$54.9 million and \$65.7 million, respectively. The actual fuel cost will be recognized in purchased power expense in the month of purchase and collected in rates.

Edgar Filing: MGE ENERGY INC - Form 10-Q

The following table summarizes the fair value of the derivative instruments on the consolidated balance sheet. All derivative instruments in this table are presented on a gross basis and are calculated prior to the netting of instruments with the same counterparty under a master netting agreement as well as the netting of collateral. For financial statement purposes, MGE Energy and MGE have netted instruments with the same counterparty under a master netting agreement as well as the netting of collateral. At September 30, 2014, MGE Energy and MGE had the right to reclaim collateral (a receivable) of \$0.6 million.

| <i>(In thousands)</i> | Asset Derivatives | | Liability Derivatives | |
|--------------------------------|------------------------|------------|----------------------------------|------------|
| | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| September 30, 2014 | | | | |
| Commodity derivative contracts | Other current assets | \$ 1,507 | Derivative liability (current) | \$ 532 |
| Commodity derivative contracts | Other deferred charges | 48 | Derivative liability (long-term) | 4 |
| FTRs | Other current assets | 1,237 | Derivative liability (current) | - |
| Ten-year PPA | N/A | N/A | Derivative liability (current) | 7,120 |
| Ten-year PPA | N/A | N/A | Derivative liability (long-term) | 47,820 |
| December 31, 2013 | | | | |
| Commodity derivative contracts | Other current assets | \$ 1,356 | Derivative liability (current) | \$ 51 |
| Commodity derivative contracts | Other deferred charges | 167 | Derivative liability (long-term) | 48 |
| FTRs | Other current assets | 363 | Derivative liability (current) | - |
| Ten-year PPA | N/A | N/A | Derivative liability (current) | 7,750 |
| Ten-year PPA | N/A | N/A | Derivative liability (long-term) | 57,930 |

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

Offsetting of Derivative Assets

| <i>(In thousands)</i> | Gross amounts | Gross amounts offset in balance sheet | Collateral posted against derivative positions | Net amount presented in balance sheet |
|--------------------------------|------------------|--|---|---|
| September 30, 2014 | | | | |
| Commodity derivative contracts | \$ 1,555 | \$ (525) | \$ - | \$ 1,030 |
| FTRs | 1,237 | - | - | 1,237 |
| December 31, 2013 | | | | |
| Commodity derivative contracts | \$ 1,523 | \$ (99) | \$ (175) | \$ 1,249 |
| FTRs | 363 | - | - | 363 |

Offsetting of Derivative Liabilities

| <i>(In thousands)</i> | Gross amounts | Gross amounts offset in balance sheet | Collateral posted against derivative positions | Net amount presented in balance sheet |
|--------------------------------|------------------|--|---|---|
| September 30, 2014 | | | | |
| Commodity derivative contracts | \$ 536 | \$ (525) | \$ - | \$ 11 |
| Ten-year PPA | 54,940 | - | - | 54,940 |
| December 31, 2013 | | | | |
| Commodity derivative contracts | \$ 99 | \$ (99) | \$ - | \$ - |
| Ten-year PPA | 65,680 | - | - | 65,680 |

The following tables summarize the unrealized and realized gains (losses) related to the derivative instruments on the consolidated balance sheet at September 30, 2014 and 2013, and the consolidated income statement for the three and nine months ended September 30, 2014 and 2013.

| <i>(In thousands)</i> | 2014 | | 2013 | |
|---|---|-------------------------|---|-------------------------|
| | Current and long-term regulatory asset | Other current assets | Current and long-term regulatory asset | Other current assets |
| Three Months Ended September 30: | | | | |
| Balance at July 1, | \$ 48,853 | \$ 676 | \$ 66,649 | \$ 658 |

Edgar Filing: MGE ENERGY INC - Form 10-Q

| | | | | |
|---|-----------|---------|-----------|--------|
| Change in unrealized loss | 5,329 | - | 2,330 | - |
| Realized gain (loss) reclassified to a deferred account | (314) | 314 | (275) | 275 |
| Realized gain (loss) reclassified to income statement | (1,184) | (249) | (621) | (111) |
| Balance at September 30, | \$ 52,684 | \$ 741 | \$ 68,083 | \$ 822 |
| Nine Months Ended September 30: | | | | |
| Balance at January 1, | \$ 63,893 | \$ 411 | \$ 72,329 | \$ 574 |
| Change in unrealized gain | (18,090) | - | (1,330) | - |
| Realized gain (loss) reclassified to a deferred account | 1,120 | (1,120) | (953) | 953 |
| Realized gain (loss) reclassified to income statement | 5,761 | 1,450 | (1,963) | (705) |
| Balance at September 30, | \$ 52,684 | \$ 741 | \$ 68,083 | \$ 822 |

| | 2014 | | 2013 | |
|---|--|------------------|--|------------------|
| | Fuel for electric generation/ purchased power | Cost of gas sold | Fuel for electric generation/ purchased power | Cost of gas sold |
| <i>(In thousands)</i> | | | | |
| Three Months Ended September 30: | | | | |