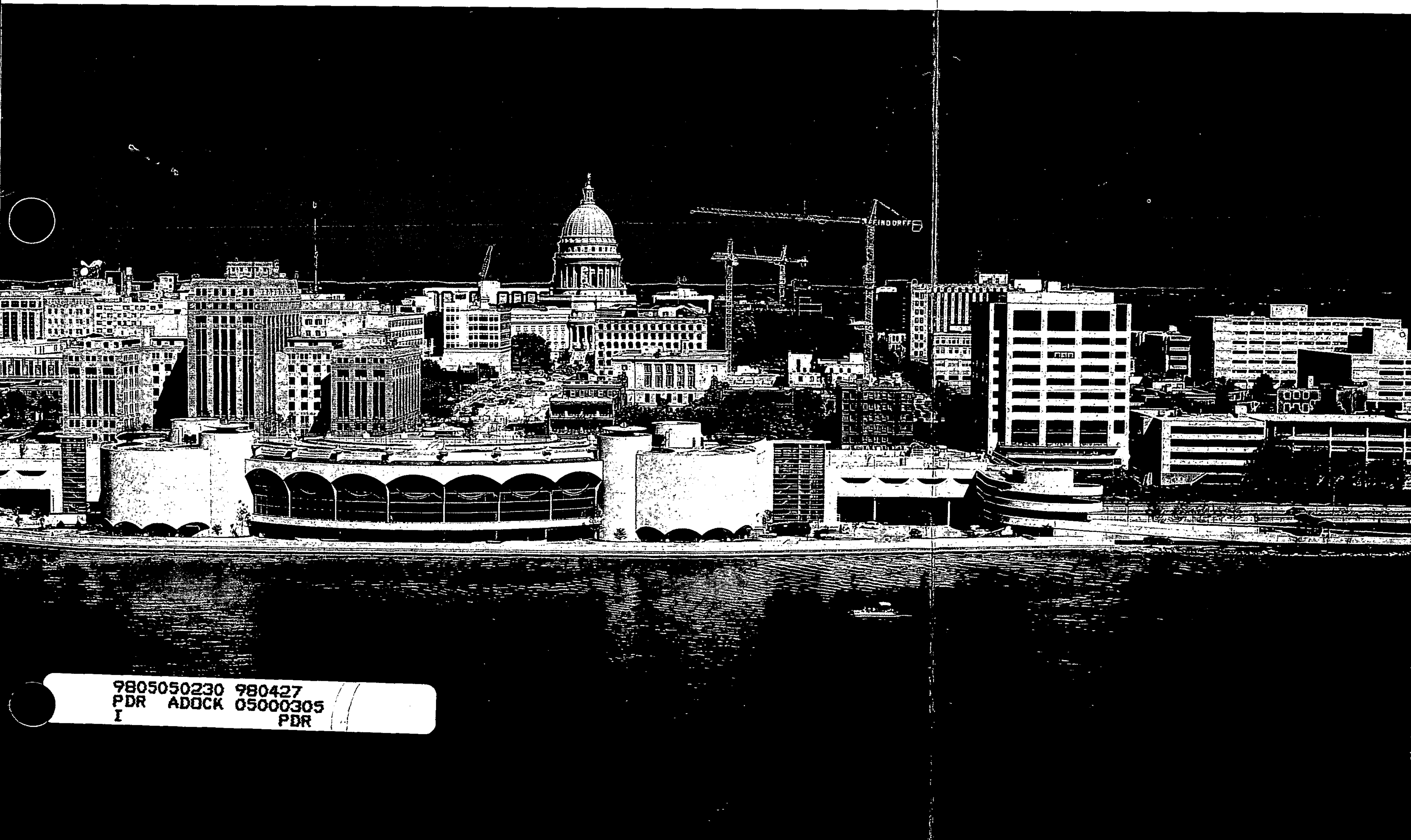
Madison Gas and Electric Company 1997 Annual Report

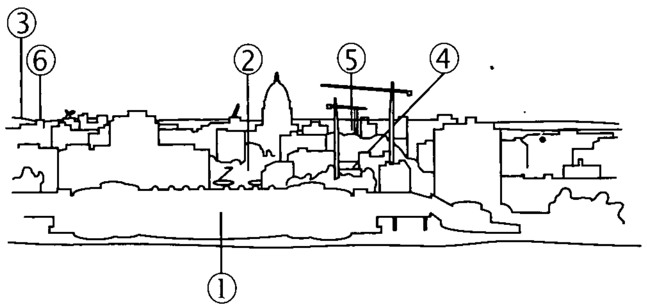
MGE®

# Customers and Community

Construction cranes dominated the downtown Madison skyline in 1997, signs of a robust local economy.



## The Cover




*The six major building projects that appear in this view of downtown Madison from Lake Monona total more than $225 million. Several other significant construction projects totalling nearly $74 million got under way in Dane County during the year. Businesses invested more than $2 billion in new commercial and industrial construction in Dane County between 1990 and 1997. MGE actively supports growth in the communities it serves.*

1. Monona Terrace Community and Convention Center
2. Capitol-Monona Terrace Promenade
3. University of Wisconsin Kohl Center sports arena
4. Block 89 retail-office-parking complex
5. 22 E. Mifflin Building
6. 201 West Washington Avenue Office Building

### Madison Gas and Electric Company

MGE's core strengths:

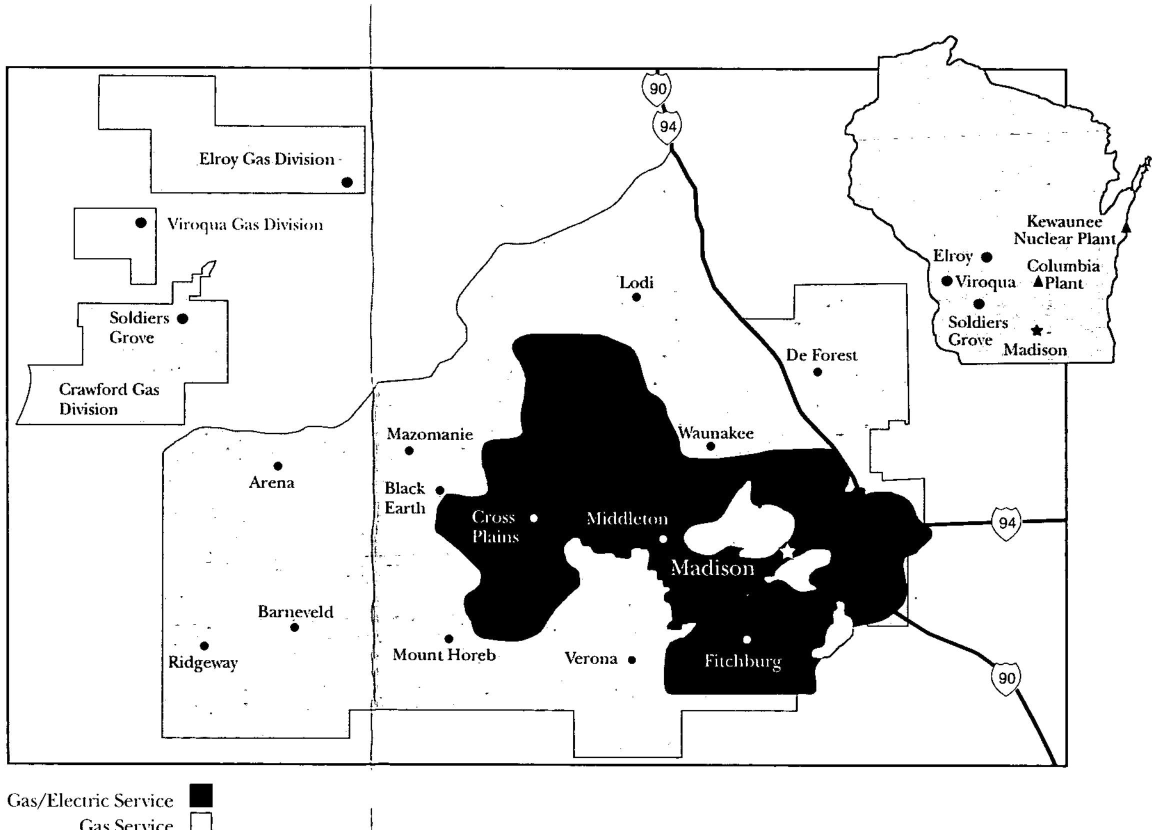
- Close relationship with customers and communities
- Excellent competitive position
- Thriving service territory
- Foresight to shape our future
- Ability to seize new opportunities
- Commitment to the environment

MGE is an investor-owned public utility headquartered in Madison, Wisconsin. The company generates, transmits and distributes electricity to nearly 123,000 customers in a 250-square-mile area of Dane County.

MGE also transports and distributes natural gas to more than 107,000 customers in 1,325 square miles of service territory in seven counties. MGE has served the Madison area since 1896.

National Energy Management, a joint venture between MGE's gas marketing subsidiaries and National Gas and Electric of Houston, serves 1,000 industrial and commercial customers in a multistate area. National Energy Management is based in Chicago.

**Internet: http://www.mge.com**




## Contents



### The Area We Serve

Electric Service

MGE provides electric service in Madison, Monona, Fitchburg, Middleton, Cross Plains and other Dane County communities. The population totals 260,000. Generating facilities include the Blount Generating Station and several combustion turbines at Madison, the Columbia Energy Center at Portage and the Kewaunee Nuclear Power Plant at Kewaunee.

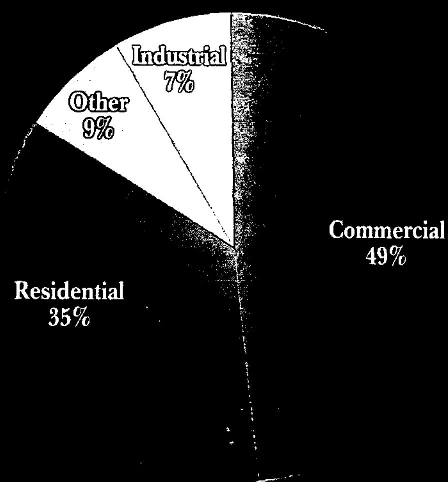
Natural Gas Service

MGE provides natural gas service in Columbia, Crawford, Dane, Iowa, Juneau, Monroe and Vernon counties. The population is 345,000. Gas is transported via ANR Pipeline Co., Northern Natural Gas Co. and others.

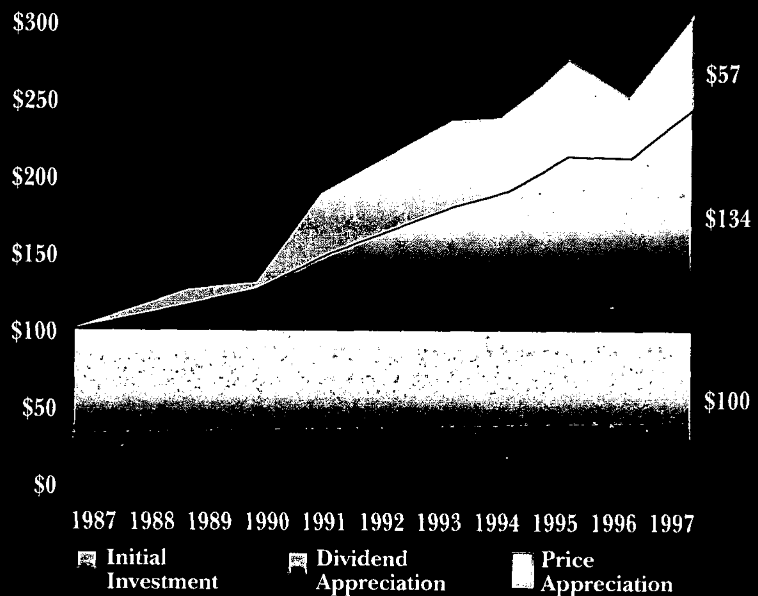
Madison Gas and Electric Company

# HIGHLIGHTS

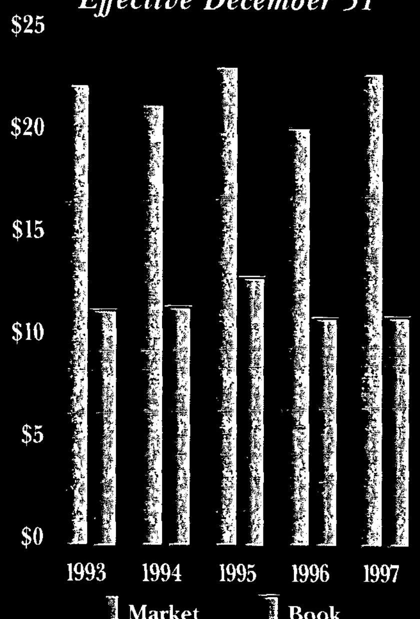
MGE Customer Mix
*Based on 1997 Electric Operating Revenues*




10-Year Investment Growth




Market Price and Book Value
*Effective December 31*



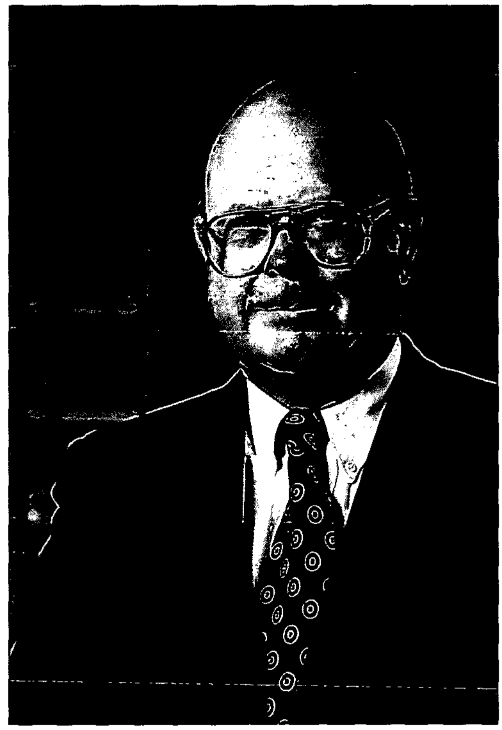

Total Operating Revenues
*Millions*


Dividends Per Share
*Annualized*

## To Our Shareholders

We are a vital partner with customers and communities. When our customers succeed, we succeed.

This report describes many ways that our involvement with customers and communities benefits our investors.



### Achieving Results

MGE earned $1.40 per share in 1997. We achieved these quality earnings despite mild weather and higher costs due to an extended nuclear plant outage.

We had the foresight to lease portable generators and accelerate repairs to maintain reliable electric service for customers. MGE is the **only** major utility in Wisconsin that did **not** interrupt service to any customers when Upper Midwest electric supplies were tight last summer. We recovered most of the cost incurred to maintain a reliable electric supply.

### Increasing Value

MGE's stock price closed 1997 at $23 per share. This represented a 52-week high and a 13.6% increase in value compared to the 1996 year-end closing price.

In September, your board of directors increased the quarterly dividend paid on MGE common stock to 32⅔ cents per share. Our company has increased dividends annually since 1980 and paid cash dividends each year since 1909.

### Recovering Costs

The Public Service Commission of Wisconsin authorized an electric rate increase of 3.1% and a gas rate increase of 3.5% effective August 20. The electric rate increase primarily covers accelerated depreciation and decommissioning costs for the Kewaunee Nuclear Power Plant. The gas rate increase covers costs for technology upgrades, infrastructure improvements and expansions.

Prior to this increase, MGE had not raised electric rates since 1990 or gas rates since 1989. Electric rates were reduced twice and gas rates were cut three times during these years. As a result, MGE customers are still paying lower rates in 1998 than they did in 1990.

### Maintaining High Reliability

The electric supply problems that affected utilities in the Upper Midwest last summer will not be resolved by the summer of 1998. We plan to contract for more outside generation and transmission capacity and lease portable generators, if necessary, to meet customers' needs.

We have also requested bids for up to 100 megawatts (MW) of new generating capacity. This added capacity would meet our customers' energy needs for the foreseeable future. Ideally, all state utilities would work together to contract for up to 500 MW of new generation that would significantly strengthen electric reliability in eastern Wisconsin.

### Advocating Fair Competition

MGE is the only investor-owned utility in Wisconsin that supports comprehensive electric restructuring. In order to achieve real competition, it is necessary to break up ownership of transmission and generation. No utility should have so much market power that it could manipulate the system and artificially increase prices at customers' expense.

## Building on Strengths

MGE will succeed in a competitive electric industry. We rank high on key factors that are vital for success. Our strengths include:

- **Competitive prices.** Our total costs are competitive regionally and well below the national average.
- **No stranded investment.** Our coal-fired power plants are very competitive in the region. We will be able to sell this power to our customers or others in an open market. Our investment in the Kewaunee plant will be fully amortized and our decommissioning costs fully funded by the year 2002.
- **A diverse customer mix.** MGE is less dependent on industrial customers than most other utilities. Industrial customers will be the primary target of electric marketers in the future.
- **Excellent customer service.** Customers rate us highly. They are more likely to stay with MGE because of our superior energy and support services.
- **A vibrant service territory.** We serve the most recession-proof economy in the Midwest. A 1997 study by economist and author William Fruth showed that Madison ranked third in the nation for economic strength out of 313 metro areas. The city also ranked 20th in the nation for growth in manufacturing jobs over 10 years.

## Competing Successfully

MGE is very competitive in the restructured gas industry. Since 1990, we have bought the lowest-cost gas supply, on average, of all investor-owned utilities based in Wisconsin.

In 1997, our unregulated gas marketing subsidiaries teamed up with a Houston-based company to form National Energy Management. This Chicago-based joint venture sells gas to approximately 1,000 commercial and industrial customers in a multistate area.

## Strengthening Management

MGE's board of directors promoted the following individuals to new positions: Terry A. Hanson, vice president - finance; Thomas R. Krull, vice president - gas and electric operations; Jeffrey C. Newman, treasurer; Ronald L. Semmann, group vice president; Joe R. Trueblood, assistant vice president - gas operations; and Peter J. Waldron, vice president - power supply operations and engineering. The board also elected Scott A. Neitzel to the position of assistant vice president - gas rates and fuels.

We have an exceptional management team and dedicated employees who will continue MGE's tradition of excellent service. We respond quickly to customers' needs and find innovative ways to grow earnings.

## Providing Solid Returns

MGE will remain an excellent choice for people who want to invest in a quality utility. We have a solid track record of dividend growth and stock price appreciation.

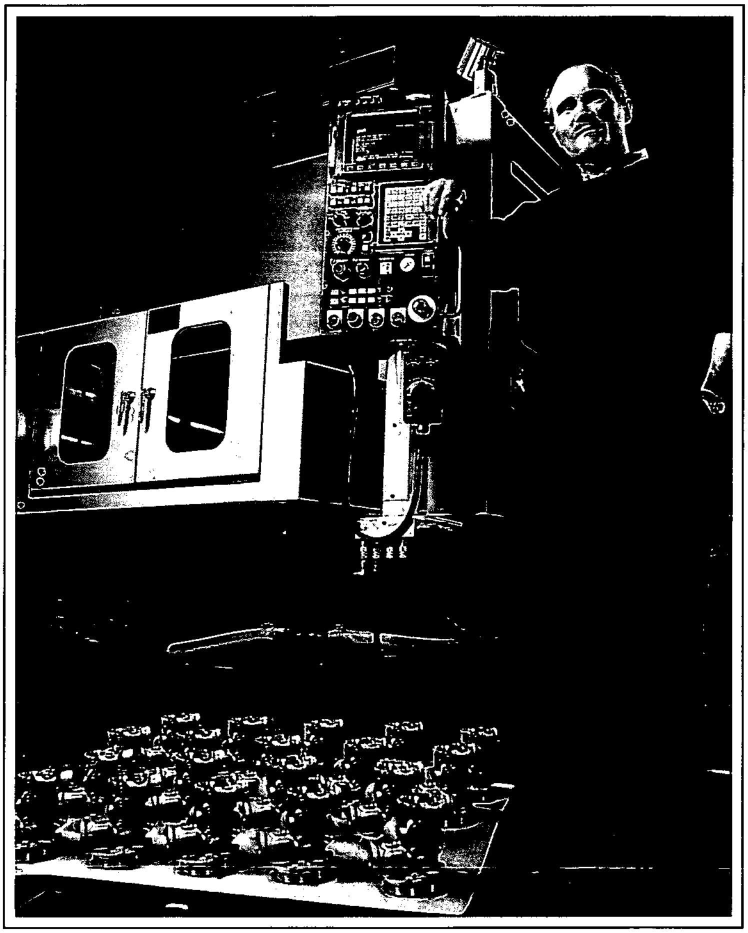
We will focus on customers, grow our distribution business and develop innovative services that help our customers and communities thrive. These strategies will increase revenues and produce strong results for our investors.

Thank you for your confidence and support.

David C. Mebane

David C. Mebane
Chairman, President and Chief Executive Officer
February 6, 1998

SERVIN



*Tim Hameister, president of Production Machine and Enterprises, has invested $370,000 in new equipment that is paid for with energy savings through MGE's Shared Savings Program.*

# Providing Full-Service Solutions

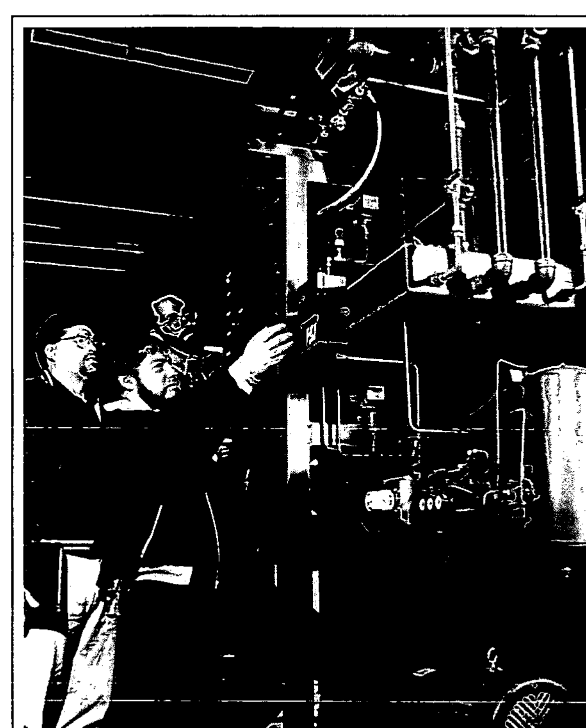
MGE is a full-service energy provider — offering solutions and assistance that go beyond the meter. Engineering expertise, research, financing and project management help customers make wise investments that benefit their bottom lines. MGE helps by:

- Offering loans and leases to finance efficiency improvements that can be paid for through energy savings. In four years, the Shared Savings Program has financed more than $7 million in projects.
- Managing a $6 million turbine-replacement project that will more than triple generating capacity at the University of Wisconsin's Charter Street Plant. When the system is up and running, MGE will turn operations over to the university.
- Addressing back-up generation needs and helping customers qualify for money-saving interruptible rates.
- Providing information to thousands of customers about business trends, safety, efficiency and environmental issues through seminars and trade shows.

# Exploring New Technologies

MGE helps customers improve efficiency and save money through new technologies.

A detailed engineering analysis by MGE convinced Coating Place, Inc., to install a heat recovery system. The new system captures energy from heat used in the production process. That energy is "recycled" to heat the company's facilities, replacing three boilers. The new system will save Coating Place more than $62,000 each year in fuel costs.



*Rick Martin (front), Coating Place design engineer; John Schroeckenthaler (left), president, Three Star Mechanical, Inc.; and Chuck Sasso, MGE senior engineer, teamed up to engineer, design and install a heat recovery system at Coating Place.*

# Customers

*Sonic Foundry, which "graduated" from the Madison Enterprise Center last year, expects to employ 100 people in Madison by 1999 thanks to the leadership of Monty Schmidt (front), president; Rimas Buinevicius (center), chief executive officer; and Curtis Palmer, chief technology officer.*

## Helping New Firms Grow Stronger

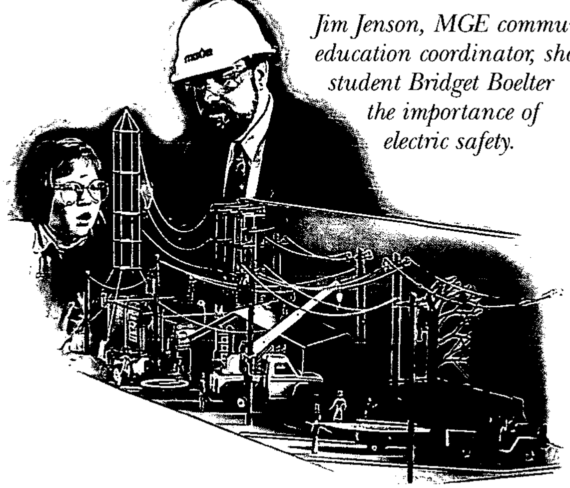
MGE helps new companies grow by supporting business incubators.

The Madison Enterprise Center (MEC) pays only $1 a year to lease a building MGE owns in downtown Madison. The MGE Innovation Center helps high-technology firms get started at the University Research Park. These two incubators offer new firms lower rent, technical advice and shared services.

Sonic Foundry moved into the MEC in 1993 with only two employees. Last year, the company expanded into a renovated 10,000-square-foot warehouse in downtown Madison. This rapidly growing audio software company has increased sales by 200% annually and created 50 new jobs.

The MEC and MGE Innovation Center have helped launch more than 50 companies that employ more than 300 people in Madison.

While most new businesses have a 65% failure rate, these business incubators have achieved greater than a 70% success rate — with help from MGE.



*Jim Jenson, MGE community education coordinator, shows student Bridget Boelter the importance of electric safety.*

# Educating Customers

Teaching customers how to use energy wisely and safely is a top priority. MGE reaches more than 2,500 elementary students each year with its "Switch to Safety" classroom demonstration (see photo above).

MGE also played a key role in developing the first statewide, comprehensive K–12 energy education curriculum. At least 600 teachers throughout Wisconsin will benefit from these new ideas for incorporating energy education into their classes.

# Developing Partnerships

MGE received national recognition for developing an innovative partnership with 38 libraries in its service area. This comprehensive program provides energy education through displays, books, workshops and children's programming.

MGE is the first utility in the nation to sponsor portable energy meters that can be checked out at local libraries. Customers use these devices to learn how much it costs to operate their appliances.

# Cooperating with Communities

MGE works with communities and neighborhoods to create attractive, safe and affordable places to live, work and play.

Downtown revitalization in Madison got a boost when MGE committed $30,000 over the next three years to redevelop the Bassett neighborhood. MGE was the first major corporation to help fund this effort.

MGE has invested more than $2 million in low-income weatherization projects since 1991. Free home workshops teach people repair skills and tips that will increase the safety and comfort of their homes.

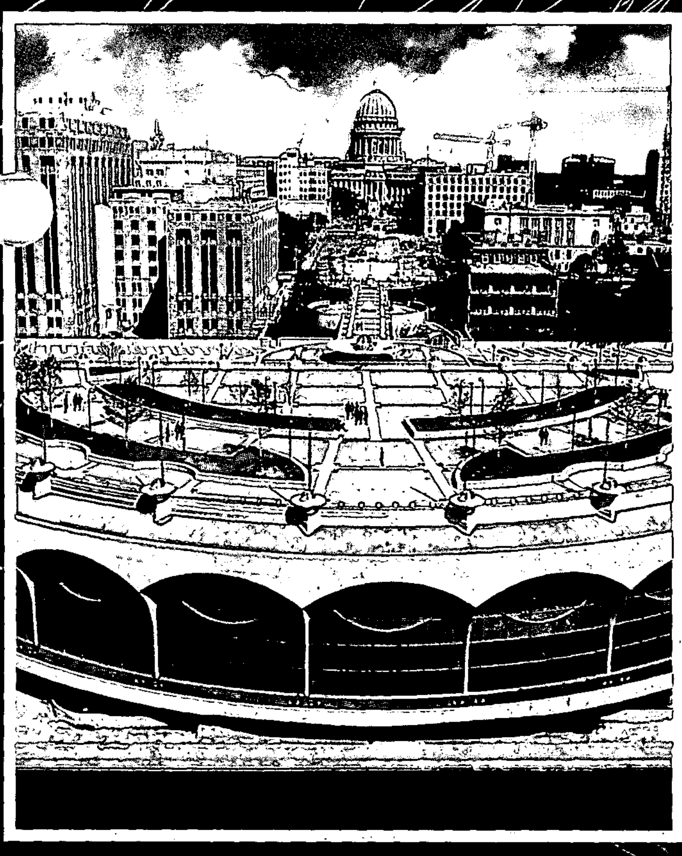
MGE also cooperates on projects that improve aesthetics and increase reliability for customers.

- The City of Fitchburg and MGE shared the cost of burying high-voltage electric lines as part of a project to expand County Highway PD to four lanes.
- MGE received an award from the Capital Community Citizens for burying electric lines and improving lighting in Madison's Dudgeon-Monroe Neighborhood.

*MGE cable splicers and linemen Howard Mooney (front left), Curt Mork (right) and Scott Mancheski prepare cables that will connect MGE's overhead lines with the underground transmission line along County Highway PD in Fitchburg.*

# Our Communities

*Photo at left: Bob Stoffs (right), MGE residential services coordinator, shows Madison resident Mike Gmeinder how to use a portable energy meter. MGE is the first utility in the nation to make these devices available at public libraries.*

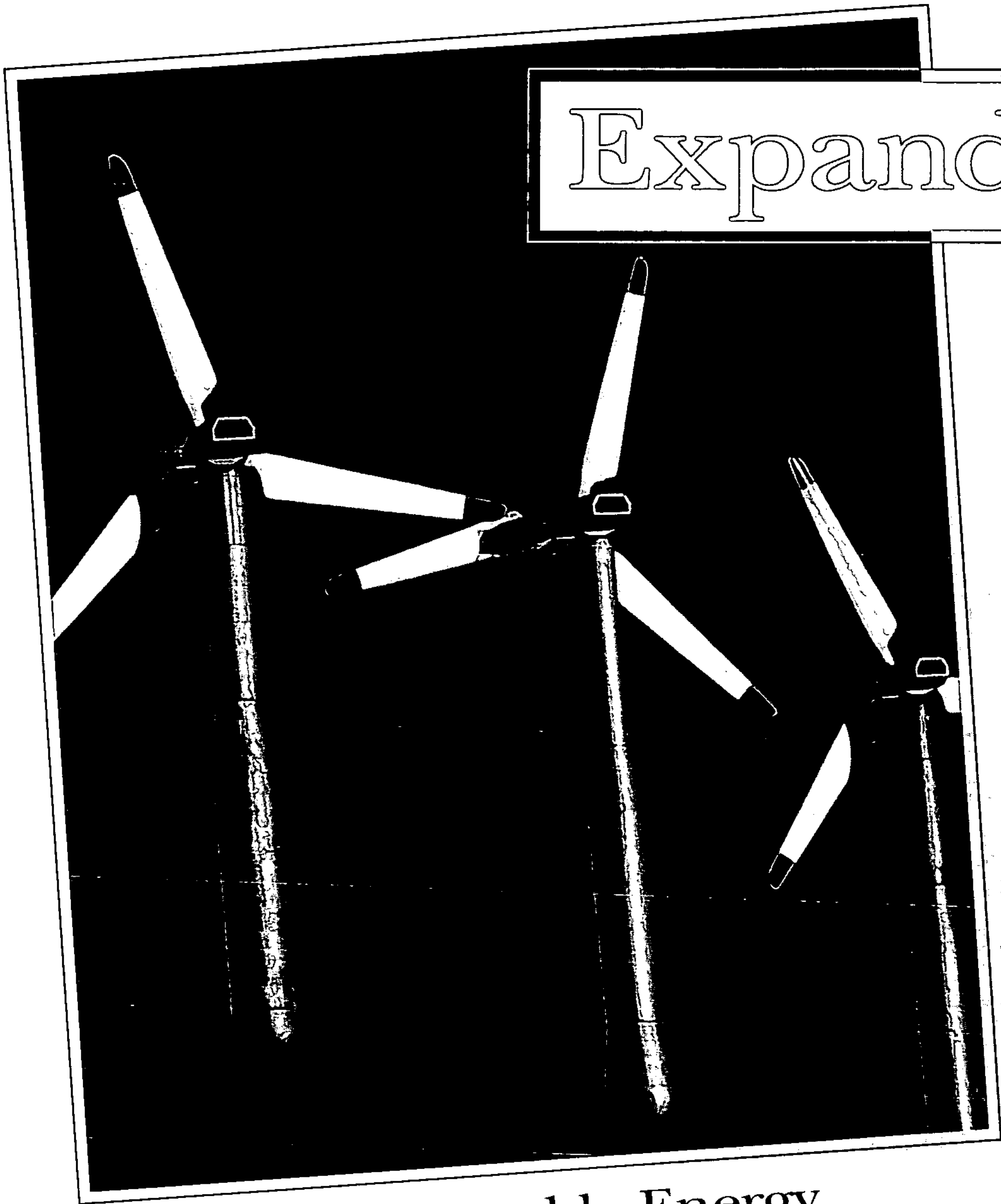


*Operating the Monona Terrace Community and Convention Center is more affordable because MGE assisted with back-up generation, a cost-saving interruptible rate and financing for new equipment.*

## Energizing Communities

**MGE is an active partner in the community — from donating time to build facilities for the spectacular Fourth of July Rhythm & Booms celebration in Madison to being one of the top 10 contributors to United Way of Dane County.**

# Expanding our



*MGE is a leader in developing clean, Wisconsin-based wind energy. By the summer of 1999, customers will be able to buy this renewable energy in 100-kilowatt-hour blocks.*

## Capturing Renewable Energy

Many customers concerned about the environment want to buy electricity produced with renewable resources. MGE is responding by building the largest wind energy project in Wisconsin.

MGE teamed up with Northern Alternative Energy, a leading Midwestern wind developer, to build this $14 million project. The first phase will include 15 wind-powered turbines that can generate 11.25 megawatts of electricity. The wind turbines, which should be operating by the summer of 1999, will be located in eastern Wisconsin.

A new "green pricing" program will allow MGE customers to buy wind energy in blocks of 100 kilowatt-hours. Up to 20,000 customers could participate in this program.

MGE is also a partner in a $2 million wind project that was recently completed as part of a statewide study. Two wind turbines, located near Green Bay, Wis., will produce enough power to serve about 500 homes.

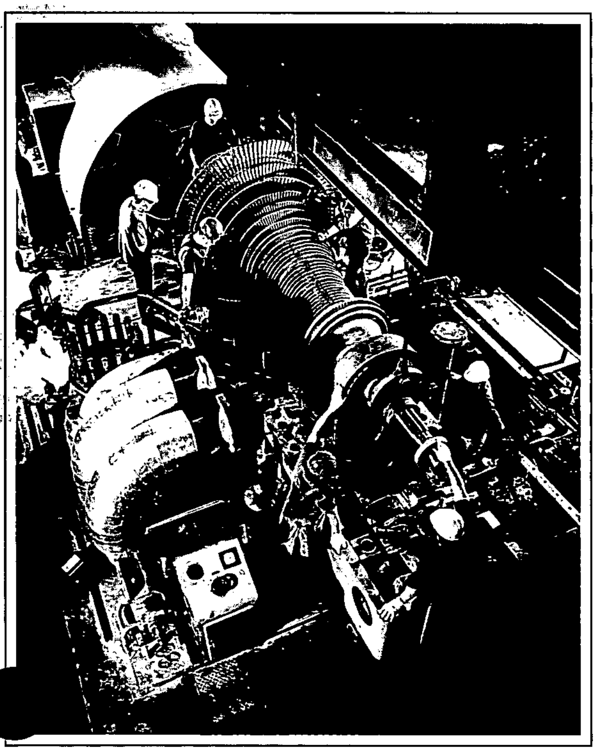
# POWER SUPPLY

## Providing Reliable Service

When the Upper Midwest faced an energy supply crisis last summer, MGE was the only major utility in Wisconsin that did **not** interrupt electric service to any customers. MGE proactively planned to meet electric demands by:

- Leasing portable generators that produced 30 megawatts (MW) of electricity;
- Accelerating repairs at the Blount Generating Station in Madison;
- Inspecting transmission lines to detect and repair any weaknesses;
- Communicating with customers to help them prepare for possible power outages.

E is seeking bids for up to 100 MW of new erating capacity by the summer of 2000 — enough capacity to meet customers' needs for the foreseeable future.



*Accelerating repairs at the Blount Generating Station in Madison helped ensure full capacity to meet high electric demands during the summer of 1997.*

*Albert Jesse, president of Madison General Fuels, Inc., monitors a roll of plastic as it feeds into a shredder. Madison General Fuels acquires and processes waste that is burned at Blount Generating Station in Madison.*

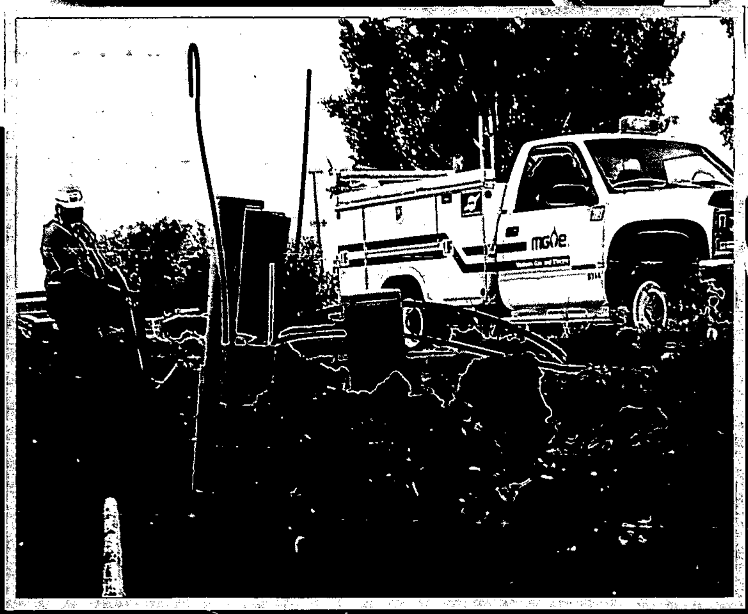
## Expanding Alternate Fuels

A 7,200-square-foot addition to the Blount Generating Station in Madison allows MGE to expand the amount of alternate fuels burned at the plant each day. Added space and equipment make it easier to prepare waste paper and plastic to burn in the boilers.

MGE is a leader in using alternate fuels to generate electricity. The company burned 5,855 tons of alternate fuels in 1997, up 26% from the previous year. The new addition offers even more room to grow in the future.

Alternate fuels have a high energy content and cost about 45% less than coal. They are also environmentally friendly — producing less ash and resulting in lower air emissions than coal. MGE also helps save landfill space by burning waste products that cannot be recycled.

MGE fully supports alternative energy sources that add value for customers and communities.



*Bruce Hanson, MGE acting foreman, inspects a joint gas and electric installation that will serve a new business.*

# Delivering

## Cutting Costs, Adding Value

MGE has cut costs more than 20% by installing gas and electric services simultaneously for homes and businesses. In 1997, this streamlined process allowed the company to install new services typically eight to 14 days ahead of the date requested by customers.

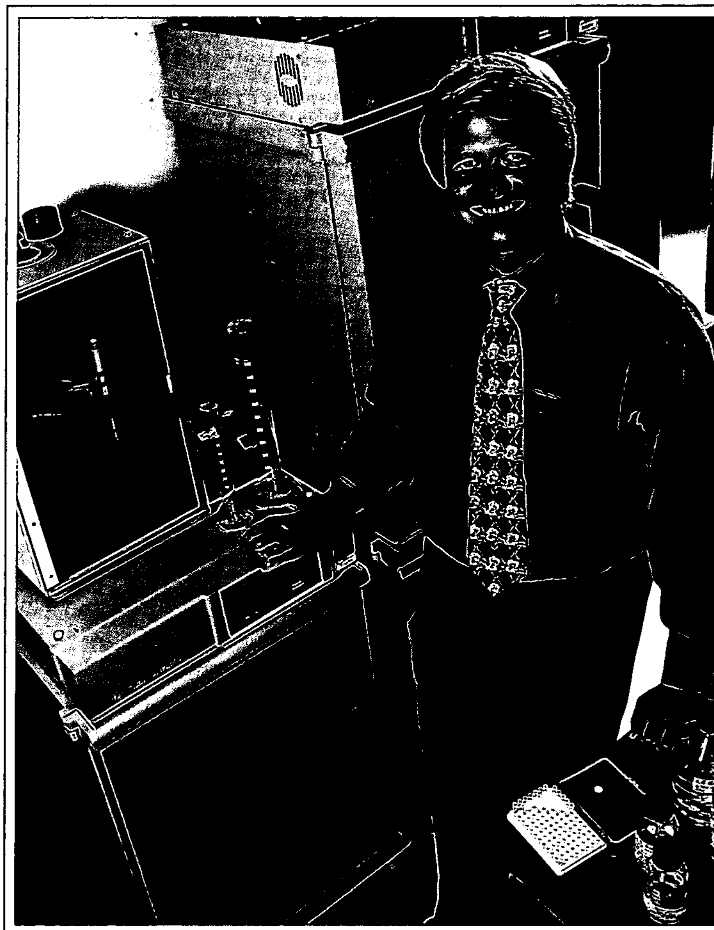
This teamwork also receives high ratings from customers. Surveys show that customers are very satisfied with the quality of work and the value received from MGE.

## What's New With Your MGE Bill?

mge

In future years, customers may have the option to choose their energy supplier. Anticipating this, MGE introduced a new bill format that breaks out: 1) the cost to produce or purchase gas or electricity and 2) the cost to deliver that service to homes and businesses. Customers will be able to make better decisions if they understand what is included in their price. MGE will continue providing high value for the price customers pay.

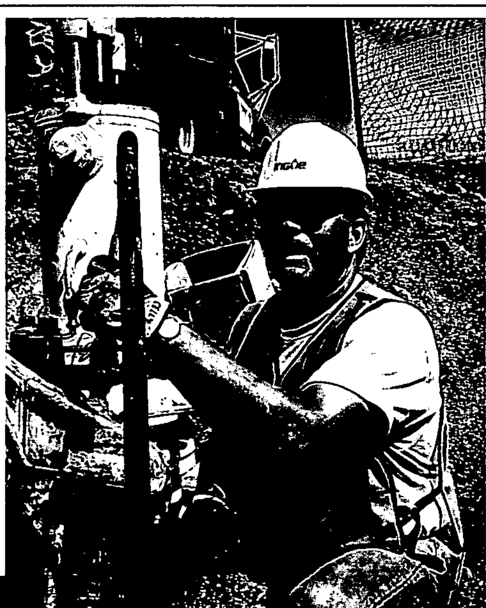
# VALUE



*Third Wave Technologies expanded into a 26,000-square-foot facility at the University Research Park last year. Lance Fors, president and CEO, started the company four years ago. This fast-growing firm expects to employ 250 people within the next four years.*

## Investing in Growth

Central Wisconsin Development Corp. (CWDC), an MGE subsidiary, has committed millions of dollars to finance business parks, new buildings and growing companies in its service territory. CWDC also has an equity interest in fast-growing companies — like Third Wave Technologies — that have significantly increased in value. Investing in business growth is an excellent way to maintain a healthy economy and ultimately increase revenues for MGE.



*Gerald Celentani, pressure control serviceman, pipe fitter and repairman, installs equipment that enables MGE to increase gas pressure and reliability for customers in its western territory.*

## Providing Competitive Service

MGE has a track record of providing reliable service and competing successfully in a restructured gas industry.

Since 1990, MGE has purchased the lowest-cost gas supply, on average, of all investor-owned utilities based in Wisconsin. MGE closely monitors markets to buy gas at the best possible prices. As a result, MGE's gas prices, on average, have dropped about 25% since 1986.

MGE upgraded a major portion of its natural gas system to meet customers' growing needs in its western service area. Increasing capacity to handle higher gas pressure adds reliability for customers, especially in cold weather. MGE successfully completed this complex project without interrupting service to customers.

## Responsibility for Financial Statements

The management of Madison Gas and Electric Company is responsible for the preparation and presentation of the financial information in this Annual Report. The following financial statements have been prepared in accordance with generally accepted accounting principles consistently applied and reflect management's best estimates and informed judgments as required.

To fulfill these responsibilities, management has developed and maintains a comprehensive system of internal operating, accounting, and financial controls. These controls provide reasonable assurance that the Company's assets are safeguarded, transactions are properly recorded, and the resulting financial statements are reliable. An internal audit function assists management in monitoring the effectiveness of the controls.

The Report of Independent Accountants on the financial statements by Coopers & Lybrand L.L.P. appears below. The responsibility of the independent accountants is limited to the audit of the financial statements presented and the expression of an opinion as to their fairness.

The Board of Directors maintains oversight of the Company's financial situation through its monthly review of operations and financial condition and its selection of the independent accountants. The Audit Committee, comprised of all Board members who are not employees or officers of the Company, also meets periodically with the independent accountants and the Company's internal audit staff who have complete access to and meet with the Audit Committee, without management representatives present, to review accounting, auditing, and financial matters. Pertinent items discussed at the meetings are reviewed with the full Board of Directors.

David C. Mebane
Chairman, President and Chief Executive Officer

Terry A. Hanson
Vice President - Finance

## Responsibility for Financial Statements

To the Shareholders and Board of Directors, Madison Gas and Electric Company:

We have audited the accompanying consolidated balance sheets and statements of capitalization of MADISON GAS AND ELECTRIC COMPANY and subsidiaries as of December 31, 1997 and 1996, and the related consolidated statements of income and retained income and cash flows for the years ended December 31, 1997, 1996, and 1995. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. 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. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Madison Gas and Electric Company and subsidiaries as of December 31, 1997 and 1996, and the consolidated results of their operations and their cash flows for the years ended December 31, 1997, 1996, and 1995, in conformity with generally accepted accounting principles.

Coopers & Lybrand LLP

Milwaukee, Wisconsin
February 6, 1998

# Management's Discussion and Analysis of Financial Condition and Results of Operations

## General

The following discussion and analysis provides information which management believes is relevant to an assessment and understanding of Madison Gas and Electric Company's (the Company) consolidated results of operations and financial condition. The discussion should be read in conjunction with the consolidated financial statements and notes thereto.

Certain matters that are discussed in the Management's Discussion and Analysis are forward-looking statements and can generally be identified by words such as "believes," "anticipates," or "expects." These forward-looking statements are subject to certain risks or uncertainties which could cause actual results to differ materially from those currently anticipated.

## Results of Operations

### Earnings Overview

Consolidated earnings for the Company were $1.40 per share in 1997 despite mild weather and an extended outage at the Kewaunee Nuclear Power Plant (Kewaunee). As a result of Kewaunee being out of service for the first half of the year, the Company had to replace the generation normally provided by Kewaunee with more expensive purchased power. The Company also faced regional power shortages during the summer of 1997, incurring extra expenses for actions taken by the Company to prevent power outages for the Company's customers. The Company was the only major utility in Wisconsin that did not interrupt service to any of its customers.

Earnings from core utility operations were $1.48 per share in 1996, but the consolidated earnings were negatively impacted by the following items: a one-time charge of $10.4 million (after tax) to reflect the current value of the Company's investments in its gas marketing subsidiaries, a one-time charge of $1.6 million (after tax) resulting from a refund to natural gas customers under a sharing mechanism between Great Lakes Energy Corp. (GLENCO) and the Company, and operating losses of $5.4 million (after tax) from the Company's gas marketing subsidiaries. Consolidated earnings per share for the Company were $0.40 in 1996.

Consolidated earnings for the Company were $1.49 per share in 1995. Above-normal temperatures experienced during the summer months helped offset the negative impacts of a 3.3 percent electric rate decrease which was effective January 1, 1995.

### Electric Sales and Revenues

Electric retail sales for 1997 increased 2.9 percent from 1996 despite the cooler-than-normal temperatures experienced in the summer. The increase in retail sales is due to an increase in the number of electric customers and average usage per retail customer. The electric sales breakdown by customer class is shown in the table below:

| Electric Sales *Megawatt Hours* | 1997 | 1996 | % Change |
|---|---|---|---|
| Residential | 720,576 | 725,471 | (0.7) |
| Commercial | 1,420,347 | 1,381,043 | 2.8 |
| Industrial | 307,485 | 289,903 | 6.1 |
| Other | 332,995 | 305,962 | 8.8 |
| Total Retail | 2,781,403 | 2,702,379 | 2.9 |
| Resale – Utilities | 64,914 | 26,815 | 142.1 |
| Total Sales | 2,846,317 | 2,729,194 | 4.3 |

Electric revenues increased $10.4 million or 6.8 percent in 1997 compared to 1996. The increase reflects higher electric sales, a 3.1 percent increase in electric rates effective August 20, 1997, and an interim rate surcharge of 0.507 cents per kilowatt-hour related to the extended outage at Kewaunee which was in effect from March through June (see Note 3).

Electric revenues and retail sales for 1996 were virtually unchanged when compared to 1995.

### Gas Sales and Revenues

Total gas therms delivered by the Company decreased 4.9 percent in 1997 compared to 1996, largely reflecting the warmer weather throughout the winter months of 1997. Total heating degree days (as measured by the number of degrees the mean daily temperature is below 65 degrees Fahrenheit) decreased 9.7 percent for the winter heating season (January through March, November and December) of 1997 when compared to 1996. The table below shows total gas deliveries by customer class:

| Therms Delivered *Thousands* | 1997 | 1996 | % Change |
|---|---|---|---|
| Residential | 87,664 | 96,062 | (8.7) |
| Commercial and Industrial | 87,717 | 93,723 | (6.4) |
| Total Retail System | 175,381 | 189,785 | (7.6) |
| Transport | 40,947 | 37,707 | 8.6 |
| Total Gas Deliveries | 216,328 | 227,492 | (4.9) |

Despite the decrease in gas delivered in 1997, gas revenues increased by 1.0 percent when compared to 1996. The increase in revenues, despite a decrease in gas deliveries, was due primarily to higher-unit gas costs, specifically during the first quarter. These costs were passed on to customers through the Purchased Gas Adjustment Clause (PGAC). A gas rate increase of 3.5 percent went into effect August 20, 1997, which also contributed to the increased revenues.

Gas delivered to customers in 1996 increased 3.3 percent compared to 1995, and revenues increased $5.5 million or 5.8 percent during the same period. This was mainly attributable to the increase in gas deliveries due to the colder weather experienced during the first quarter of 1996.

## Electric Fuel and Natural Gas Costs

Electric fuel and purchased power costs increased $6.4 million or 16.7 percent in 1997 compared to the same period a year ago. As previously mentioned, this was due to the increased purchased power costs associated with replacing generation lost from the extended outage at Kewaunee. Kewaunee normally provides approximately 25 percent of the generation requirements of the Company. Higher generation costs during July due to the unavailability of power resulting from the regional power shortages also increased fuel and purchased power costs in 1997 compared to 1996. The Company's electric margin (revenues less fuel and purchased power) increased $4.0 million or 3.5 percent during 1997 compared to 1996.

Electric fuel and purchased power costs increased $2.3 million or 6.4 percent from 1995 to 1996. This increase is also due to the higher cost of replacement power from the extended outage at Kewaunee. Kewaunee was removed from service in September 1996 for scheduled refueling and maintenance work and did not return to service until June 1997. The electric margin decreased $3.1 million or 2.6 percent during 1996 compared to 1995. This decrease in the electric margin was a result of the increase in replacement purchased power costs related to the extended outage at Kewaunee.

Natural gas costs decreased $0.9 million or 1.4 percent in 1997 compared to 1996 due mainly to the decrease in gas delivered caused by the warm winter weather. Gas margin (revenues less natural gas purchased) increased by $1.9 million or 5.6 percent in 1997 compared to 1996. This was a result of continued customer growth and the rate increase mentioned previously.

Natural gas costs increased $8.5 million or 14.8 percent during 1996 compared to 1995. The cold first quarter of 1996 and the subsequent demand for natural gas increased the cost per therm accordingly. The cost per therm in 1996 increased $0.04 or 13.4 percent over 1995.

## Other Operating Expenses

Operations and maintenance (O&M) expenses increased $4.2 million or 5.9 percent in 1997 compared to 1996. The primary reasons are the higher repair costs for Company-owned generation due to the extended outage of Kewaunee. The co-owners of Kewaunee received authorization from the Public Service Commission of Wisconsin (PSCW) to defer a majority of the costs for steam generator repairs (see Note 3). O&M expenses decreased $2.8 million or 3.8 percent during 1996 compared to 1995.

Depreciation and amortization expense increased $2.8 million or 11.0 percent for the year ended 1997 compared to the same period a year ago. This increase is due, in part, to the accelerated depreciation of Kewaunee. Depreciation expense related to decommissioning costs increased $1.8 million or 37.9 percent in 1997 compared to 1996 because of the acceleration of decommissioning of Kewaunee. The PSCW approved accelerated depreciation and decommission funding for Kewaunee based on its service life ending at the end of 2002.

## Other Nonoperating Expenses

The Company's nonutility income for 1997 was $0.8 million compared to operating losses of $5.4 million in 1996. The Company's two gas marketing subsidiaries, GLENCO and American Energy Management Inc. (AEM), formed a joint venture effective January 1, 1997, with another gas marketing company to market natural gas and energy services to industrial and commercial customers in a multistate area. The joint venture is called National Energy Management, L.L.C., and is based in Chicago.

The Company recorded a one-time charge in 1996 of $10.4 million (after tax) to properly reflect the current value of the Company's investments in its gas marketing subsidiaries and reorganizing these activities for the future (see Note 4).

## Electric and Gas Operations Outlook

The Company anticipates electric and gas customer growth at a compound rate of 1 to 2 percent over the next five-year period ending December 31, 2002. The service territory remains well-insulated against economic downturns.

The Company expects to remain a strong competitor in a restructured electric industry because of its low generation costs, competitive rates, low percentage of industrial customers, and lower risk of stranded investments in power plants. The Company continues to offer competitive rates and services to meet the needs of its customers in a deregulated natural gas market.

## Liquidity and Capital Resources

### Cash Provided by Operating Activities

Cash provided by operating activities decreased $7.5 million or 15.5 percent in 1997 compared to 1996. This is mainly due to the reduction in current payables of the Company's gas marketing subsidiaries, GLENCO and AEM. Cash provided by operating activities decreased $2.5 million or 4.9 percent in 1996 compared to 1995.

### Capital Requirements and Investing Activities

The Company's liquidity is primarily affected by the requirement of its ongoing construction program. Capital expenditures in 1997 were $21.6 million. It is anticipated that capital expenditures will be $46 million in 1998. The major capital projects for 1998 include the wind energy project in northeastern Wisconsin, which will cost about $14 million, and Company-owned backup generation projects costing about $3 million. The backup generation projects will help maintain electric reliability. Estimated capital expenditures for the years 1999 through 2002 will average $33 million per year.

Capital expenditures and nuclear fuel estimated for 1998, actual for 1997, and the average for the three-year period 1994 through 1996 are shown below.

### Financing Activities and Capitalization Matters

In April 1997, the Company purchased on the open market $3.8 million of its First Mortgage Bonds. In June 1997, the Company entered into a fixed interest rate agreement for $5.0 million maturing June 2004.

At December 31, 1997, bank lines of credit available to the Company were $52 million. Bank lines are generally used to support the Company's commercial paper issued which represents a primary source of short-term financing. The Company's dealer-issued commercial paper carries the highest ratings assigned by Moody's Investors Service and Standard & Poor's Corporation.

The Company's existing bonds are rated AA by Standard & Poor's and Aa2 by Moody's Investors Service. Capitalization ratios are shown in the Summary of Selected Financial and Operating Data on page 29.

## Expenditures for Construction and Nuclear Fuel

| For the years ended December 31: *(Thousands of dollars)* | 1998 Estimated | | 1997 | | Annual Average 1994 to 1996 | |
|---|---|---|---|---|---|---|
| Electric | | | | | | |
| Production | $17,977 | 38.7% | $ 5,005 | 23.1% | $ 1,911 | 8.5% |
| Transmission | 2,065 | 4.5 | 1,602 | 7.4 | 1,151 | 5.1 |
| Distribution and General | 12,034 | 25.9 | 8,287 | 38.3 | 8,965 | 39.8 |
| Nuclear Fuel | 4,228 | 9.1 | 1,394 | 6.4 | 2,752 | 12.2 |
| Total Electric | 36,304 | 78.2 | 16,288 | 75.2 | 14,779 | 65.6 |
| Gas | 6,441 | 13.9 | 4,427 | 20.5 | 5,908 | 26.3 |
| Common | 3,655 | 7.9 | 920 | 4.3 | 1,812 | 8.1 |
| Total | $46,400 | 100.0% | $21,635 | 100.0% | $22,499 | 100.0% |

## Kewaunee Nuclear Power Plant
The Company has a 17.8 percent ownership interest in Kewaunee, which it owns jointly with two other utilities. Kewaunee is operating with a license that expires in 2013. Kewaunee returned to service in June 1997, after having been out of service since September 1996, for refueling, routine maintenance, and repair of the steam generators. Kewaunee is currently operating at 97 percent of rated capacity because certain steam generator tubes have been removed from service rather than repaired. Additional replacement power costs due to the extended outage were recovered through a customer surcharge from March 6, 1997, through July 1, 1997 (see Note 3).

Effective March 20, 1997, the Kewaunee co-owners received authorization from the PSCW to defer all costs associated with the resleeving of the steam generators. The co-owners of Kewaunee have requested rate recovery of these deferred costs through a customer surcharge (see Note 3).

Public hearings were held in January 1998 regarding the application filed with the PSCW requesting replacement of the steam generators at Kewaunee. A decision by the PSCW is expected in March 1998. The Company opposes replacement of the steam generators at Kewaunee.

## Electric Industry Trend
In February 1996, the PSCW submitted a report to the State Legislature on electric utility restructuring in Wisconsin. Included in the report was a 32-step work plan and time line summarizing expected restructuring activities. During the summer of 1997, Wisconsin and Illinois experienced electric supply shortages due to outages of a number of nuclear plants in Illinois and Wisconsin, including Kewaunee. The electric reliability crisis caused the PSCW to revise its previous plans for restructuring the electric industry. In October 1997, the PSCW stated that retail competition cannot occur until all the safeguards are in place to protect consumers. Also, prior to any significant restructuring, reliability concerns must be addressed. This conclusion was consistent with plans proposed by the Company and a broad coalition of customers.

The new plan focuses on the construction of a generation and transmission infrastructure by all Wisconsin utilities to increase the amount of power in the state and the state's ability to obtain electricity from other regions. The PSCW plans to remove any barriers to open access to the transmission system that currently exist and to move forward in its efforts to develop a strong state and regional Independent System Operator (ISO). This would assure that the transmission system is operated safely, reliably, and with open and nondiscriminatory access. Also in its revised plan, the PSCW plans to explore new ways to promote the development of renewable energy sources. The Company is in the process of building a $14 million wind generation project which will allow its customers to purchase blocks of energy produced with renewable resources. The PSCW has not set a date for retail competition and has concluded that any decision to go to retail competition in the electric industry remains to be made in the future. The Company cannot predict what impact future PSCW actions may have on its future financial condition, cash flows, or results of operations. However, the Company believes it is well-positioned to compete in a deregulated market.

## Regulatory and Accounting Issues
The Company's recent rate order authorized a gas cost recovery mechanism that allows recovery of pipeline capacity, Federal Energy Regulatory Commission (FERC)-approved/mandated charges, and supply/demand costs. Under the new mechanism, gas commodity costs will be compared to a monthly benchmark equal to the first-of-the-month index plus adders reflecting the effects on pricing for reliability, flexibility, weather, and variable transportation costs. If actual costs are below the benchmark, full recovery is allowed. Gas commodity costs above the benchmark will be reviewed by the PSCW. A target will also be determined for capacity release. Capacity release above the target will be shared 60 percent with the ratepayers and 40 percent with the shareholders. Any shortfalls in capacity release will be shared 40 percent with the ratepayers and 60 percent with the shareholders.

The restructuring of the electric industry could affect the eligibility of the Company to continue applying Statement of Financial Accounting Standard (SFAS) No. 71, "Accounting for the Effects of Certain Types of Regulation." Under this situation, continued deferral of certain regulatory asset and liability amounts on the Company's books may no longer be appropriate as allowed under SFAS No. 71. The Company is unable to predict whether any adjustments to regulatory assets and liabilities will occur in the future. The PSCW's restructuring plan specifically recognizes the need to allow recovery for commitments made under prior regulatory regimes.

Effective January 1, 1996, the Company adopted SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of." This statement requires that long-lived assets and certain identifiable intangibles held and used by the Company be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. SFAS No. 121 also requires that assets to be disposed of be reported at the lower of the carrying amount or the fair value less costs to sell. Adoption of this statement did not have a material impact on the Company's financial position, results of operations, or cash flows.

In February 1997, SFAS No. 128, "Earnings Per Share," was issued. SFAS No. 128 simplifies the standards for computing earnings per share and requires the presentation of two new amounts, basic and diluted earnings per share. The Company has retroactively adopted this standard for all prior periods reported.

In June 1997, SFAS No. 131, "Disclosure about Segments of an Enterprise and Related Information," was issued. SFAS No. 131 requires that public business enterprises report certain information about operating segments in complete sets of financial statements of the Company and in condensed financial statements of interim periods issued to shareholders. The objective of requiring disclosures about segments of an enterprise and related information is to provide information about different types of business activities in which the Company engages and the different economic environments in which it operates in order to help users of financial statements better understand the Company's performance, assess its prospects for future net cash flows, and make more informed judgements about the Company as a whole.

## Mergers

In May 1995, Northern States Power Company (NSP) and Wisconsin Energy Corporation (WEC) announced a proposed $6 billion merger. A company called Primergy Corporation (Primergy) was contemplated to be formed as a result of the merger. On May 14, 1997, the FERC rejected the merger as filed, citing concerns over dominance in the Midwest power and transmission markets. The FERC stated that Primergy would be able to dominate the eastern Wisconsin and upper Michigan power generation market. On May 16, 1997, the Board of Directors from both NSP and WEC agreed to terminate their merger agreement.

## Inflation

The current financial statements report operating results in terms of historical cost. Even though the statements provide a reasonable, objective, quantifiable statement of financial results, they do not evaluate the impact of inflation. For ratemaking purposes, projected normal operating costs include impacts of inflation recoverable in revenues. However, electric and gas utilities, in general, are adversely impacted by inflation because depreciation of the utility plant is limited to the recovery of historical costs. Thus, cash flows from the recovery of existing utility plant, to a certain extent, may not be adequate to provide replacement of plant investment.

## Environmental Issues

Phase II of the Federal Clean Air Act amendments of 1990 sets stringent $SO_2$ and nitrogen oxide emission limitations, which generally take effect January 1, 2000. These may result in increased capital and operating and maintenance expenditures. Phase II emission compliance strategies for the Company include the following: fuel switching, emission trading, purchased power agreements, new emission control devices, or installation of new fuel-burning technologies and clean coal technologies. Phase II emission compliance strategies and their costs are currently being evaluated. The Company expects no major capital expenditures as a result of Phase II.

The Company is listed as a potentially responsible party on the roster of generators for the Refuse Hideaway Landfill in Middleton, Wisconsin, and the Lenz Oil site in Lemont, Illinois. The Refuse Hideaway Landfill was used for the disposal of fly-ash sludge from 1980 to 1984. The Lenz Oil Site was operated for several years as a facility for the storage and processing of waste oil. The Environmental Protection Agency (EPA) has placed the two sites on the national priorities Superfund list of sites requiring clean up under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA). The scope of liability under CERCLA is very broad.

A group of companies is currently negotiating with the EPA on the cleanup of the sites. In the opinion of management and legal counsel, the Company's share of the final cleanup costs will not result in any materially adverse effects on the operations, cash flows, or financial position of the Company. Significant insurance recovery may also be available for the cleanup.

## Year 2000

The Company has established a Year 2000 project coordinator and a Year 2000 compliance team to identify our systems, equipment, and operations that will be impacted by the year 2000. These actions are necessary to ensure that the systems and applications will recognize and process the year 2000 and beyond. The Year 2000 team has started to identify the major areas that will be impacted by the year 2000 and initial conversion efforts are under way. The Company is working with suppliers, dealers, financial institutions, and others with which it does business to coordinate year 2000 conversion. The Company is estimating a cost of $2.9 million to become Year 2000 compliant.

## Management's Discussion and Analysis of Financial Condition and Results of Operations

| For the years ended December 31<br>*(Thousands of dollars, except per-share amounts)* | 1997 | 1996 | 1995 |
|---|---|---|---|
| Operating Revenues | | | |
| Electric | $163,123 | $152,747 | $153,554 |
| Gas | 101,525 | 100,544 | 95,036 |
| Total Operating Revenues | 264,648 | 253,291 | 248,590 |
| Operating Expenses | | | |
| Fuel for electric generation | 30,764 | 26,676 | 28,017 |
| Purchased power | 14,008 | 11,687 | 8,048 |
| Natural gas purchased | 65,079 | 66,021 | 57,488 |
| Other operations | 62,018 | 58,178 | 61,499 |
| Maintenance | 12,735 | 12,414 | 11,858 |
| Depreciation and amortization | 28,317 | 25,510 | 24,815 |
| Other general taxes | 8,797 | 8,736 | 8,709 |
| Income tax items | 11,940 | 12,553 | 14,285 |
| Total Operating Expenses | 233,658 | 221,775 | 214,719 |
| Net Operating Income | 30,990 | 31,516 | 33,871 |
| AFUDC - equity funds | 28 | 40 | 57 |
| Other income, net | 1,445 | 1,517 | 549 |
| Write down of nonregulated gas subsidiaries, net | — | (10,400) | — |
| Non-utility operating (loss)/income, net | 784 | (5,355) | 1,000 |
| Income Before Interest Expense | 33,247 | 17,318 | 35,477 |
| Interest Expense | | | |
| Interest on long-term debt | 9,641 | 9,815 | 10,331 |
| Other interest | 1,098 | 1,097 | 1,205 |
| AFUDC - borrowed funds | (15) | (21) | (29) |
| Net Interest Expense | 10,724 | 10,891 | 11,507 |
| Net Income | 22,523 | 6,427 | 23,970 |
| Preferred stock dividends | — | — | 64 |
| Earnings on Common Stock | $ 22,523 | $ 6,427 | $ 23,906 |
| Earnings Per Share of Common Stock (basic and diluted)<br>(Average shares outstanding - 16,079,718 for all years) | $ 1.40 | $ 0.40 | $ 1.49 |

## Consolidated Statements of Retained Income

| For the years ended December 31<br>*(Thousands of dollars)* | 1997 | 1996 | 1995 |
|---|---|---|---|
| Balance - Beginning of Year | $ 50,451 | $ 64,499 | $ 60,851 |
| Add - Net income | 22,523 | 6,427 | 23,970 |
| Deduct - Cash dividends on common stock | (20,689) | (20,475) | (20,258) |
| (Dividends per share were $1.29, $1.27, and $1.26, respectively) | | | |
| Preferred stock dividend | — | — | (64) |
| Balance - End of Year | $ 52,285 | $ 50,451 | $ 64,499 |

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

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# Consolidated Statements of Cash Flows

| For the years ended December 31 (Thousands of dollars) | 1997 | 1996 | 1995 |
|---|---|---|---|
| **Operating Activities** | | | |
| Net income | $ 22,523 | $ 6,427 | $ 23,970 |
| Items not affecting cash: | | | |
| Depreciation and amortization | 28,317 | 25,510 | 24,815 |
| Deferred income taxes | (1,400) | (7,181) | (2,442) |
| Amortization of nuclear fuel | 1,517 | 2,098 | 2,740 |
| Amortization of investment tax credits | (753) | (792) | (768) |
| AFUDC – equity funds | (28) | (40) | (57) |
| Write down of nonregulated gas subsidiaries | — | 15,741 | — |
| Other | 431 | 1,146 | 1,729 |
| Net Funds Provided from Operations | 50,607 | 42,909 | 49,987 |
| Changes in working capital, excluding cash equivalents, sinking funds, maturities, and interim loans: | | | |
| Decrease/(increase) in current assets | 6,162 | (3,445) | (12,168) |
| (Decrease)/increase in current liabilities | (21,174) | 2,458 | 11,287 |
| Other noncurrent items, net | 5,244 | 6,386 | 1,716 |
| Cash Provided by Operating Activities | 40,839 | 48,308 | 50,822 |
| **Financing Activities** | | | |
| Cash dividends on common and preferred stock | (20,689) | (20,475) | (20,322) |
| Maturities/redemptions of First Mortgage Bonds | (3,800) | (7,840) | (13,263) |
| Increase in long-term debt | 5,000 | — | 11,000 |
| Other decreases in First Mortgage Bonds | (163) | (162) | (199) |
| Decrease in preferred stock | — | — | (5,300) |
| Decrease in bond construction funds, net | — | — | 8,090 |
| Increase/(decrease) in interim loans | 3,750 | 9,250 | (8,100) |
| Cash Used for Financing Activities | (15,902) | (19,227) | (28,094) |
| **Investing Activities** | | | |
| Acquisition of nonregulated subsidiary | — | — | (8,036) |
| Additions to utility plant and nuclear fuel | (21,635) | (21,906) | (19,162) |
| AFUDC – borrowed funds | (15) | (21) | (29) |
| Increase in nuclear decommissioning fund | (6,467) | (4,710) | (4,191) |
| Cash Used for Investing Activities | (28,117) | (26,637) | (31,418) |
| Change in Cash and Cash Equivalents | (3,180) | 2,444 | (8,690) |
| Cash and cash equivalents at beginning of period | 5,288 | 2,844 | 11,534 |
| Cash and cash equivalents at end of period | $ 2,108 | $ 5,288 | $ 2,844 |

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

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## Consolidated Balance Sheets

| At December 31<br>*(Thousands of dollars)* | 1997 | 1996 |
|---|---|---|
| **Assets** | | |
| Utility Plant, at original cost, in service: | | |
| Electric | $ 510,405 | $ 500,690 |
| Gas | 181,861 | 178,312 |
| Gross Plant in Service | 692,266 | 679,002 |
| Less accumulated provision for depreciation | (407,602) | (374,315) |
| Net Plant in Service | 284,664 | 304,687 |
| Construction work in progress | 10,995 | 7,517 |
| Nuclear decommissioning fund | 59,179 | 44,617 |
| Nuclear fuel, net | 8,255 | 8,378 |
| Total Utility Plant | 363,093 | 365,199 |
| Other Property and Investments | 8,252 | 7,115 |
| Current Assets | | |
| Cash and cash equivalents | 2,108 | 5,288 |
| Accounts receivable, less reserves of $1,235 and $1,220, respectively | 28,395 | 39,145 |
| Unbilled revenue | 13,580 | 13,852 |
| Materials and supplies, at lower of average cost or market | 5,557 | 5,740 |
| Fossil fuel, at lower of average cost or market | 3,605 | 1,808 |
| Stored natural gas, at lower of average cost or market | 9,851 | 7,189 |
| Prepaid taxes | 7,190 | 7,258 |
| Other prepayments | 2,081 | 1,429 |
| Total Current Assets | 72,367 | 81,709 |
| Deferred Charges | 28,078 | 30,146 |
| Total Assets | $ 471,790 | $ 484,169 |
| **Capitalization and Liabilities** | | |
| Capitalization (see statement) | $ 310,846 | $ 307,975 |
| Current Liabilities | | |
| Long-term debt sinking fund requirements | 200 | 200 |
| Interim loans – commercial paper outstanding | 33,500 | 29,750 |
| Accounts payable | 14,528 | 30,094 |
| Accrued interest | 2,206 | 2,322 |
| Accrued nonregulated items | 4,837 | 7,923 |
| Other | 5,326 | 7,732 |
| Total Current Liabilities | 60,597 | 78,021 |
| Other Credits | | |
| Deferred income taxes | 45,572 | 46,972 |
| Regulatory liability – SFAS 109 | 24,875 | 23,914 |
| Investment tax credit – deferred | 10,685 | 11,439 |
| Other regulatory liabilities | 19,215 | 15,848 |
| Total Other Credits | 100,347 | 98,173 |
| Commitments | — | — |
| Total Capitalization and Liabilities | $ 471,790 | $ 484,169 |

*The accompanying notes are an integral part of the above balance sheets.*

# Consolidated Statements of Capitalization

| At December 31 (Thousands of dollars) | 1997 | 1996 |
|---|---|---|
| Common Shareholders' Equity | | |
| Common stock – par value $1 per share: | | |
| Authorized 50,000,000 shares | | |
| Outstanding 16,079,718 shares | $ 16,080 | $ 16,080 |
| Amount received in excess of par value | 112,558 | 112,558 |
| Retained income | 52,285 | 50,451 |
| Total Common Shareholders' Equity | 180,923 | 179,089 |
| First Mortgage Bonds | | |
| 6½%, 2006 Series: | | |
| Pollution Control Revenue Bonds | 6,675 | 6,875 |
| 8.50%, 2022 Series | 40,000 | 40,000 |
| 6.75%, 2027A Series: | | |
| Industrial Development Revenue Bonds | 28,000 | 28,000 |
| 6.70%, 2027B Series: | | |
| Industrial Development Revenue Bonds | 19,300 | 19,300 |
| 7.70%, 2028 Series | 21,200 | 25,000 |
| First Mortgage Bonds Outstanding | 115,175 | 119,175 |
| Unamortized discount and premium on bonds, net | (1,052) | (1,089) |
| Long-term debt sinking fund requirements | (200) | (200) |
| Total First Mortgage Bonds | 113,923 | 117,886 |
| Other Long-Term Debt | | |
| 6.01%, due 2000 | 11,000 | 11,000 |
| 6.91%, due 2004 | 5,000 | — |
| Total Capitalization | $310,846 | $307,975 |

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

December 31, 1997, 1996, and 1995

## 1. Summary of Significant Accounting Policies

### a. General

Madison Gas and Electric Company (the Company) is an investor-owned public utility headquartered in Madison, Wisconsin. The Company generates, transmits, and distributes electricity to about 123,000 customers in a 250-square-mile area of Dane County. The Company also transports and distributes natural gas to over 107,000 customers in 1,325 square miles of service territory in seven counties.

The consolidated financial statements reflect the application of certain accounting policies described in this note. The financial statements include the accounts of the Company and its subsidiaries. All significant inter-company accounts and transactions have been eliminated in consolidation. The Company records unbilled revenue on the basis of service rendered. Gas revenues are subject to an adjustment clause related to periodic changes in the cost of gas.

Preparation of the consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. They also affect the disclosure of contingencies. Actual results could differ from those estimates.

### b. Utility Plant

Utility plant is stated at the original cost of construction, which includes indirect costs consisting of payroll taxes, pensions, postretirement benefits, other fringe benefits, administrative and general costs, and an allowance for funds used during construction (AFUDC).

AFUDC represents the approximate cost of debt and equity capital devoted to plant under construction. The Company presently capitalizes AFUDC at a rate of 10.76 percent on 50 percent of construction work in progress. The AFUDC rate approximates the Company's cost of capital. The portion of the allowance applicable to borrowed funds is presented in the Consolidated Statements of Income as a reduction of interest expense, while the portion of the allowance applicable to equity funds is presented as other income. Although the allowance does not represent current cash income, it is recovered under the ratemaking process over the service lives of the related properties.

Substantially all of the Company's utility plant is subject to a first mortgage lien.

### c. Nuclear Fuel

The cost of nuclear fuel used for electric generation is being amortized to fuel expense and recovered in rates based on the quantity of heat produced for the generation of electric energy by the Kewaunee Nuclear Power Plant (Kewaunee). Such cost includes a provision for estimated future disposal costs of spent nuclear fuel. The Company currently pays disposal fees to the Department of Energy based on net nuclear generation. The Company has recovered through rates and satisfied its known fuel disposal liability for past nuclear generation.

The National Energy Policy Act enacted in 1992 contains a provision for all utilities that have used federal enrichment facilities to pay a special assessment for decontamination and decommissioning for these facilities. This special assessment will be based on past enrichment, and the Company has accrued and deferred an estimate of $2.2 million for the Company's portion of the special assessment. The Company believes all costs will be recovered in future rates.

### d. Joint Plant Ownership

The Company and two other Wisconsin investor-owned utilities jointly own two electric generating facilities, which account for 54 percent (325 mw) of the Company's net generating capability. Power from the facilities is shared in proportion to the companies' ownership interests. The Company's interests are 22 percent (232 mw) of the coal-fired Columbia Energy Center (Columbia) and 17.8 percent (93 mw) of Kewaunee. Each owner provides its own financing and reflects its respective portion of facilities and operating costs in its financial statements. The Company's portions of these facilities, included in its gross utility plant in service, and the related accumulated depreciation reserves at December 31, were as follows:

| | Columbia | | Kewaunee | |
|---|---|---|---|---|
| *(Thousands of dollars)* | 1997 | 1996 | 1997 | 1996 |
| Utility plant | $85,183 | $85,377 | $57,883 | $57,929 |
| Accumulated depreciation | (48,762) | (46,704) | (38,799) | (36,271) |
| Net Plant | $36,421 | $38,673 | $19,084 | $21,658 |

### e. Depreciation

Provisions at composite straight-line depreciation rates, excluding decommissioning costs discussed as follows, approximate the following percentages of the cost of depreciable property: electric, 3.4 percent in 1997 and 3.3 percent in 1996 and 1995; gas, 3.4 percent in 1997 and 1996 and 3.5 percent in 1995. Depreciation rates are approved by the Public Service Commission of Wisconsin (PSCW) and are generally based on the estimated economic lives of property.

Nuclear decommissioning costs are being accrued to an end-of-service life of 2002 for Kewaunee. These costs are currently recovered from customers in rates and are deposited in external trusts. For 1997, the decommissioning costs recovered in rates were $4.9 million.

Decommissioning costs are recovered through depreciation expense, excluding earnings on the trusts. Net earnings on the trusts are included in other income. The long-term, after-tax earnings assumption on these trusts is 5.6 percent. As of December 31, 1997, the decommissioning trusts, totaling $59.2 million, are shown on the balance sheet in the utility plant section and offset by an equal amount under accumulated provision for depreciation.

The Company's share of Kewaunee decommissioning costs is estimated to be $78.8 million in current dollars based on a site-specific study performed in 1992 using immediate dismantlement as the method of decommissioning. Decommissioning costs as studied are assumed to inflate at an average rate of 6.0 percent. Physical decommissioning is expected to occur during the period 2014 through 2021, with additional expenditures being incurred during the period 2022 through 2039 related to the storage of spent nuclear fuel at the plant site.

## f. Income Taxes

Total income taxes in the Consolidated Statements of Income are as follows:

| *(Thousands of dollars)* | 1997 | 1996 | 1995 |
|---|---|---|---|
| Income taxes charged to operations | $11,940 | $12,553 | $14,285 |
| Income taxes charged to other income | 1,571 | (7,942) | 786 |
| Total income taxes | $13,511 | $ 4,611 | $15,071 |

Total income taxes consist of the following provision (benefit) components for the years ended December 31:

| *(Thousands of dollars)* | 1997 | 1996 | 1995 |
|---|---|---|---|
| Currently payable | | | |
| Federal | $12,229 | $ 9,317 | $14,602 |
| State | 3,435 | 3,267 | 3,679 |
| Net deferred | | | |
| Federal | (1,308) | (7,079) | (2,217) |
| State | (92) | (102) | (225) |
| Amortized investment tax credits | (753) | (792) | (768) |
| Total income taxes | $13,511 | $ 4,611 | $15,071 |

Deferred income taxes are provided to reflect the expected tax consequences of temporary differences between the tax basis of assets and liabilities and their reported amounts in the financial statements. Investment tax credits from regulated operations are amortized over the service lives of the property to which they relate.

The differences between the federal statutory income tax rate and the Company's effective rate are as follows:

| | 1997 | 1996 | 1995 |
|---|---|---|---|
| Statutory federal income tax rate | 35.0% | 35.0% | 35.0% |
| Amortized investment tax credits | (2.1) | (7.2) | (2.0) |
| State income taxes, net of federal benefit | 5.9 | 7.3 | 5.8 |
| Valuation allowance | (0.2) | 10.9 | — |
| Other, individually insignificant | (1.1) | (4.2) | (0.2) |
| Effective income tax rate | 37.5% | 41.8% | 38.6% |

The significant components of deferred tax liabilities (assets) that appear on the Consolidated Balance Sheets as of December 31 are as follows:

| *(Thousands of dollars)* | 1997 | 1996 |
|---|---|---|
| Property-related | $ 57,951 | $ 59,522 |
| Other | 6,026 | 6,788 |
| Gross deferred income tax liabilities | 63,977 | 66,310 |
| Accrued expenses | (6,344) | (7,629) |
| Other | (3,166) | (3,311) |
| Deferred tax regulatory account | (9,983) | (9,598) |
| Gross deferred income tax assets | (19,493) | (20,538) |
| Less valuation allowance | 1,088 | 1,200 |
| Net deferred income tax assets | (18,405) | (19,338) |
| Deferred income taxes | $ 45,572 | $ 46,972 |

Excess deferred income taxes, resulting chiefly from taxes provided at rates higher than current rates, have been recorded as a net regulatory liability ($24.9 million and $23.9 million at December 31, 1997 and 1996, respectively), refundable through future rates.

As discussed in Note 4, the Company's nonregulated gas marketing subsidiaries have entered into a joint venture with an unrelated third party. Realization of state deferred tax assets including net operating loss carryforwards of these subsidiaries is dependent on future income of the joint venture in states where the subsidiaries file separate tax returns. Due to the circumstances associated with these temporary differences, a valuation allowance was established at December 31, 1997 and 1996, for these deferred tax assets.

For tax purposes, these subsidiaries, as of December 31, 1997, had approximately $10.4 million of state tax net operating loss carryforwards which expire, if unused, in the year 2012.

## g. Pension Plans

The Company maintains two defined benefit plans for its employees. The pension benefit formula used in the determination of pension costs is based on the average compensation earned during the last five years of employment for the salaried plan and career earnings for the non-salaried plan subject to a monthly maximum.

Effective January 1, 1995, the Company began recovering pension costs in customer rates under Statement of Financial Accounting Standard (SFAS) No. 87, "Employers' Accounting for Pensions." Prior to this date, pension costs were recovered in rates as funded. The plans' assets are in a master trust with a bank.

The funded status of the plans at December 31 is as follows:

| *(Thousands of dollars)* | 1997 | 1996 |
|---|---|---|
| Fair value of plan assets | $70,298 | $58,770 |
| Actuarial present value of benefits rendered to date - Accumulated benefits based on compensation to date, including vested benefits of $47,958 and $40,840, respectively | 54,025 | 46,019 |
| Additional benefits based on estimated future salary levels | 11,085 | 9,093 |
| Projected benefit obligation | $65,110 | $55,112 |
| Plan assets greater than projected benefit obligation | 5,188 | 3,658 |
| Unrecognized net gain | (6,390) | (5,381) |
| Unrecognized prior service cost | 1,140 | 1,004 |
| Net liability | $ (62) | $ (719) |

Components of net pension costs for the years ended December 31 are:

| *(Thousands of dollars)* | 1997 | 1996 | 1995 |
|---|---|---|---|
| Service costs (benefits earned during the period) | $ 1,616 | $ 1,715 | $ 1,416 |
| Interest costs on projected benefit obligation | 4,421 | 4,090 | 3,724 |
| Actual return on plan assets | (12,244) | (7,302) | (10,033) |
| Net amortization and deferral | 6,856 | 2,553 | 6,466 |
| Net pension costs | $ 649 | $ 1,056 | $ 1,573 |

The assumed rates for calculations used in the above tables were:

| | 1997 | 1996 | 1995 |
|---|---|---|---|
| Expected long-term rate of return on plan assets | 9.50% | 9.50% | 9.50% |
| Average rate of increase in salaries | 5.00% | 5.00% | 5.00% |
| Weighted average discount rate | 7.25% | 7.75% | 7.25% |

In addition to the noted plans, the Company also maintains two defined-contribution 401(k) benefit plans for its employees. The Company's cost of the 401(k) plan was $0.3 million in 1997 and $0.2 million in years 1996 and 1995.

## h. Postretirement Benefits Other than Pensions

The Company provides health care and life insurance benefits for its retired employees, and substantially all of the Company's employees may become eligible for these benefits upon retirement. These benefits are accrued over the period in which employees provide services to the Company.

The Company 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. The Company's obligation and costs are based on a discount rate of 7.25 percent in 1997, 7.75 percent in 1996, and 7.25 percent in 1995. The net periodic benefit costs for the years 1997 through 1995 were based on an assumed long-term rate of return on plan assets of 9.5 percent. The assumed rate of increase in health care costs (health-care-cost trend rate) is 10 percent in 1997, decreasing gradually to 5 percent in 2003 and remaining constant thereafter. Increasing the health-care-cost trend rates of future years by one percentage point would increase the accumulated postretirement benefit obligation by $2.8 million and would increase annual aggregate service and interest costs by $0.4 million.

The Company's policy is to fund the obligation to the yearly maximum through tax-advantaged vehicles. The plan's assets are in trust or on reserve with an insurance company.

The funded status of the plan at December 31 is as follows:

| *(Thousands of dollars)* | 1997 | 1996 |
|---|---|---|
| Accumulated postretirement benefit obligation (APBO): | | |
| Retirees | $ (4,122) | $ (4,192) |
| Fully eligible active plan participants | (2,091) | (1,662) |
| Other active plan participants | (9,570) | (8,526) |
| Total | (15,783) | (14,380) |
| Plan assets at fair value | 4,467 | 3,602 |
| APBO in excess of plan assets | (11,316) | (10,778) |
| Unrecognized transition obligation | 6,511 | 6,945 |
| Unrecognized prior service costs | 2,111 | 2,000 |
| Unrecognized gain | (1,832) | (1,825) |
| Accrued postretirement benefit liability | $ (4,526) | $ (3,658) |

Components of net periodic benefit costs for the years ended December 31 are as follows:

| *(Thousands of dollars)* | 1997 | 1996 | 1995 |
|---|---|---|---|
| Service cost | $ 490 | $ 546 | $ 429 |
| Interest cost on APBO | 1,062 | 1,062 | 989 |
| Actual return on plan assets | (388) | (287) | (177) |
| Net amortization and deferral | 583 | 622 | 606 |
| Regulatory effect based on phase in | — | 402 | 95 |
| Net periodic benefit cost | $1,747 | $2,345 | $1,942 |

### i. Fair Value of Financial Instruments

At December 31, 1997, the carrying amount of cash and cash equivalents approximates fair value. The estimated fair market value of the Company's First Mortgage Bonds and other long-term debt, based on quoted market prices at December 31, is as follows:

| *(Thousands of dollars)* | 1997 | 1996 |
|---|---|---|
| Carrying amount (includes sinking funds) | $131,175 | $130,175 |
| Fair market value | $137,611 | $136,332 |

## 2. Capitalization Matters

### a. First Mortgage Bonds and Other Long-Term Debt

On April 18, 1997, the Company purchased on the open market $3.8 million of its 7.70%, 2028 series, First Mortgage Bonds. The Company purchased these bonds at a discount and later retired them. On June 10, 1997, the Company entered into a fixed interest rate agreement in the principal amount of $5.0 million at 6.91%, maturing on June 10, 2004.

The annual sinking fund requirements of the outstanding First Mortgage Bonds is $0.2 million in 1998 through 2002.

### b. Preferred Stock

The Company has 1,175,000 shares of $25 par value redeemable preferred stock, cumulative, that is authorized but unissued at December 31, 1997.

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

For short-term borrowings, the Company generally issues commercial paper (issued at the prevailing discount rate at the time of issuance) which is supported by unused bank lines of credit. Through negotiations with several banks, the Company had $52 million in bank lines of credit.

Information concerning short-term borrowings for the years is set forth below:

| *(Thousands of dollars)* | 1997 | 1996 | 1995 |
|---|---|---|---|
| December 31: | | | |
| Available lines of credit (MGE) | $52,000 | $45,000 | $35,000 |
| Available lines of credit (GLENCO) | $ — | $10,000 | $ 5,000 |
| Commercial paper outstanding | $33,500 | $29,750 | $20,500 |
| Weighted average interest rate | 6.06% | 5.63% | 5.86% |
| During the year: | | | |
| Maximum short-term borrowings | $33,500 | $29,750 | $28,600 |
| Average short-term borrowings | $16,816 | $13,805 | $16,091 |
| Weighted average interest rate | 5.68% | 5.53% | 6.03% |

## 3. Rate Matters

The Company received an interim rate order from the PSCW in March 1997. The order provided for a 0.507 cents per kilowatt-hour surcharge on customers' bills to cover costs incurred by the Company while Kewaunee remained out of service. Additional replacement power costs in the amount of about $1.0 million per month were recovered through the customer surcharge during the period March 6, 1997, through July 1, 1997.

In August 1997, the PSCW's rate order became effective increasing electric rates $4.9 million, or 3.1 percent, and natural gas rates $3.5 million, or 3.5 percent. These rates will remain in place until the next test year, which is scheduled to begin January 1, 1999. These current rates are based on an authorized return on common stock equity of 12.0 percent. The proposed early recovery of the Kewaunee investment and accelerated decommissioning collections are the primary reasons for the increase in electric rates. Gas rates increased due to substantial technology upgrades and infrastructure improvements as well as higher operating costs due to inflation. Prior to the recently approved increases, electric rates had not been increased since 1990 and were reduced in 1993 and 1994. Gas rates had not been increased since 1989 and were reduced in 1990, 1992, and 1993.

The co-owners of Kewaunee filed an application with the PSCW in November 1997 for a customer surcharge to recover costs associated with the 1997 steam generator repairs. The Company's portion of these costs is approximately $1.8 million (excluding carrying costs). The Company has requested recovery of these costs through a customer surcharge which would be collected over a four-month period in 1998. A PSCW decision is expected to be made sometime in the first quarter of 1998.

## 4. Gas Marketing Subsidiaries

In December 1996, the Company wrote down its investment in both Great Lakes Energy Corp. (GLENCO) and American Energy Management Inc. (AEM), the Company's gas marketing subsidiaries, to properly reflect current value. The write down resulted in an after-tax charge to income of $10.4 million. As of December 31, 1997, a $4.8 million liability remains to account for the remaining commitment and contingencies related to this write down. GLENCO and AEM formed a joint venture with another gas marketing company effective January 1, 1997. The joint venture is called National Energy Management L.L.C. and is based in Chicago.

Also in December 1996, the Company had a one-time after-tax charge of $1.6 million on net income. The charge resulted from a refund to the Company's natural gas customers. Under a sharing mechanism with GLENCO, an economic benefit based on GLENCO's net income was passed back to the Company's natural gas utility customers.

## 5. Commitments

Utility plant construction expenditures for 1998, including the Company's proportional share of jointly owned electric power production facilities and purchases of fuel for Kewaunee, are estimated to be $46 million and substantial commitments have been incurred in connection with such expenditures. Significant commitments have also been made for fuel for Columbia.

## 6. Segments of Business

The table below presents information pertaining to the Company's segments of business. Information regarding the distribution of net assets between electric and gas for th years ended December 31 is set forth on page 29.

| *(Thousands of dollars)* | 1997 | 1996 | 1995 |
|---|---|---|---|
| Electric Operations | | | |
| Total revenues | $163,123 | $152,747 | $153,554 |
| Operation and maintenance expenses | 100,854 | 90,862 | 89,994 |
| Depreciation and amortization | 22,799 | 20,094 | 19,503 |
| Other general taxes | 6,937 | 7,000 | 6,908 |
| Pre-tax Operating Income | $ 32,533 | $ 34,791 | $ 37,149 |
| Income taxes | 9,106 | 10,221 | 11,193 |
| Net Operating Income | $ 23,427 | $ 24,570 | $ 25,956 |
| Construction and Nuclear Fuel Expenditures (Electric) | $ 16,849 | $ 16,855 | $ 14,006 |
| Gas Operations | | | |
| Operating revenues | $101,525 | $100,544 | $ 95,036 |
| Revenues from sales to electric utility | 6,038 | 2,304 | 3,100 |
| Total Revenues | 107,563 | 102,848 | 98,136 |
| Operation and maintenance expenses | 89,788 | 86,418 | 80,017 |
| Depreciation and amortization | 5,518 | 5,416 | 5,312 |
| Other general taxes | 1,860 | 1,736 | 1,801 |
| Pre-tax Operating Income | 10,397 | 9,278 | 11,006 |
| Income taxes | 2,834 | 2,332 | 3,091 |
| Net Operating Income | $ 7,563 | $ 6,946 | $ 7,915 |
| Construction Expenditures (Gas) | $ 4,786 | $ 5,051 | $ 5,156 |

## 7. Supplemental Casb Flow Information

For purposes of the Consolidated Statements of Cash Flows, the Company considers cash equivalents to be those investments that are highly liquid with maturity dates of less than three months.

Cash payments for interest and income taxes for the years ended December 31 were as follows:

| *(Thousands of dollars)* | 1997 | 1996 | 1995 |
|---|---|---|---|
| Interest paid, net of amounts capitalized ...... | $10,841 | $10,932 | $11,894 |
| Income taxes paid, net ... | $15,365 | $16,041 | $18,016 |

## 8. Regulatory Assets and Liabilities

Pursuant to SFAS No. 71 "Accounting for the Effects of Certain Types of Regulation," the Company capitalizes, as deferred charges, incurred costs that are expected to be recovered in future electric and natural gas rates. The Company also records as other credits, obligations to customers to refund previously collected revenue or to spend revenue collected from customers on future costs. The Company's regulatory assets and liabilities, included in deferred charges and credits on the balance sheet, consisted of the following as of December 31:

| | 1997 | | 1996 | |
|---|---|---|---|---|
| *(Thousands of dollars)* | Assets | Liabilities | Assets | Liabilities |
| Demand-side management........ | $10,052 | $ 759 | $12,284 | $ 728 |
| Decommissioning & decontamination ........... | 2,300 | 2,211 | 2,403 | 2,403 |
| Unamortized debt expense........ | 5,072 | — | 5,260 | — |
| Other postretirement benefits................ | 58 | 4,567 | — | 3,481 |
| Kewaunee outage/repairs .... | 2,052 | 933 | — | — |
| Summer power shortages............. | 1,704 | — | — | — |
| Subtotal regulatory assets/liabilities ... | 21,238 | 8,470 | 19,947 | 6,612 |
| Other deferred items..... | 6,840 | 10,745 | 10,199 | 9,236 |
| Subtotal deferred items ..... | 28,078 | 19,215 | 30,146 | 15,848 |
| Regulatory liability – SFAS 109 ............. | — | 24,875 | — | 23,914 |
| Total .................... | $28,078 | $44,090 | $30,146 | $39,762 |

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## Summary of Selected Financial and Operating Data

| | 1997 | 1996 | 1995 | 1994 | 1993 | 1987 |
|---|---|---|---|---|---|---|
| **Electric** | | | | | | |
| Operating Revenues ($000s) | | | | | | |
| Residential | $ 55,506 | $ 53,971 | $ 54,928 | $ 51,751 | $ 51,718 | $ 42,987 |
| Commercial power and lighting | 79,004 | 74,291 | 72,885 | 79,295 | 78,085 | 65,934 |
| Industrial power and lighting | 11,261 | 10,095 | 10,245 | 9,022 | 7,999 | 5,627 |
| Street and highway lighting and public authorities | 14,808 | 13,236 | 13,855 | 7,684 | 8,076 | 8,992 |
| Other utilities | 1,566 | 466 | 1,092 | 1,584 | 367 | 1,299 |
| Miscellaneous | 978 | 688 | 549 | 329 | 956 | 489 |
| Total Operating Revenues | $ 163,123 | $ 152,747 | $ 153,554 | $ 149,665 | $ 147,201 | $ 125,328 |
| Kilowatt-hour Sales (000s) | | | | | | |
| Residential | 720,576 | 725,471 | 735,442 | 679,211 | 666,991 | 596,769 |
| Commercial power and lighting | 1,420,347 | 1,381,043 | 1,347,947 | 1,448,474 | 1,405,857 | 1,156,463 |
| Industrial power and lighting | 307,485 | 289,903 | 292,649 | 221,384 | 173,266 | 113,353 |
| Street and highway lighting and public authorities | 332,995 | 305,962 | 320,869 | 169,755 | 176,389 | 195,488 |
| Other utilities | 64,914 | 26,815 | 26,344 | 34,990 | 12,510 | 22,288 |
| Total Sales | 2,846,317 | 2,729,194 | 2,723,251 | 2,553,814 | 2,435,013 | 2,084,361 |
| Average Number of Customers | | | | | | |
| Residential | 105,787 | 104,778 | 103,624 | 102,255 | 100,721 | 93,243 |
| Commercial power and lighting | 16,144 | 15,841 | 15,581 | 15,348 | 15,037 | 13,740 |
| Industrial power and lighting | 76 | 74 | 75 | 75 | 77 | 77 |
| Street and highway lighting and public authorities | 52 | 52 | 52 | 51 | 53 | 50 |
| Other utilities | 5 | 5 | 5 | 4 | 3 | 4 |
| Total Average Customers | 122,064 | 120,750 | 119,337 | 117,733 | 115,891 | 107,114 |
| **Gas** | | | | | | |
| Operating Revenues ($000s) | | | | | | |
| Residential | $ 55,652 | $ 57,486 | $ 53,021 | $ 51,812 | $ 52,598 | $ 41,788 |
| Commercial | 37,530 | 36,917 | 33,550 | 33,436 | 35,757 | 29,942 |
| Industrial | 1,582 | 1,105 | 2,361 | 2,547 | 2,088 | 2,623 |
| Best efforts (includes interruptible boiler fuel) | 2,554 | 3,849 | 4,147 | 5,782 | 5,723 | 883 |
| Gas transport, net | 2,035 | 2,360 | 1,540 | 968 | 151 | 1,286 |
| Miscellaneous | 2,172 | (1,173) | 417 | 762 | 615 | 283 |
| Total Operating Revenues | $ 101,525 | $ 100,544 | $ 95,036 | $ 95,307 | $ 96,932 | $ 76,805 |
| Therms Sold and Transported (000s) | | | | | | |
| Residential | 87,664 | 96,062 | 89,099 | 84,326 | 84,713 | 65,336 |
| Commercial | 75,822 | 79,381 | 73,307 | 73,752 | 83,807 | 58,136 |
| Industrial | 5,057 | 2,653 | 6,279 | 8,056 | 6,651 | 5,944 |
| Best efforts (includes interruptible boiler fuel) | 6,838 | 11,689 | 15,143 | 18,633 | 18,079 | 2,968 |
| Gas transport, net | 40,947 | 37,707 | 36,502 | 22,463 | 1,678 | 19,052 |
| Total Sold and Transported | 216,328 | 227,492 | 220,330 | 207,230 | 194,928 | 151,436 |
| Average Number of Customers | | | | | | |
| Residential | 93,847 | 91,918 | 89,952 | 87,194 | 83,129 | 69,088 |
| Commercial | 12,104 | 11,799 | 11,483 | 11,053 | 10,477 | 8,457 |
| Industrial | 69 | 76 | 74 | 68 | 71 | 67 |
| Best efforts (includes interruptible boiler fuel) | 21 | 54 | 60 | 64 | 53 | 2 |
| Total Average Customers | 106,041 | 103,847 | 101,569 | 98,379 | 93,730 | 77,614 |

## Summary of Selected Financial and Operating Data

| *(Thousands of dollars, except per-share amounts)* | 1997 | 1996 | 1995 | 1994 | 1993 | 1987 |
|---|---|---|---|---|---|---|
| **Income, Earnings, and Dividends** | | | | | | |
| Net income | $ 22,523 | $ 6,427 | $ 23,970 | $ 25,011 | $ 24,675 | $ 19,627 |
| Earnings on common stock | $ 22,523 | $ 6,427 | $ 23,906 | $ 24,540 | $ 24,186 | $ 19,034 |
| Earnings per average common share | $ 1.40 | $ 0.40 | $ 1.49 | $ 1.53 | $ 1.51 | $ 1.29 |
| Cash dividends paid per common share | $ 1.286 | $ 1.273 | $ 1.260 | $ 1.247 | $ 1.227 | $ 1.060 |
| **Assets (year end)** | | | | | | |
| Electric | $313,855 | $315,022 | $327,053 | $323,870 | $328,048 | $249,878 |
| Gas | 118,339 | 116,723 | 119,968 | 118,210 | 114,626 | 84,096 |
| Assets not allocated | 39,596 | 52,424 | 46,855 | 45,679 | 22,690 | 30,741 |
| Total | $471,790 | $484,169 | $493,876 | $487,759 | $465,364 | $364,715 |
| **Internal Generation of Cash** | | | | | | |
| Total cash used for construction expenditures and nuclear fuel | $ 21,635 | $ 21,906 | $ 19,162 | $ 26,429 | $ 23,648 | $ 32,644 |
| Percent generated internally | 137.5% | 101.6% | 126.0% | 120.8% | 128.3% | 70.9% |
| **Long-term Debt and Redeemable Preferred Stock, Net (year end)** | $129,923 | $128,886 | $129,048 | $135,900 | $125,796 | $139,338 |
| **Capitalization Ratios (year end)** | | | | | | |
| Common shareholders' equity | 52.5% | 53.0% | 55.1% | 53.4% | 55.3% | 47.9% |
| Redeemable preferred stock | 0.0 | 0.0 | 0.0 | 1.5 | 1.7 | 2.2 |
| Long-term debt | 37.8 | 38.2 | 39.1 | 37.0 | 36.0 | 46.2 |
| Short-term debt (interim loans) | 9.7 | 8.8 | 5.8 | 8.1 | 7.0 | 3.7 |
| **Common Stock Data (year end)** | | | | | | |
| Per share – Close | $ 23 | $ 20¼ | $ 23⅜ | $ 21⅝ | $ 22½ | $ 14⅝ |
| – Book value | $ 11.25 | $ 11.14 | $ 12.01 | $ 11.79 | $ 11.51 | $ 9.67 |
| Shares (000s) – Outstanding | 16,080 | 16,080 | 16,080 | 16,080 | 16,055 | 14,916 |
| – Authorized | 50,000 | 50,000 | 28,000 | 28,000 | 28,000 | 14,000 |
| **Interest Coverages (excludes AFUDC)** | | | | | | |
| Pre-tax | 4.21 | 2.73 | 4.31 | 4.54 | 4.30 | 3.36 |
| After-tax | 3.09 | 1.58 | 3.07 | 3.22 | 3.10 | 2.41 |
| **Sources of Energy Generated and Purchased Power** | | | | | | |
| Coal | 63.2% | 63.4% | 61.3% | 55.6% | 47.1% | 58.8% |
| Nuclear | 14.2 | 19.6 | 23.5 | 26.2 | 26.6 | 32.4 |
| Purchased Power | 17.7 | 14.9 | 11.6 | 16.4 | 23.1 | 7.6 |
| Gas | 4.5 | 1.8 | 3.4 | 1.6 | 3.2 | 1.0 |
| Other | 0.4 | 0.3 | 0.2 | 0.2 | — | 0.2 |
| **Cooling Degree Days** (Normal – 611) | 410 | 408 | 982 | 637 | 630 | 766 |
| **Heating Degree Days** (Normal – 7,490) | 7,522 | 8,124 | 7,431 | 7,170 | 7,351 | 6,528 |

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## Quarterly Summary of Operations and Stock Prices

| *(Thousands of dollars, except per share amounts)* | Quarters Ended (Unaudited) March 31 | June 30 | Sept. 30 | Dec. 31 |
|---|---|---|---|---|
| **1997** | | | | |
| Operating Revenues: | | | | |
| Electric | $37,431 | $40,653 | $45,502 | $39,537 |
| Gas | 47,482 | 12,599 | 7,655 | 33,789 |
| Total | 84,913 | 53,252 | 53,157 | 73,326 |
| Operating Expenses | 75,560 | 48,511 | 45,328 | 64,259 |
| Net Operating Income | 9,353 | 4,741 | 7,829 | 9,067 |
| Interest, Preferred Dividends, and Other | 1,317 | 2,175 | 2,182 | 2,793 |
| Earnings on Common Stock | $ 8,036 | $ 2,566 | $ 5,647 | $ 6,274 |
| Earnings per Common Share | 50.0¢ | 16.0¢ | 35.0¢ | 39.0¢ |
| Dividends Paid per Common Share | 32.0¢ | 32.0¢ | 32.3¢ | 32.3¢ |
| Price per Common Share – High | $ 21¾ | $ 21¼ | $ 21¼ | $ 23¾ |
| – Low | $ 18½ | $ 19½ | $ 19⅞ | $ 19⅝ |
| **1996** | | | | |
| Operating Revenues: | | | | |
| Electric | $36,078 | $35,996 | $44,547 | $36,126 |
| Gas | 43,977 | 14,378 | 8,345 | 33,844 |
| Total | 80,055 | 50,374 | 52,892 | 69,970 |
| Operating Expenses | 68,311 | 44,059 | 43,851 | 65,554 |
| Net Operating Income | 11,744 | 6,315 | 9,041 | 4,416 |
| Interest, Preferred Dividends, and Other | 4,378 | 3,274 | 3,559 | 13,878 |
| Earnings on Common Stock | $ 7,366 | $ 3,041 | $ 5,482 | $(9,462) |
| Earnings per Common Share | 46.0¢ | 19.0¢ | 34.0¢ | (59.0)¢ |
| Dividends Paid per Common Share | 31.7¢ | 31.7¢ | 32.0¢ | 32.0¢ |
| Price per Common Share – High | $ 27½ | $ 25¾ | $ 23¾ | $ 22⅜ |
| – Low | $ 23⅛ | $ 21½ | $ 21½ | $ 19⅝ |

Notes:

(1) The quarterly results of operations within a year are not comparable because of seasonal and other factors.

(2) The sum of earnings per share of common stock for any four quarterly periods may vary slightly from the earnings per share of common stock for the equivalent 12-month period due to the effect of rounding each quarterly period separately.

(3) There were 18,383 shareholders as of January 31, 1998. Currently, there are no restrictions on the Company's ability to pay dividends and none are expected in the foreseeable future. The Company has regularly paid dividends to its shareholders and expects that it will continue to do so in the future.

(4) The Company's common stock trades on The Nasdaq National Stock Market under the symbol MDSN.

(5) December 1996 includes one-time after-tax charges of $10.4 million for restructuring of gas marketing subsidiaries and $1.6 million for a gas customer refund.

# Board of Directors

**Jean Manchester Biddick**
Retired Chief Executive Officer
Neesvig's Inc.
Age 71
Director Since 1982

**Richard E. Blaney**
Retired President
Richard Blaney Seeds Inc.
Age 61
Director Since 1974

**David C. Mebane**
Chairman, President and
Chief Executive Officer
Age 64
Director Since 1984

**Regina M. Millner**
President
RMM Enterprises, Inc.
Age 53
Director Since 1996

**Frederic E. Mohs**
Partner
Mohs, MacDonald, Widder
& Paradise, Attorneys at Law
Age 60
Director Since 1975

**Phillip C. Stark**
Chairman of the Board
The Stark Company
Age 72
Director Since 1985

**H. Lee Swanson**
Chief Executive Officer,
President and Director
State Bank of Cross Plains
Age 59
Director Since 1988

**Frank C. Vondrasek**
Vice Chairman
Age 69
Director Since 1982

## Audit Committee
Directors Biddick, Blaney, Millner,
Mohs, Stark, Swanson and Vondrasek

## Compensation Committee
Directors Blaney, Mohs and Stark

## Executive Committee
Directors Biddick, Blaney, Mebane,
Mohs and Vondrasek

## Personnel Committee
Directors Biddick, Mebane, Millner,
Mohs, Swanson and Vondrasek

Note: Ages as of January 1, 1998.

## Officers of the Company

David C. Mebane
Chairman, President and
Chief Executive Officer
Age 64
Years of Service, 20

Mark C. Williamson
Senior Vice President -
Energy Services
Age 44
Years of Service, 11

Gary J. Wolter
Senior Vice President -
Administration and Secretary
Age 43
Years of Service, 13

Ronald L. Semmann
Group Vice President
Age 62
Years of Service -
Joined MGE in May 1997

James C. Boll
Vice President - Law and
Corporate Communications
Age 62
Years of Service, 7

Terry A. Hanson
Vice President - Finance
Age 46
Years of Service, 16

Lynn K. Hobbie
Vice President - Marketing
Age 39
Years of Service, 12

Thomas R. Krull
Vice President -
Gas and Electric Operations
Age 48
Years of Service, 25

Peter J. Waldron
Vice President -
Power Supply Operations
and Engineering
Age 40
Years of Service, 17

Jeffrey C. Newman
Treasurer
Age 35
Years of Service, 13

Scott A. Neitzel
Assistant Vice President -
Gas Rates and Fuels
Age 37
Years of Service -
Joined MGE in August 1997

Joe R. Trueblood
Assistant Vice President -
Gas Operations
Age 63
Years of Service, 23

Carol A. Wiskowski
Assistant Vice President -
Administration and
Assistant Secretary
Age 58
Years of Service, 31

Note: Ages, years of service and positions as of January 1, 1998.

# Shareholder Information

## Shareholder Services

We welcome calls from shareholders. Please use the toll-free telephone numbers below for questions about your account, dividend payments, dividend reinvestment, lost certificates and stock transfers:

Madison calling area, (608) 252-4744
Other Wisconsin areas, 1-800-362-6423
Outside Wisconsin, 1-800-356-6423
(Continental U.S.)

If you prefer to write to us, address correspondence to:

MGE Shareholder Services
Post Office Box 1231
Madison, WI 53701-1231

Be sure to notify us in writing when a stock certificate is lost or stolen. Also notify us if you do not receive a dividend check or statement within 10 days of the scheduled payment date. Please report name and address changes to us promptly.

## Dividend Payment Dates

Dividends on the company's common stock in 1998 are expected to be paid quarterly on the 15th of March, June, September and December. The record date for dividend payments is the first day of the payment month.

## Transfer Agent & Registrar

Harris Trust and Savings Bank
Post Office Box 755
Chicago, IL 60690

## Investors Plus Plan

MGE's Investors Plus Plan offers investors the opportunity to purchase company stock directly from MGE. Investors can make cash payments of $25 to $25,000 per quarter per account. A minimum of $50 is required for a first-time investment.

Shares can be purchased each month by automatic deductions from checking or savings accounts.

Shareholders may reinvest all or a portion of cash dividends received on any or all shares of common stock in their account. Cash dividends can be paid by check or electronic deposit.

For more information or to receive the plan prospectus, contact MGE Shareholder Services.

## Stock Listing

The company's common stock trades on the Nasdaq National Stock Market under the symbol MDSN. It is listed in most newspaper stock tables as MadsnGas or MadGE.

## 1998 Annual Meeting

The annual meeting of shareholders will be held Tuesday, May 5, 1998, at 11 a.m.

Exhibition Hall
Dane County Expo Center
1919 Expo Way
Madison, Wis

## Reports Available

Upon request, we will provide you with a copy of Form 10-K, our 1997 Annual Report to the Securities and Exchange Commission. A Statistical Supplement to this Annual Report to shareholders also is available. It contains additional financial and operating data. Please address requests for these reports to:

Terry A. Hanson, Vice President - Finance
Madison Gas and Electric Company
Post Office Box 1231
Madison, WI 53701-1231

**MGE General Offices**
**133 South Blair Street**
**Post Office Box 1231**
**Madison, WI 53701-1231**
**Telephone (608) 252-7000**
**Internet: http://www.mge.com**

**Business hours: 8 a.m. to 4:30 p.m.**
**Central Time, Monday through Friday**

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