

WISCONSIN PUBLIC POWER INC.

Financial Statements

December 31, 2004 and 2003

(With Independent Auditors' Report Thereon)



KPMG LLP
4200 Wells Fargo Center
90 South Seventh Street
Minneapolis, MN 55402

Independent Auditors' Report

The Board of Directors
Wisconsin Public Power Inc.:

We have audited the accompanying balance sheets of Wisconsin Public Power Inc. (WPPI) as of December 31, 2004 and 2003, and the related statements of revenues, expenses, and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of WPPI's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of American Transmission Company LLC (ATC) (a 5.5 percent owned investee company). WPPI's investment in ATC at December 31, 2004 and 2003 was \$26,975,087 and \$20,942,467, respectively, and its equity in earnings of ATC was \$4,230,530 and \$3,439,494 for the years ended December 31, 2004 and 2003, respectively. The financial statements of ATC were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for ATC, is based solely on the report of the other auditors.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of WPPI's internal control over financial reporting. Accordingly, we express no such opinion. 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 and the report of the other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the report of the other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of WPPI as of December 31, 2004 and 2003, and the changes in its financial position and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.



The management's discussion and analysis on pages 3 through 9 is not a required part of the basic financial statements of WPPI but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

KPMG LLP

February 18, 2005

WISCONSIN PUBLIC POWER INC.

Management's Discussion and Analysis

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Financial Statement Overview

This discussion and analysis provides an overview of the financial performance of Wisconsin Public Power Inc. (WPPI) for the year ended December 31, 2004. The information presented should be read in conjunction with WPPI's financial statements and the accompanying notes.

WPPI follows the Uniform System of Accounts prescribed by the Federal Energy Regulatory Commission. The financial statements are prepared on the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America.

WPPI's financial statements include the Balance Sheet, the Statement of Revenues, Expenses, and Changes in Net Assets, and the Statement of Cash Flows. The Balance Sheet provides information about the nature and amount of assets and obligations (liabilities) of WPPI as of the end of the year. The Statement of Revenues, Expenses, and Changes in Net Assets report revenues and expenses for the current year. The Statement of Cash Flows reports cash receipts, cash payments, and net changes in cash resulting from operating, noncapital financing, investing, and capital and related financing activities.

Financial Highlights

The following table summarizes the financial position of WPPI as of December 31, 2004 and 2003:

Condensed Balance Sheets

Assets	<u>2004</u>	<u>2003</u>	<u>Dollar change</u>	<u>Percentage change</u>
Capital assets, net of accumulated depreciation	\$ 129,727,892	127,825,548	1,902,344	1.5%
Noncurrent assets	81,857,295	86,179,456	(4,322,161)	-5.0%
Current assets	44,620,847	53,661,048	(9,040,201)	-16.8%
Deferred costs	<u>27,171,118</u>	<u>23,834,684</u>	<u>3,336,434</u>	14.0%
Total assets	<u>\$ 283,377,152</u>	<u>291,500,736</u>	<u>(8,123,584)</u>	-2.8%
Liabilities and Net Assets				
Long-term debt	\$ 158,273,732	162,034,567	(3,760,835)	-2.3%
Current liabilities	27,974,279	28,268,691	(294,412)	-1.0%
Rate stabilization	35,127,846	37,694,606	(2,566,760)	-6.8%
Other deferred credits and liabilities	<u>10,887,995</u>	<u>16,489,572</u>	<u>(5,601,577)</u>	-34.0%
Total liabilities	<u>232,263,852</u>	<u>244,487,436</u>	<u>(12,223,584)</u>	-5.0%
Net assets:				
Invested in capital assets, net of related debt	(35,639,020)	(37,132,766)	1,493,746	-4.0%
Restricted	53,218,725	61,219,993	(8,001,268)	-13.1%
Unrestricted	<u>33,533,595</u>	<u>22,926,073</u>	<u>10,607,522</u>	46.3%
Total net assets	<u>51,113,300</u>	<u>47,013,300</u>	<u>4,100,000</u>	8.7%
Total liabilities and net assets	<u>\$ 283,377,152</u>	<u>291,500,736</u>	<u>(8,123,584)</u>	-2.8%

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Total assets decreased approximately \$8.1 million primarily due to decreases in restricted cash and investments of approximately \$9 million related to use of reserve fund monies. Approximately \$6.0 million was spent for repairs and major maintenance related to a stator ground fault in the generator of Boswell Energy Center Unit 4 and cracked turbine blades in South Fond du Lac Combustion Turbine 1. \$1.7 million of this amount came from WPPI's Self-Insurance Fund, and approximately \$4.3 million from WPPI's Renewals & Replacements Fund was utilized to perform accelerated maintenance during the outages in addition to required repairs. Approximately \$3 million from WPPI's Rate Stabilization Fund was used to offset relatively high replacement power costs while those generating units were out of service.

Total liabilities decreased by a total of approximately \$12.2 million. Outstanding long-term debt was reduced by approximately \$3.8 million as a result of scheduled debt service payments. Current liabilities decreased by approximately \$300,000 as a result of normal fluctuations in short-term liabilities such as accounts payable. Rate Stabilization reserves decreased by approximately \$2.5 million as a result of the approximately \$3 million use of the fund described above, followed by a partial replenishment of approximately \$450,000 at year-end. Other deferred credits and liabilities decreased by approximately \$5.6 million due primarily to utilization of Self-Insurance and Renewals & Replacements funds as described above.

Net assets of WPPI totaled approximately \$51 million at the close of 2004, an increase of \$4.1 million from the prior year. This increase was after WPPI took charges against earnings of \$1,180,000 to replenish its Renewals & Replacements Fund and \$950,000 to replenish its Self-Insurance Fund after their utilization during 2004, and deferred revenue of approximately \$450,000 to partially replenish the Rate Stabilization Fund after utilization during 2004. Including the year-end deferral, the total amount in the Rate Stabilization Fund was approximately \$35.1 million on December 31, 2004.

At the close of 2000, WPPI used available funds to invest \$16.9 million in the newly created American Transmission Company (ATC). This investment, which is accounted for using the equity method, had increased to approximately \$27 million at the end of 2004. The Board of Directors adopted a resolution on December 18, 2003 that included designation of \$8.65 million in proceeds from a contract settlement to be used for future capital investment in ATC. Approximately \$5 million of those designated funds was invested in ATC during 2004. On December 16, 2004, the Board of Directors adopted a resolution that included designation of \$4.1 million of 2004 net income for future investment in ATC. Both of these designations are part of an overall plan to maintain WPPI's ownership share of ATC at approximately 5.5%. Each capital contribution converts current assets of cash into a noncurrent asset, but does not otherwise affect WPPI's balance sheet. Quarterly equity dividends are recorded as part of net income, which increases the amount of noncurrent assets and net assets on the balance sheet at year-end. Dividends are accrued monthly as an increase in equity, with a subsequent reduction in the value of the investment when the cash portion of the dividend is paid out each quarter. ATC retains approximately 20% of its net earnings each year, WPPI's share of which is credited to WPPI's capital account.

WPPI's cost to decommission its share of Boswell Unit 4 is projected to be approximately \$4.8 million in 2024, assuming an annual inflation rate of 3%. The majority of the estimated decommissioning cost of the coal-fired plant is related to the ash ponds. Prior to 2003, WPPI recorded approximately \$1.4 million as a decommissioning liability and set aside funds in its Decommissioning Fund. In 2003, WPPI adopted Statement of Financial Accounting Standards No. 143, *Accounting for Asset Retirement Obligations*. To ensure that sufficient funds are accumulated and that these costs are equitably distributed to customers, level funding of the remaining estimated

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decommissioning liability began in 1996. The Decommissioning Fund had assets of approximately \$1.8 million at the end of 2004.

The Self-Insurance Fund was established to cover uninsured losses at WPPI's generating plants and other potential uninsured losses. The generating plants are covered by insurance, including property and boiler and machinery policies, with substantial deductibles. Deductibles equal \$1 million per occurrence on the Boswell Energy Center Unit 4 coal plant, with 20% of that amount (\$200,000) being the responsibility of WPPI. South Fond du Lac Combustion Turbine Units 1 and 4 each have deductibles of \$1.5 million per occurrence, with WPPI being responsible for 100% of the costs. The Island Street Peaking Plant has a deductible of \$500,000 per occurrence, with WPPI being responsible for 100% of the costs. On December 12, 2003, South Fond du Lac Unit 1 sustained significant damage when a compressor blade snapped during turbine operation. The cost to repair the damage exceeded the insurance deductible of \$1.5 million. The deductible was paid utilizing the monies in the Self-Insurance Fund. On February 6, 2004, Boswell Energy Center Unit 4 incurred a ground fault in the stator of the generator. Repairs to the unit exceeded the \$1 million insurance deductible. WPPI paid for its 20% share of the deductible utilizing monies in the Self-Insurance Fund. These actions reduced the Self-Insurance Fund from approximately \$3.7 million to approximately \$2 million. In light of these losses, on December 16, 2004, the Board of Directors approved a charge against 2004 earnings of \$950,000 to bring the balance of the Fund up to approximately \$3 million, which is an amount sufficient to cover simultaneous events at the plants with the largest deductibles – South Fond du Lac Unit 1 and Unit 4.

The outages required to repair Boswell Unit 4 and South Fond du Lac Unit 1 were also utilized to accelerate scheduled major maintenance that would otherwise have required separate unit shutdowns at a later date. This allowed the units to resume operation with all damage repaired and a state of maintenance that should increase their availability over the next 8 to 10 years. The accelerated maintenance was paid for utilizing the Renewals & Replacements Fund. South Fond du Lac Unit 4 also received accelerated major maintenance during 2004 to bring it to an equivalent state of readiness to South Fond du Lac Unit 1. Utilization of the Renewals & Replacements Fund for accelerated maintenance on Boswell Unit 4 and South Fond du Lac Units 1 and 4 reduced the Renewals & Replacements Fund from approximately \$9.5 million on December 31, 2003 to a level of approximately \$2.3 million on December 31, 2004. On December 16, 2004, the Board of Directors approved a charge against 2004 earnings of \$1,180,000 to partially replenish the Renewals & Replacements Fund. The same amount will be budgeted for deposit each year through 2014 to provide for scheduled major maintenance.

In 1992, the Board of Directors changed its policy to allow members' equity (net assets) to grow only by the 10% coverage in excess of debt service each year. Any revenues yielding coverage in excess of 110% of debt service were deferred to the Rate Stabilization Fund. In 1997, the prospect of major changes in the industry, including possible deregulation, prompted the Board of Directors to add a 3% margin to member rates to build the Rate Stabilization Fund, with collections beginning in 1998 and ending at the close of 2002. Subsequently, the Board chose to extend the collections through 2003. The collections were adjusted slightly in 2000, with only revenues received from the 3% margin being deferred rather than all revenues yielding debt service coverage in excess of 110%. In December of 2003, the Board of Directors discontinued the 3% collection and instead set rates for 2004 to recover debt service coverage of 145% rather than 110%. This change had no material effect on rates. The Board will annually decide the disposition of any earnings from debt service coverage collections over 110% of debt service. Such funds may be used for further investments in the American Transmission Company, deposits in the Rate Stabilization Fund, or other purposes. Four members that joined WPPI in 2001 and 2002 must make additional payments for deposit to the Rate Stabilization Fund equal to what they would have

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contributed had they been members in 1998-2002. These collections added \$634,585 to the Rate Stabilization Fund in 2004 and \$629,557 to the Rate Stabilization Fund in 2003. Approximately \$1.1 million in additional payments remain to be made. These members are all on track to complete their additional deposits to the Rate Stabilization Fund by the middle of 2006.

Debt service coverage collections before final Board deferrals of revenue or charges against earnings totaled 150.3% of debt service in 2004. On December 16, 2004, the Board adopted a resolution on the disposition of 2004 earnings that included four components. A charge against earnings of \$1,180,000 was made to partially replenish the Renewals & Replacements Fund and put the fund on a path to pay for projected major maintenance over the next 10 years. A charge against earnings of \$950,000 was made to increase the balance of the Self-Insurance Fund. WPPI retained \$4,100,000 as net income and designated for future investment in the American Transmission Company. Any remaining earnings after those items were to be deposited in the Rate Stabilization Fund to partially replenish it after the use of approximately \$3 million during 2004. As a result, \$449,839 in deferred revenue was deposited in the Rate Stabilization Fund, resulting in a balance of \$35,127,846 as of December 31, 2004. After those actions, final debt service coverage for 2004 is 132.5%, above the 110% coverage amount required by WPPI's Bond Resolution.

Most capital expenditures, other than major construction projects, are funded through current rates charged to members. A majority of the projected costs of scheduled major maintenance outages are collected through rates in advance of the scheduled outage. In 2004, major maintenance was performed on Boswell Energy Center Unit 4 and South Fond du Lac Unit 1 at the same time as the units were out of service due to aforementioned breakdowns. WPPI's 20% share of major maintenance at Boswell 4 was approximately \$600,000, in addition to the \$200,000 insurance deductible paid from the Self-Insurance Fund. Major maintenance performed on South Fond du Lac 1 in 2004 totaled approximately \$3.5 million in addition to the \$1.5 million insurance deductible paid from the Self-Insurance Fund. South Fond du Lac Unit 4 also had major maintenance work done during 2004 to prevent a possible turbine blade failure of the type experienced by Unit 1. Approximately \$2.6 million of major maintenance was performed on South Fond du Lac Unit 4.

To meet a portion of its long-term capacity needs, WPPI installed a new 52-megawatt combustion turbine in Kaukauna, Wisconsin that began commercial operation on May 15, 2004. Initial costs of approximately \$2.2 million incurred in 2002 for the Kaukauna combustion turbine project were paid with available funds in 2002 and reimbursed with proceeds of the 2003A Power Supply System Revenue Bonds. The project was completed using proceeds of the 2003A Power Supply System Revenue Bonds. At the end of 2004, the total cost of the project, which was completed in 2004, was approximately \$25 million.

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The following table summarizes the changes in financial position for WPPI for the years ended December 31, 2004 and 2003:

Condensed Statements of Revenues, Expenses, and Changes in Net Assets

	<u>2004</u>	<u>2003</u>	<u>Dollar change</u>	<u>Percentage change</u>
Operating revenues	\$ 223,028,979	221,267,276	1,761,703	0.8%
Operating expenses	<u>214,692,925</u>	<u>207,462,818</u>	<u>7,230,107</u>	3.5%
Operating income	8,336,054	13,804,458	(5,468,404)	-39.6%
Net investment income, equity in earnings of ATC, and unrealized gain (loss) on interest rate swaps	5,344,627	5,920,130	(575,503)	-9.7%
Interest expense and debt-related expenses	(9,989,948)	(9,483,620)	(506,328)	5.3%
Other nonoperating expenses	<u>(147,092)</u>	<u>(59,233)</u>	<u>(87,859)</u>	148.3%
Change in net assets before future recoverable costs and cumulative effect of change in accounting principle	3,543,641	10,181,735	(6,638,094)	-65.2%
Future recoverable costs	<u>556,359</u>	<u>221,680</u>	<u>334,679</u>	151.0%
Change in net assets before cumulative effect of change in accounting principle	4,100,000	10,403,415	(6,303,415)	-60.6%
Cumulative effect of change in accounting principle	<u>—</u>	<u>312,837</u>	<u>(312,837)</u>	0.0%
Change in net assets	4,100,000	10,716,252	(6,616,252)	-61.7%
Net assets, beginning of year	<u>47,013,300</u>	<u>36,297,048</u>	<u>10,716,252</u>	29.5%
Net assets, end of year	\$ <u><u>51,113,300</u></u>	<u><u>47,013,300</u></u>	<u><u>4,100,000</u></u>	8.7%

Sales to members for 2004 increased 10.3% over 2003, coming in at approximately \$196.4 million versus \$178.1 million in the prior year. The increase in revenues from sales to members from 2003 to 2004 is attributable to an increase in rates to members of 4.1% over 2003 rates, compounded by an increase in total megawatt hours sold.

Total 2004 revenue of approximately \$223.0 million amounted to a 0.8% increase over 2003 revenue of approximately \$221.3 million. Overall, revenue did not grow in proportion to member sales growth due to a decline in sales to others. Generation repairs at Boswell Unit 4 and South Fond du Lac Units 1 and 4 did not allow sales of excess power to others for a significant part of 2004. As a result, sales to others for 2004 of approximately \$22.8 million were 26.7% lower than the 2003 total of approximately \$31.1 million.

Purchased power increased to approximately \$181.2 million in 2004 from approximately \$164.2 million in 2003, reflecting the purchase of replacement power for the periods when the aforementioned WPPI generating units

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were out of service, and also reflecting increased fuel costs, particularly for natural gas, for WPPI's major suppliers of purchased power.

Fuel expense was approximately \$9.6 million less in 2004 than 2003. The drop in this expense category was also directly attributable to the repair and major maintenance outages at WPPI generating units. Because the units were not producing electricity for significant periods of 2004, less fuel was used in 2004 compared to 2003.

Other power production expense is composed solely of the expenses of Boswell Unit 4 and South Fond du Lac Units 1 and 4. To avoid the significant rate impacts that overhauls of the South Fond du Lac units would cause, maintenance expenses are accrued for each megawatt hour generated by the South Fond du Lac units in addition to an annual fixed accrual. These accruals are included in other power production expense, and the funds are set aside in the Renewals & Replacements Fund. Both Boswell Unit 4 and South Fond du Lac Units 1 and 4 produced fewer megawatt hours in 2004 compared to 2003, resulting in a drop in other power production expense to approximately \$5.3 million in 2004 from approximately \$6.8 million in 2003.

Tax expense was approximately \$595,000 higher in 2004 than in 2003. Property tax expense accrued on Boswell Unit 4 was approximately \$390,000 more in 2004 than 2003, and in-lieu-of-property-tax payments on the new Island Street Peaking Plant in Kaukauna, Wisconsin were approximately \$265,000, while in-lieu-of-property-tax payments on South Fond du Lac Units 1 and 4 were approximately \$60,000 lower in 2004 compared to 2003.

Other income was approximately \$800,000 in 2004 compared to 2003 when approximately \$12 million was received due to over \$11 million in one-time revenues from the negotiated buy out of a power supply contract in the amount of \$8.65 million plus approximately \$2.40 million in one-time refunds received from power and transmission providers as a result of litigation.

Administrative and general expenses increased approximately 3.6% compared to 2003. The increase was due primarily to the rising cost of health insurance along with annual increases in employee compensation, plus expenses associated with preparing for the Midwest Independent System Operator Electricity Market scheduled to begin on April 1, 2005.

Interest expense increased by approximately \$343,000 compared to 2003, as a result of fluctuations in the interest rates for the 2003B and 2003C floating-to-fixed-rate swaps. These rates are synthetically fixed, which means the net interest will fluctuate slightly around a base level during the year based on the market rates for 35-day auction rate debt and the one month London Interbank Offered Rate (LIBOR).

The 2003B swap had an original notional amount of \$65,700,000, which is reduced each year by principal retirement. WPPI pays short-term 35-day auction rate interest to buyers of 35-day securities sold in an amount equal to the outstanding principal of the notional amount, and pays the swap counterparty a fixed rate of 3.355%. WPPI receives interest earnings equal to 67% of the one-month LIBOR rate from the counterparty. For 2004, the effective net interest rate on the 2003B bonds averaged 3.69%. The termination date of the swap is July 1, 2021.

The 2003C swap had an original notional amount of \$39,350,000, which is reduced each year by principal retirement. WPPI pays short-term 35-day auction rate interest to buyers of 35-day securities sold in an amount equal to the outstanding principal of the notional amount, and pays the swap counterparty a fixed rate of 2.805%. WPPI receives interest earnings equal to 67% of the one-month LIBOR rate from the counterparty. For 2004, the effective net interest rate averaged 3.11%. The termination date of the swap is July 1, 2023.

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In 1999, the Board of Directors declared \$1,025,000 surplus under the bond resolution and funded an employee retention plan. Since that time the amount set aside for the plan has been increased by \$567,967. On an accounting basis, retention plan benefit expenses are being accrued as employees earn the benefits. Accrued retention plan benefit expenses were approximately \$200,000 in 2004 and \$300,000 in 2003.

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Balance Sheets

December 31, 2004 and 2003

Assets	2004	2003
Capital assets:		
Electric plant and equipment	\$ 208,917,656	184,225,003
Accumulated depreciation and amortization	<u>(79,247,568)</u>	<u>(74,529,912)</u>
Electric plant and equipment, net	<u>129,670,088</u>	<u>109,695,091</u>
Construction work in progress	<u>57,804</u>	<u>18,130,457</u>
Noncurrent assets:		
Restricted assets:		
Cash and investments	48,345,733	54,456,157
Interest receivable	18,439	58,230
Investments	6,557,361	9,159,138
Fair value of interest rate swap agreement	(280,985)	502,683
Investment in ATC	26,975,087	20,942,467
Receivables from members	241,660	1,057,147
Notes receivable	<u>—</u>	<u>3,634</u>
Total noncurrent assets	<u>81,857,295</u>	<u>86,179,456</u>
Current assets:		
Cash and investments	15,085,838	19,486,945
Restricted cash and investments	5,950,766	14,595,346
Receivables:		
Power sales accounts receivable	17,762,864	15,609,872
Other	2,467,746	969,436
Interest receivable	<u>433,256</u>	<u>154,281</u>
Total receivables	20,663,866	16,733,589
Inventories	2,586,520	2,608,433
Prepayments	<u>333,857</u>	<u>236,735</u>
Total current assets	<u>44,620,847</u>	<u>53,661,048</u>
Deferred costs:		
Unamortized bond issuance costs	2,589,393	2,828,487
Future recoverable costs	20,331,191	19,774,833
Other deferred charges	<u>4,250,534</u>	<u>1,231,364</u>
Total deferred costs	<u>27,171,118</u>	<u>23,834,684</u>
Total assets	\$ <u><u>283,377,152</u></u>	\$ <u><u>291,500,736</u></u>

See accompanying notes to financial statements.

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Balance Sheets

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Liabilities and Net Assets	2004	2003
Long-term debt:		
Revenue bonds (net of unamortized discount)	\$ 158,273,732	162,034,567
Current liabilities:		
Liabilities payable from restricted assets:		
Current maturities of long-term debt	5,600,000	7,985,000
Interest accrued	2,326,215	2,447,522
Accounts payable	16,185,583	16,801,597
Other current liabilities	3,862,481	1,034,572
Total current liabilities	<u>27,974,279</u>	<u>28,268,691</u>
Deferred credits and other liabilities:		
Operating reserves and accrued liabilities	9,081,927	14,769,507
Rate stabilization	35,127,846	37,694,606
Asset retirement obligation	1,806,068	1,720,065
Total deferred credits and other liabilities	<u>46,015,841</u>	<u>54,184,178</u>
Total liabilities	<u>232,263,852</u>	<u>244,487,436</u>
Net assets:		
Invested in capital assets, net of related debt	(35,639,020)	(37,132,766)
Restricted	53,218,725	61,219,993
Unrestricted	33,533,595	22,926,073
Total net assets	51,113,300	47,013,300
Total net assets and liabilities	<u>\$ 283,377,152</u>	<u>291,500,736</u>

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Statements of Revenues, Expenses, and Changes in Net Assets

Years ended December 31, 2004 and 2003

	<u>2004</u>	<u>2003</u>
Operating revenues:		
Sales to members	\$ 196,421,285	178,109,849
Rate stabilization	3,016,600	—
Sales to others	22,777,895	31,067,405
Other income	813,199	12,090,022
Total operating revenues	<u>223,028,979</u>	<u>221,267,276</u>
Operating expenses:		
Purchased power	181,170,782	164,218,593
Fuel	8,458,159	18,036,601
Other power production	5,261,339	6,789,607
Administrative and general	11,334,693	10,974,256
Depreciation and amortization	5,998,809	5,570,077
Taxes	2,469,143	1,873,684
Total operating expenses	<u>214,692,925</u>	<u>207,462,818</u>
Operating income	<u>8,336,054</u>	<u>13,804,458</u>
Nonoperating revenues (expenses):		
Investment income	2,157,289	1,918,609
Equity in earnings of ATC	4,230,530	3,439,494
Unrealized (loss) gain on interest rate swap agreement	(783,668)	502,683
Net (decrease) increase in fair value of investments	(259,524)	59,344
Interest expense	(7,911,689)	(7,567,876)
Amortization of debt-related costs	(2,078,259)	(1,915,744)
Other	(29,500)	(27,500)
Loss on disposal of assets	(117,592)	(31,733)
Total nonoperating expenses, net	<u>(4,792,413)</u>	<u>(3,622,723)</u>
Change in net assets before future recoverable costs	3,543,641	10,181,735
Future recoverable costs	<u>556,359</u>	<u>221,680</u>
Change in net assets before cumulative effect of change in accounting principle	4,100,000	10,403,415
Cumulative effect of change in accounting principle	<u>—</u>	<u>312,837</u>
Change in net assets	4,100,000	10,716,252
Total net assets, beginning of year	<u>47,013,300</u>	<u>36,297,048</u>
Total net assets, end of year	\$ <u><u>51,113,300</u></u>	<u><u>47,013,300</u></u>

See accompanying notes to financial statements.

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Statements of Cash Flows

Years ended December 31, 2004 and 2003

	<u>2004</u>	<u>2003</u>
Cash flows from operating activities:		
Cash receipts from members and others	\$ 217,614,831	225,888,810
Cash payments for purchased power	(181,437,294)	(162,409,052)
Cash payments for fuel	(8,373,551)	(17,480,877)
Cash payments for operations and management	(3,651,529)	(2,823,452)
Cash payments for payroll and ad valorem taxes	(2,506,210)	(2,312,364)
Cash payments to employees	(4,844,036)	(4,530,082)
Cash payments for administrative and general	(6,278,845)	(4,315,441)
Net cash provided by operating activities	<u>10,523,366</u>	<u>32,017,542</u>
Cash flows from noncapital financing activities:		
Cash payments for other nonoperating expenses	<u>(29,500)</u>	<u>(27,500)</u>
Cash flows from investing activities:		
Investments purchased	(51,507,406)	(64,843,227)
Investment in ATC	(5,025,966)	(1,007,869)
Investments sold	42,954,143	45,343,823
Investment income	1,939,217	1,783,324
Cash distributions received from ATC	3,223,876	2,612,903
Cash receipts from notes	15,137	27,680
Net cash used in investing activities	<u>(8,400,999)</u>	<u>(16,083,366)</u>
Cash flows from capital and related financing activities:		
Acquisition and construction of capital assets	(15,904,835)	(15,920,679)
Proceeds from issuance of new debt	—	192,040,000
Principal paid and defeased	(7,985,000)	(174,925,000)
Interest paid	(8,291,454)	(9,460,210)
Net cash used in capital and related financing activities	<u>(32,181,289)</u>	<u>(8,265,889)</u>
Increase (decrease) in cash and cash equivalents	(30,088,422)	7,640,787
Cash and cash equivalents, beginning of year	<u>66,197,595</u>	<u>58,556,808</u>
Cash and cash equivalents, end of year	\$ <u>36,109,173</u>	\$ <u>66,197,595</u>
Reconciliation of operating income to net cash flows from operating activities:		
Operating income	\$ 8,336,054	13,804,458
Noncash item included in operating income:		
Depreciation and amortization	5,998,809	5,570,077
Changes in assets and liabilities:		
Receivables	(3,651,302)	(747,578)
Inventories	21,913	22,651
Prepayments	(97,122)	101,895
Accounts payable and other current liabilities	2,711,345	2,932,620
Deferred credits and other liabilities	222,839	10,255,349
Other deferred charges	(3,019,170)	78,070
Net cash provided by operating activities	\$ <u>10,523,366</u>	\$ <u>32,017,542</u>

As of December 31, 2004 and 2003, WPPI held \$66,805,612 and \$52,442,458, respectively, of investments considered to be noncash equivalents.

See accompanying notes to financial statements.

WISCONSIN PUBLIC POWER INC.

Notes to Financial Statements

December 31, 2004 and 2003

(1) Summary of Significant Accounting Policies

(a) *Organization and Operations*

Wisconsin Public Power Inc. (WPPI) is a municipal electric company and political subdivision of the State of Wisconsin, formed in 1980. The purpose and function of WPPI is to provide an adequate, economical, and reliable wholesale supply of electricity to its members for distribution by the members' electric utilities to their retail customers. WPPI is owned by its member municipalities, which govern its policies. WPPI had 37 members as of December 31, 2004, with two additional members joining effective January 1, 2005 and March 1, 2005, respectively.

WPPI sells power to its members under power sales contracts that remain in effect until 2037. Under the contracts, WPPI has agreed to sell and deliver to each member, and each member has agreed to take and pay for its electric power requirements, with certain exceptions related to existing member-owned hydroelectric facilities and other specified generation. Also, from time to time, WPPI sells capacity and energy at market prices to other entities.

In addition to its power supply program, WPPI offers various services to members that are intended to enable members to operate their electric systems more efficiently. The services include rate analyses, rate comparisons, computer network support, large-customer billing, equipment testing, joint purchasing of equipment and supplies, joint arrangements for disposal of hazardous waste, and various energy- and customer-related programs.

WPPI supplies the power requirements of its members from a mix of resources, including an undivided 20% ownership in the 535 MW Boswell Unit 4 coal-fired steam unit near Grand Rapids, Minnesota; two 86 MW combustion turbine units near Fond du Lac, Wisconsin; a 52 MW combustion turbine in Kaukauna; member generation under contract to WPPI; and power purchases from other entities. Minnesota Power owns the remaining interest in Boswell Unit 4 and is the operating agent responsible for operation and maintenance of the unit. WPPI's undivided ownership interest in Boswell Unit 4 is included in capital assets. WPPI pays 20% of the total cost to operate and maintain Boswell Unit 4. South Fond du Lac Units 1 and 4 are two of the four combustion turbine units located on a site owned by Alliant Energy. Alliant owns the other two units on the site and operates and maintains the units owned by WPPI. WPPI compensates Alliant for these services. Construction was completed on the Kaukauna combustion turbine in 2004. WPPI owns the unit, and Kaukauna Utilities operates it. WPPI compensates Kaukauna Utilities for operating and maintaining the combustion turbine. The member generation under contract to WPPI consists of a number of small generating units, totaling approximately 37 MW of capacity. The remainder of WPPI's power requirements is purchased from other entities.

(b) *Basis of Presentation/Chart of Accounts*

The financial statements are prepared on the accrual basis of accounting, in conformity with accounting principles generally accepted in the United States of America, including the application of Statement of Financial Accounting Standards (SFAS) No. 71, *Accounting for the Effect of Certain Types of Regulation*, as the statement relates to the deferral of revenues and expenses to future periods in which the revenues are earned or the expenses are recovered through the rate-making

WISCONSIN PUBLIC POWER INC.

Notes to Financial Statements

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process. WPPI uses the Uniform System of Accounts prescribed by the Federal Energy Regulatory Commission (FERC).

WPPI complies with all applicable pronouncements of the Governmental Accounting Standards Board (GASB). In accordance with GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, WPPI also complies with the pronouncements of the Financial Accounting Standards Board that do not conflict with GASB pronouncements.

(c) *Change in Accounting Principles*

On January 1, 2003, WPPI recorded a cumulative effect of an accounting change associated with the adoption of SFAS No. 143, *Accounting for Asset Retirement Obligations*. This statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS No. 143 requires an enterprise to record the fair value of an asset retirement obligation as a liability in the period in which it incurs a legal obligation associated with the retirement of a tangible long-lived asset. The cumulative effect of the accounting change was an increase in net capital assets of \$576,824, an increase in accrued liabilities of \$263,987, and a change in net assets of \$312,837.

(d) *Use of Estimates in the Preparation of Financial Statements*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(e) *Capital Assets*

Additions to and replacements of capital assets are recorded at original cost, including allowance for borrowed funds if acquired with tax-exempt debt. Depreciation is recorded using the straight-line method using service lives of 2 to 35 years.

(f) *Cash Equivalents*

For purposes of the statement of cash flows, cash equivalents are cash and investments having an initial maturity of three months or less when purchased.

(g) *Inventories*

Inventories include fuel and repair parts. They are charged to plant or operation and maintenance expense at average cost when used. Inventories are valued at the lower of average cost or fair value.

(h) *Unamortized Bond Issuance Costs*

Bond issuance costs are amortized over the repayment period of the related issues using a method that approximates the effective-interest method.

WISCONSIN PUBLIC POWER INC.

Notes to Financial Statements

December 31, 2004 and 2003

(i) Future Recoverable Costs

Revenues from members include amounts to pay bond principal and interest. For financial reporting purposes, WPPI recognizes depreciation and amortization pertaining to fixed assets and other assets financed by bond principal. As allowed through the application of the provisions of SFAS No. 71, future recoverable costs represent the difference between depreciation and amortization of assets financed with bond proceeds and the related principal recovered in rates in the present period. These costs will be recovered in future periods when the principal amounts exceed the related depreciation and amortization.

(j) Other Deferred Charges

Other deferred charges primarily represent costs associated with the buyout of WPPI's obligations under capacity purchase agreements with two of its members. As allowed through the application of SFAS No. 71, such effects have been deferred and are being amortized for rate-making purposes over the original terms of the capacity purchase agreements, which expire in 2007 and 2009, respectively.

(k) Rates

Rates are reviewed and adopted by WPPI's board of directors annually. Under the bond resolution, WPPI's rates are expected to yield net revenues for an annual period equal to at least 1.10 times the aggregate debt service for that period. Rates are not subject to state or federal regulation.

During 2003, rates were to collect an additional 3% margin over that called for in the bond resolution to build the rate stabilization fund. Beginning in 2004, in December of each year the Board of Directors determines how to distribute the margin between 110% and 145% of coverage. As allowed through the application of the provisions of SFAS No. 71, the margin may be deposited in the rate stabilization fund and is also reported as deferred credits on the accompanying balance sheet to be distributed in future years as revenues in the statement of revenues, expenses, and changes in net assets to cover costs that otherwise would be recovered through its rates to members. For the years ended December 31, 2004 and 2003, \$449,840 and \$4,784,834, respectively, was deferred and added to the rate stabilization fund. In 2004, \$3,016,600 of the rate stabilization fund was used to curb the impact of major outages and recognized as revenue.

(l) Taxes

WPPI is exempt from federal, Wisconsin, and Minnesota income taxes as a political subdivision of the State of Wisconsin. Tax expense includes Minnesota property taxes, Wisconsin payments-in-lieu-of-ad valorem taxes, payroll-related taxes, and emission fees.

(m) Vacation and Sick Leave

Under terms of employment, employees are granted one day of sick leave per month. Accrued sick leave is not paid to employees when they leave employment.

Employees are allowed to accumulate up to five days of vacation pay. In extraordinary circumstances, the chief executive officer may allow an employee to accumulate additional vacation pay. Accrued vacation is not considered material; therefore, no liability is recorded.

WISCONSIN PUBLIC POWER INC.

Notes to Financial Statements

December 31, 2004 and 2003

(n) *Operating Revenues and Expenses*

Operating revenues result from exchange transactions associated with the principal activity of WPPI, the sale of electricity. Reported operating revenues are affected by the contributions to or distributions from the rate stabilization account. Operating expenses are defined as expenses directly related to, or incurred in support of, the provision of electricity and other services to the members. All other expenses are classified as nonoperating expenses.

(o) *Fair Value of Financial Instruments*

The carrying amount of WPPI's cash and cash equivalents, receivables, and accounts payable approximates fair value because of the short maturities of these instruments. Investments are carried at fair value based on quoted market prices. The fair value of WPPI's long-term debt is estimated by discounting future cash flows using interest rates that approximate those that could currently be obtained by WPPI. The fair value of long-term debt as of December 31, 2004 and 2003 is approximately \$190 million and \$199 million, respectively.

(p) *Reclassifications*

Certain 2003 financial statement amounts have been reclassified to conform with the 2004 presentation.

(2) *Deposits and Investments*

WPPI's deposits and investments are categorized to give an indication of the level of risk assumed by the entity at year-end. Category 1 includes items that are insured or registered or that are collateralized by or evidenced by securities held by WPPI or its agent in WPPI's name. Category 2 includes deposits collateralized with securities held by the pledging institution's trust department or agent in WPPI's name, or uninsured and unregistered investments for which the securities are held by the counterparty's trust department or agent in WPPI's name. Category 3 includes uncollateralized deposits, and uninsured and uncollateralized investments.

WISCONSIN PUBLIC POWER INC.

Notes to Financial Statements

December 31, 2004 and 2003

At December 31, 2004, WPPI's balances were as follows:

	<u>Category</u>			<u>Bank balance</u>	<u>Carrying amount</u>
	<u>1</u>	<u>2</u>	<u>3</u>		
U.S. treasury and agency securities	\$ 46,122,338	—	—	46,122,338	46,122,338
Corporate bonds	2,479,144	—	—	2,479,144	2,479,144
Bank One	100,000	—	358,590	458,590	43,975
	<u>\$ 48,701,482</u>	<u>—</u>	<u>358,590</u>	<u>49,060,072</u>	<u>48,645,457</u>
Investments not subject to categorization:					
Money market mutual fund					26,231,980
Investment in American Transmission Company (note 5)					26,975,087
Mutual funds					1,061,961
Cash on hand					300
Total cash and investments					<u>\$ 102,914,785</u>

At December 31, 2003, WPPI's balances were as follows:

	<u>Category</u>			<u>Bank balance</u>	<u>Carrying amount</u>
	<u>1</u>	<u>2</u>	<u>3</u>		
U.S. treasury and agency securities	\$ 31,009,153	—	—	31,009,153	31,900,954
Repurchase agreements	5,196,557	—	—	5,196,557	5,196,557
Corporate bonds	510,290	—	—	510,290	535,058
Bank of Sun Prairie	100,000	—	132,391	232,391	250,149
Johnson Bank	500	—	—	500	500
	<u>\$ 36,816,500</u>	<u>—</u>	<u>132,391</u>	<u>36,948,891</u>	<u>37,883,218</u>
Investments not subject to categorization:					
Money market mutual fund					58,833,627
Investment in American Transmission Company (note 5)					20,942,467
Mutual funds					980,591
Cash on hand					150
Total cash and investments					<u>\$ 118,640,053</u>

Deposits and investments in each bank are insured by the Federal Deposit Insurance Corporation (FDIC) in the amount of \$100,000 for interest-bearing accounts and \$100,000 for non-interest-bearing accounts. Deposits and investments are also insured for \$400,000 by the State Deposit Guarantee Fund (SDGF). However, due to the relatively small size of the SDGF in relation to the total deposits covered and other legal implications, recovery of material principal losses of the pool may not be significant to the utility. This coverage has not been considered in computing the amounts in Category 1 above.

WISCONSIN PUBLIC POWER INC.

Notes to Financial Statements

December 31, 2004 and 2003

Investments are stated at fair value, which is the amount at which an investment could be exchanged in a current transaction between willing parties. Fair values are based on quoted market prices. Adjustments necessary to record investments at fair value are recorded in the statements of revenues, expenses, and changes in net assets.

(3) Funds

WPPI's bond resolution requires the segregation of bond proceeds and establishment of various funds, and prescribes the application of WPPI's revenues. Also, it defines what type of securities WPPI may invest in. Funds consist principally of cash, money market funds, repurchase agreements, investments in the LGIP, treasury notes, agencies, treasury strips, and corporate bonds. The fund's purposes and balances are summarized below:

<u>Fund</u>	<u>Held by</u>	<u>Purpose</u>
Construction	Trustee	To provide for the acquisition and construction of the power supply system.
Debt Service	Trustee	To accumulate principal and interest associated with each bond series.
Debt Service Reserve	Trustee	To establish a reserve equal to the largest principal and interest payment that would have to be made in any one year during the remaining life of the bonds.
Revenue	WPPI	To accumulate revenues and to provide for the payment of expenses and for disposition of revenues to various funds.
Renewals & Replacements	WPPI	To provide a reserve to be applied to the payment of the costs of renewals, replacements, and repairs to the power supply system.
Self-Insurance	WPPI	To provide a reserve to be applied to the payment of claims and losses arising from hazards and risks to the extent that the insurance required to be maintained does not cover such claims or losses.
Rate Stabilization	WPPI	To accumulate revenues which will be used to reduce rates in a future period.
Decommissioning	WPPI	To accumulate funds to pay for the eventual costs of decommissioning, retirement, or disposal of major facilities.

WISCONSIN PUBLIC POWER INC.

Notes to Financial Statements

December 31, 2004 and 2003

	<u>2004</u>	<u>2003</u>
Restricted cash and investments:		
Noncurrent:		
Debt service reserve accounts	\$ 8,130,135	8,102,526
Renewals & Replacements Fund	2,260,369	9,543,730
Self-Insurance Fund	2,078,805	2,390,360
Rate Stabilization Fund	33,736,915	32,486,880
Decommissioning	<u>2,139,509</u>	<u>1,932,661</u>
Total noncurrent	<u>48,345,733</u>	<u>54,456,157</u>
Current:		
Construction Fund	1,096,213	7,889,740
Debt Service Funds	<u>4,854,553</u>	<u>6,705,606</u>
Total current	<u>5,950,766</u>	<u>14,595,346</u>
Total restricted cash and investments	<u>54,296,499</u>	<u>69,051,503</u>
Unrestricted cash and investments:		
Noncurrent:		
Investments	6,557,361	9,159,138
Investment in ATC	<u>26,975,087</u>	<u>20,942,467</u>
	<u>33,532,448</u>	<u>30,101,605</u>
Current cash and investments:		
Petty cash	300	1,150
Revenue Fund	<u>15,085,538</u>	<u>19,485,795</u>
	<u>15,085,838</u>	<u>19,486,945</u>
Total cash and investments	\$ <u><u>102,914,785</u></u>	\$ <u><u>118,640,053</u></u>

WISCONSIN PUBLIC POWER INC.

Notes to Financial Statements

December 31, 2004 and 2003

(4) Capital Assets

Capital asset activity for the years ended December 31, 2004 and 2003 was as follows:

2004	Beginning balance	Additions	Transfers	Retirements	Ending balance
Nondepreciable assets:					
Land	\$ 88,883	—	—	—	88,883
Construction work in progress	18,130,457	15,900,333	(33,972,986)	—	57,804
Total nondepreciable assets	18,219,340	15,900,333	(33,972,986)	—	146,687
Depreciable assets:					
Utility plant	184,136,120	510,239	33,972,986	(9,790,572)	208,828,773
Total depreciable assets	184,136,120	510,239	33,972,986	(9,790,572)	208,828,773
Accumulated depreciation and amortization	(74,529,912)	(5,998,809)	—	1,281,153	(79,247,568)
Depreciable assets, net	109,606,208	(5,488,570)	33,972,986	(8,509,419)	129,581,205
Capital assets, net	\$ 127,825,548	10,411,763	—	(8,509,419)	129,727,892
2003	Beginning balance	Additions	Transfers	Retirements	Ending balance
Nondepreciable assets:					
Land	\$ 88,883	—	—	—	88,883
Construction work in progress	2,322,097	16,156,033	(347,673)	—	18,130,457
Total nondepreciable assets	2,410,980	16,156,033	(347,673)	—	18,219,340
Depreciable assets:					
Utility plant	183,390,707	1,554,632	347,673	(1,156,892)	184,136,120
Total depreciable assets	183,390,707	1,554,632	347,673	(1,156,892)	184,136,120
Accumulated depreciation and amortization	(69,679,175)	(5,932,099)	—	1,081,362	(74,529,912)
Depreciable assets, net	113,711,532	(4,377,467)	347,673	(75,530)	109,606,208
Capital assets, net	\$ 116,122,512	11,778,566	—	(75,530)	127,825,548

Construction work in progress at December 31, 2003 consists primarily of a combustion turbine gas generator project sited at Kaukauna, Wisconsin. The project was completed in 2004. Capitalized interest of \$344,461 and \$680,644 was included as a part of the cost of the project in 2004 and 2003, respectively. The project was financed by internal funds and proceeds of the Series 2003A bond issue.

WISCONSIN PUBLIC POWER INC.

Notes to Financial Statements

December 31, 2004 and 2003

During 2004, WPPI repaired damages sustained at two of its generating facilities, Boswell Unit 4 and South Fond du Lac Unit 1. The costs of repair are included in capital asset additions. A corresponding reduction in capital assets equal to the cost of the repairs has also been included in capital asset retirements to adjust capital assets for the effects of these events.

(5) Investment in American Transmission Company

During 2000, WPPI purchased an equity interest in ATC Management Inc. and American Transmission Company LLC (collectively ATC). ATC is a for-profit, transmission-only company. It owns, plans, maintains, monitors, and operates electric transmission assets in portions of Wisconsin, Michigan, and Illinois. ATC began operations on January 1, 2001. At December 31, 2004 and 2003, WPPI's equity interest in ATC was approximately 5.5%. WPPI's investment in ATC qualifies for the equity method of accounting.

Condensed financial data of ATC for 2004 and 2003 follows:

	<u>2004</u>	<u>2003</u>
	(In millions)	
Operating statement data:		
Revenues	\$ 262.5	225.6
Operating expenses	(157.7)	(139.5)
Other income	3.0	2.5
Net interest expense	<u>(29.9)</u>	<u>(25.9)</u>
Earnings before tax	<u>\$ 77.9</u>	<u>62.7</u>
Balance sheet data:		
Current assets	\$ 30.2	33.1
Noncurrent assets	<u>1,153.7</u>	<u>927.3</u>
Total assets	<u>\$ 1,183.9</u>	<u>960.4</u>
Current liabilities	\$ 192.3	66.6
Long-term debt	448.5	448.2
Other noncurrent liabilities	6.4	12.9
Members' equity	<u>536.7</u>	<u>432.7</u>
Total liabilities and members' equity	<u>\$ 1,183.9</u>	<u>960.4</u>

WISCONSIN PUBLIC POWER INC.

Notes to Financial Statements

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(6) Long-term Debt

The following Power Supply System Revenue Bonds were issued to finance WPPI's acquisition and construction of utility plants:

	2004	2003
Revenue bonds:		
2003 Series A 3.00% to 5.25%		
Due July 1, 2004-2033	80,630,000	86,990,000
2003 Series B variable rate bonds		
Due July 1, 2004-2021	65,500,000	65,700,000
2003 Series C variable rate bonds		
Due July 1, 2004-2023	37,925,000	39,350,000
Total bonds outstanding	184,055,000	192,040,000
Less: Current maturities	5,600,000	7,985,000
Unamortized discount/premium, net	20,181,268	22,020,433
	\$ 158,273,732	162,034,567

The Power Supply System Revenue Bonds are secured by all funds and revenues of WPPI derived from the ownership and operation of its power supply system.

The unamortized discount/premium, which includes the unamortized difference between the reacquisition price and the net carrying amount of refunded debt issues, is amortized over the terms of the related bond issues using a method that approximates the effective-interest method.

During 2003, \$63,715,000 of the Power Supply System Revenue Bonds, Series 2003A, was issued to refund \$2,145,000 of outstanding Series 1991A bonds, \$32,205,000 of Series 1993A bonds, and \$37,200,000 of Series 1993B bonds. The refunded bonds were called in July 2003 and are no longer outstanding. The refunding resulted in a difference between the reacquisition price and the net carrying amount of the refunded debt of \$12,774,840. This difference, reported in the accompanying financial statements as a reduction in the carrying amount of bonds payable, is being amortized through the term of the refunded debt, which ends in 2014. WPPI completed the refunding to reduce its total debt service payments over the next 11 years by approximately \$7,934,000 and to obtain an economic gain of approximately \$5,530,000.

During 2003, \$65,700,000 of Variable Rate Power Supply System Revenue Bonds, Series 2003B, were issued to refund \$62,705,000 of outstanding Series 1993A bonds. The refunded bonds were called on July 1, 2003 and are no longer outstanding. The refunding resulted in a difference between the reacquisition price and the net carrying amount of the refunded debt of \$11,477,062. This difference, reported in the accompanying financial statements as a reduction in the carrying amount of bonds payable, is being amortized through the term of the refunding debt, which ends in 2021. WPPI completed the refunding to reduce its total debt service payments over the next 17 years by approximately \$12,338,000 and to obtain an economic gain of approximately \$8,685,000.

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Notes to Financial Statements

December 31, 2004 and 2003

During 2003, \$39,350,000 of Variable Rate Power Supply System Revenue Bonds, Series 2003C, were issued to advance refund \$34,875,000 of outstanding Series 1996A bonds. The bond proceeds were placed along with other sources of funds in an irrevocable trust with an escrow agent to provide for all future debt service payments on the refunded bonds. Accordingly, the refunded bonds are considered defeased and have been removed from the financial statements. The advance refunding resulted in a difference between the reacquisition price and the net carrying amount of the refunded debt of \$6,712,464. This difference, reported in the accompanying financial statements as a reduction in the carrying amount of bonds payable, is being amortized through the term of the refunding debt, which ends in 2023. WPPI completed the advance refunding to reduce its total debt service payments over the next 19 years by approximately \$5,284,000 and to obtain an economic gain of approximately \$3,969,000.

A total of \$33,890,000 of defeased debt remained outstanding at December 31, 2004 from advance refundings entered into by WPPI.

Long-term liability activities for the years ended December 31, 2004 and 2003 were as follows:

Long-term liabilities as of December 31, 2004	Beginning balance	Additions	Reductions	Ending balance
Long-term revenue bonds	\$ 192,040,000	—	(7,985,000)	184,055,000
Less:				
Current maturities	7,985,000	—	(2,385,000)	5,600,000
Unamortized discount/premium, net	22,020,433	—	(1,839,165)	20,181,268
Long-term revenue bonds, net	<u>\$ 162,034,567</u>	<u>—</u>	<u>(3,760,835)</u>	<u>158,273,732</u>
Deferred credits and other liabilities:				
Operating reserves and accrued liabilities	\$ 14,769,507	5,029,058	(10,716,638)	9,081,927
Rate stabilization	37,694,606	449,840	(3,016,600)	35,127,846
Asset retirement obligation	1,720,065	86,003	—	1,806,068
Total deferred credits and other liabilities	<u>\$ 54,184,178</u>	<u>5,564,901</u>	<u>(13,733,238)</u>	<u>46,015,841</u>

WISCONSIN PUBLIC POWER INC.

Notes to Financial Statements

December 31, 2004 and 2003

Long-term liabilities as of December 31, 2003	Beginning balance	Additions	Reductions	Ending balance
Long-term revenue bonds	\$ 174,925,000	192,040,000	(174,925,000)	192,040,000
Less:				
Current maturities	5,795,000	2,190,000	—	7,985,000
Unamortized discount/premium, net	17,992,871	11,767,720	(7,740,158)	37,500,749
Long-term revenue bonds, net	<u>\$ 151,137,129</u>	<u>178,082,280</u>	<u>(167,184,842)</u>	<u>146,554,251</u>
Deferred credits and other liabilities:				
Operating reserves and accrued liabilities	\$ 9,185,511	5,583,996	—	14,769,507
Rate stabilization	32,909,772	4,784,834	—	37,694,606
Decommissioning reserve	1,374,170	—	(1,374,170)	—
Asset retirement obligation	—	1,720,065	—	1,720,065
Total deferred credits and other liabilities	<u>\$ 43,469,453</u>	<u>12,088,895</u>	<u>(1,374,170)</u>	<u>54,184,178</u>

Debt service payments on the outstanding bonds and the interest rate swap agreements (see note 7) are as follows:

Year	Principal	Interest	Total
2005	\$ 5,600,000	7,342,681	12,942,681
2006	8,585,000	7,103,162	15,688,162
2007	6,085,000	6,712,168	12,797,168
2008	9,325,000	6,445,595	15,770,595
2009	6,755,000	6,023,118	12,778,118
2010-2014	46,915,000	21,644,614	68,559,614
2015-2019	63,675,000	14,467,620	78,142,620
2020-2024	26,400,000	5,041,969	31,441,969
2025-2029	5,390,000	2,165,500	7,555,500
2030-2033	5,325,000	685,250	6,010,250
	<u>\$ 184,055,000</u>	<u>77,631,677</u>	<u>261,686,677</u>

(7) Interest Rate Swap Agreement

During 2003, WPPI entered into two interest rate swap agreements with Bear Stearns. Interest rate swaps involve the contractual exchange of fixed- and floating-rate interest payment obligations based on a notional principal amount. WPPI entered into the interest rate swap agreements to manage interest rate risk caused by fluctuations in interest rates. The interest rate swap agreement dated February 6, 2003 has a notional amount of \$65,700,000. The interest rate swap agreement dated May 30, 2003 has a notional amount of \$39,350,000. WPPI is a receiver of floating-rate interest and a payer of a fixed-rate interest on both agreements. The fixed rates of interest were 3.355% and 2.805%, respectively. As of December 31,

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2004, the interest rate swaps had a negative fair value of \$280,985 and an accumulated net unrealized loss of \$783,668, as shown on the statements of revenue, expenses, and changes in net assets.

(8) Available Financing

During 2004, WPPI entered into a revolving line of credit agreement with a financial institution, which permits borrowings of up to \$5,000,000 and expires on May 31, 2005. Interest accrued on the unpaid principal amount outstanding at a rate per annum equal to the applicable British Bankers' Association LIBOR rate for deposits in U.S. dollars and the prime rate minus 175 points. The interest rate was 3.5% at December 31, 2004. At December 31, 2004, there were no amounts outstanding on the line of credit.

On February 17, 2005, the revolving line of credit was increased to \$10,000,000 and the expiration date was extended to May 31, 2006.

(9) Significant Members

Two significant members of WPPI accounted for \$49,489,096 and \$46,542,685 or approximately 22.5% and 22.0% of total sales revenues for the years ended December 31, 2004 and 2003, respectively.

(10) Employee Benefits

(a) Retirement Plan

WPPI has a Simplified Employee Pension-Individual Retirement Account (SEP-IRA) covering all of its employees funded through contributions by WPPI to an investment firm. The total contributions to the plan for the years ended December 31, 2004 and 2003 were \$546,206 and \$494,725, respectively.

(b) Retention Plan

In 1999, WPPI established an employee retention plan. The plan will make payments to specific employees after three, five, and eight years of continuing employment. Plan benefit expenses of \$189,601 and \$266,922 were accrued during 2004 and 2003, respectively. Total plan expenses in years one through eight of the program are expected to be approximately \$1.83 million.

(11) Commitments

WPPI has various long-term capacity and energy purchase contracts with various power suppliers. Capacity purchases for 2004 and 2003 totaled approximately 643 and 650 MW, respectively. WPPI does not own any transmission facilities and takes service for all of its transmission requirements under contracts and tariffs approved by FERC.

(12) Risk Management

WPPI is exposed to various risks of loss related to torts; theft of, damage to, or destruction of assets; errors and omissions; workers' compensation; and health care of its employees. The generating plants are covered by insurance, including property and boiler and machinery policies, with deductibles. Deductibles equal

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200,000 per occurrence on Boswell Unit 4, \$1.5 million per occurrence for the South Fond du Lac units, and \$500,000 per occurrence on the Kaukauna combustion turbine. Other risks are covered through the purchase of commercial insurance, with minimal deductibles.

WPPI maintains assets in the Self-Insurance Fund described in note 3 to be applied to the payment of claims and losses arising from hazards and risks to the extent that insurance does not cover such claims or losses. In December 2003, South Fond du Lac Unit 1 was damaged as a result of a mechanical failure. Costs of repair not covered by insurance are expected to be paid from the Self-Insurance Fund. Additions to the self-insurance liability in 2004 and 2003 pertain to this event.

Following is the activity for the self-insurance liability for the years ended December 31, 2004 and 2003:

	<u>2004</u>	<u>2003</u>
Self-insurance liability, beginning of year	\$ 3,567,011	2,170,788
Additions, representing interest	58,006	53,563
Additions	950,000	1,342,660
Usage	<u>(1,700,000)</u>	<u>—</u>
Self-insurance liability, end of year	<u>\$ 2,875,017</u>	<u>3,567,011</u>