

WISCONSIN PUBLIC POWER INC.

Management's Discussion and Analysis

December 31, 2004 and 2003

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>\$ 51,113,300</u>	<u>47,013,300</u>	<u>4,100,000</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.