

**WISCONSIN PUBLIC POWER INC.**

Management's Discussion and Analysis

December 31, 2005 and 2004

**Financial Statement Overview**

This discussion and analysis provides an overview of the financial performance of Wisconsin Public Power Inc. (WPPI) for the years ended December 31, 2005 and 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 U.S. generally accepted accounting principles.

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

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**Financial Changes in 2005 from 2004**

The following table summarizes the financial position of WPPI as of December 31, 2005 and 2004:

**Condensed Balance Sheets**

Assets	2005	2004	Dollar change	Percentage change
Capital assets, net of accumulated depreciation	\$ 152,374,780	129,727,892	22,646,888	17.5%
Noncurrent assets	256,907,013	82,119,841	174,787,172	212.8
Deferred costs	29,974,277	27,171,118	2,803,159	10.3
Current assets	<u>102,961,808</u>	<u>44,639,286</u>	<u>58,322,522</u>	130.7
Total assets	<u>\$ 542,217,878</u>	<u>283,658,137</u>	<u>258,559,741</u>	91.2
<b>Liabilities and Net Assets</b>				
Long-term debt	\$ 393,566,717	158,273,732	235,292,985	148.7
Rate stabilization	35,756,677	35,127,846	628,831	1.8
Other deferred credits and liabilities	12,869,345	11,168,980	1,700,365	15.2
Current liabilities	<u>42,282,486</u>	<u>27,974,279</u>	<u>14,308,207</u>	51.1
Total liabilities	<u>484,475,225</u>	<u>232,544,837</u>	<u>251,930,388</u>	108.3
<b>Net assets</b>				
Invested in capital assets, net of related debt	(75,014,999)	(30,460,234)	(44,554,765)	146.3
Restricted	107,860,040	53,218,725	54,641,315	102.7
Unrestricted	<u>24,897,612</u>	<u>28,354,809</u>	<u>(3,457,197)</u>	(12.2)
Total net assets	<u>57,742,653</u>	<u>51,113,300</u>	<u>6,629,353</u>	13.0
Total liabilities and net assets	<u>\$ 542,217,878</u>	<u>283,658,137</u>	<u>258,559,741</u>	91.2

**Total Assets**

Total assets increased by approximately \$258.6 million due primarily to WPPI issuing \$236.92 million in bonds, including a premium of approximately \$5.2 million, for total proceeds of approximately \$242.1 million, to fund the acquisition of an approximately 51 MW share in each of Elm Road Generating Station Units 1 and 2 that are being constructed in Oak Creek, Wisconsin. Construction started in mid-2005 and is expected to continue through mid-2009 for Unit 1 and mid-2010 for Unit 2. WPPI has budgeted \$210.5 million for estimated construction costs and contingencies, which will be funded by bond proceeds of approximately \$193.4 million and interest earnings on the bond proceeds of approximately \$17.1 million. The remainder of the bonds were issued to cover capitalized interest of approximately \$37.0 million, a debt service reserve of approximately \$8.2 million, and costs of issuance of approximately \$3.5 million.

Each line item that is part of the condensed balance sheets in the financial statements is discussed in more detail in the following sections. All amounts have been rounded to the nearest \$0.1 million.

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#### **Capital Assets**

Capital assets net of accumulated depreciation increased by approximately \$22.6 million. Within this category, electric plant and equipment increased a net of \$0.1 million from approximately \$208.9 million in 2004 to \$209.0 million in 2005. The increase was attributable primarily to the purchase of a van to WPPI's second metering technician with a vehicle and metering equipment for WPPI metering points.

Accumulated depreciation and amortization increased from approximately \$79.2 million in 2004 to approximately \$85.3 million in 2005, or approximately \$6.1 million. Major components of this increase include approximately \$2.6 million in accumulated depreciation for Boswell 4, approximately \$1.1 million in accumulated depreciation for South Fond du Lac 1, approximately \$1.2 million in accumulated depreciation for South Fond du Lac 4, approximately \$0.8 million in accumulated depreciation for the Island Street Peaking Plant, approximately \$0.1 million in accumulated depreciation for the Worthington Wind Turbines, and approximately \$0.4 million in accumulated depreciation for computer equipment.

Construction work in progress increased by approximately \$28.6 million, from approximately \$0.1 million in 2004 to approximately \$28.7 million in 2005. Approximately \$28.1 million of the increase was construction work in progress on Elm Road Generating Station Units 1 and 2, approximately \$0.5 million of the increase was costs of preliminary work on the Prairie State Generating Project, and approximately \$0.1 million of the increase was construction work in progress on Boswell 4.

#### **Noncurrent Assets**

Total noncurrent assets increased by approximately \$174.8 million, from approximately \$82.1 million in 2004 to approximately \$256.9 million in 2005, consisting of an increase of approximately \$175.6 million in noncurrent cash and investments, a decrease of less than \$0.1 million in interest receivable, a decrease of approximately \$5.9 million in investments held, an increase of approximately \$5.3 million in the investment in the American Transmission Company, and a decrease of approximately \$0.2 million in Rate Stabilization Contributions receivable from members, as discussed in the following paragraphs.

Noncurrent restricted cash and investments increased from approximately \$48.3 million in 2004 to approximately \$223.9 million in 2005, or a total of \$175.6 million, primarily due to the issue of the series 2005 A and 2005 B bonds. Changes in the composition of noncurrent restricted cash and investments detailed in footnote 2 are discussed in the paragraphs that follow.

Cash and investments in the Renewal and Replacement Fund increased by approximately \$3.6 million from approximately \$2.3 million in 2004 to approximately \$5.9 million in 2005 as a result of deposits made during 2005 for Boswell 4, the South Fond du Lac units, and the Island Street Peaking Plant.

Cash and investments in the Self-Insurance Fund increased by approximately \$1.0 million from approximately \$2.1 million in 2004 to approximately \$3.1 million in 2005 due to deposits to the Self-Insurance Fund out of 2004 net earnings that occurred in 2005, and from interest earnings that are retained in the fund.

Cash and investments in the Rate Stabilization Fund increased by approximately \$1.7 million, from approximately \$33.7 million in 2004 to approximately \$35.4 million in 2005. The increase in cash was a result of deposits made for new Members of approximately \$0.6 million, plus continuing deposits of approximately \$0.8 million from Members that joined WPPI several years prior who opted to make Rate Stabilization Fund

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deposits on a schedule, and a deposit of approximately \$0.4 million from year-end 2004 deferrals of net income. The increases were offset slightly by mark to market calculations on investments held in the Rate Stabilization Fund, which decreased the fund by approximately \$0.2 million, resulting in the net increase, after rounding, of approximately \$1.7 million in 2005.

Cash and investments in the Decommissioning Fund increased by approximately \$0.2 million, including approximately \$0.1 million deposited from member revenues and \$0.1 million deposited from interest earnings. These deposits brought the balance to approximately \$2.3 million in 2005 from approximately \$2.1 million in 2004.

Noncurrent Construction Fund cash and investments increased by approximately \$135.0 million, from \$0.0 in 2004 to approximately \$135.0 million in 2005. These funds came from bond proceeds for the Elm Road Generating Station project.

Noncurrent Debt Service Funds cash and investments increased by approximately \$25.3 million, from \$0.0 in 2004 to approximately \$25.3 million in 2005. These funds came from bond proceeds for the Elm Road Generating Station project.

Noncurrent Debt Service Reserve Funds cash and investments increased by approximately \$8.8 million, from approximately \$8.1 million in 2004 to approximately \$16.9 million in 2005. These funds came from approximately \$8.2 million bond proceeds for the Elm Road Generating Station project and approximately \$0.6 million in interest earnings on the 2003 Series A, B, and C, and 2005 Series A and B Debt Service Reserve Funds.

Noncurrent unrestricted investments decreased by approximately \$5.9 million, from approximately \$6.6 million in 2004 to approximately \$0.7 million in 2005, as a result of investments being held closer to maturity, which reclassifies them from the noncurrent investment category to the current assets category.

Investment in the American Transmission Company increased by approximately \$5.3 million, from approximately \$27.0 million in 2004 to approximately \$32.3 million in 2005. The increase came from approximately \$4.1 million in capital contributions by WPPI during 2005, with the remainder of approximately \$1.2 million representing 2005 earnings allocations that were retained by ATC and increased WPPI's ownership.

Noncurrent receivables from Members decreased by approximately \$0.2 million, from approximately \$0.2 million to just above \$0. The decrease was attributable to Plymouth Utilities making its final payments to the Rate Stabilization Fund as a new Member. Payments to the fund due from Oconto Falls, Prairie du Sac, and Reedsburg were moved to current receivables because they will be collected in 2006.

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#### **Deferred Costs**

Unamortized bond issuance costs increased approximately \$3.3 million, from approximately \$2.6 million in 2004 to approximately \$5.9 million in 2005 as a result of approximately \$3.5 million in unamortized costs from the 2005 A and B bond issues, less approximately \$0.2 million in 2003 A, B, and C costs that were amortized in 2005.

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, as allowed through the application of provisions under SFAS No. 71. Future recoverable costs increased by approximately \$0.7 million during 2005.

Other deferred charges decreased by approximately \$1.1 million, from approximately \$4.2 million in 2005 to approximately \$3.1 million in 2004, primarily as the result of amortizing approximately \$0.8 million for termination of a power purchase agreement with Menasha Utilities that started being amortized in 2005 on a 55-month amortization schedule, \$0.2 million in amortization for a capacity buyout agreement with Kaukauna Utilities that started in 2002 and is being amortized over 60 months.

#### **Current Assets**

Cash and investments increased approximately \$3.1 million, from approximately \$15.1 million in 2004 to approximately \$18.2 million in 2005. The total included \$6.5 million from WPPI's line of credit with Chase Bank.

Restricted cash and investments increased approximately \$45.3 million, from approximately \$6.0 million in 2004 to approximately \$51.3 million in 2005. The increase was attributable to cash from bond proceeds for construction funds expected to be used within 12 months of December 31, 2005 of approximately \$32.8 million, and capitalized interest due within 12 months of December 31, 2005 of approximately \$12.5 million.

Power sales accounts receivable increased approximately \$9.8 million, from approximately \$17.8 million in 2004 to approximately \$27.6 million in 2005. The increase was attributable to the higher cost of purchased power during December 2005, which was reflected on member invoices.

Other receivables decreased by approximately \$2.1 million, from slightly less than \$2.5 million in 2004 to approximately \$0.3 million in 2005. The decrease is a result of receivables from Members who joined in 2001 and 2002 being paid off in an amount of approximately \$0.7 million, and a decrease of approximately \$1.6 million in miscellaneous receivables consisting primarily of approximately \$1.4 million from Alliant Energy for overhaul costs of South Fond du Lac Combustion Turbine 4 and the remainder in numerous other smaller items.

Unrestricted interest receivable decreased by approximately \$0.1 million, from approximately \$0.4 million in 2004 to approximately \$0.3 million in 2003, primarily as a result of interest on the 2003 A, B, and C Debt Service Reserve Funds, which goes to the Revenue Fund, not being received by year-end 2004, but being received as the close of business in 2005.

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Restricted interest receivable increased approximately \$1.5 million, from just over \$0.0 million in 2004 to approximately \$1.5 million in 2005, primarily reflecting the reinvestment of interest earnings through December 31, 2005 on the 2005 A and B funds, which is restricted to those funds.

Inventories increased by approximately \$0.8 million, from approximately \$2.6 million in 2004 to approximately \$3.4 million in 2005 as a result of fuel stock increases at Boswell 4 and the Island Street Peaking Plant.

Prepayments increased less than \$0.1 million, rising from just over \$0.3 million in 2004 to just under \$0.4 million in 2005 primarily as a result of just over \$70,000 in January 2006 health insurance premiums paid in December 2005.

#### **Total Liabilities**

Total liabilities increased by approximately \$251.9 million due primarily to WPPI issuing \$236.92 million in bonds to fund the acquisition of an approximately 51 MW share in each of Elm Road Generating Station Units 1 and 2. WPPI has budgeted \$210.5 million for estimated construction costs and contingencies, which will be funded by bond proceeds of approximately \$193.4 million and interest earnings on the bond proceeds of approximately \$17.1 million. The remainder of the bonds were issued to cover capitalized interest of approximately \$37.0 million, a debt service reserve of approximately \$8.2 million, and costs of issuance of approximately \$3.5 million. Each line item that is part of the condensed balance sheets is discussed in more detail in the following sections.

#### **Long-Term Debt**

Revenue bonds net of unamortized premium increased by approximately \$235.3 million, from approximately \$158.3 million in 2004 to \$393.6 million in 2005. This increase included approximately \$236.9 million in new long-term debt for 2005 Series A and B, and approximately \$5.2 million for unamortized premium for Series 2005 A and B, amortization of the loss on reacquired debt for 2003 Series A, B and C of approximately \$1.3 million, the amortization of the loss on reacquired debt for 1993 Series A and B of approximately \$1.3 million. Decreases in the account included approximately \$0.9 million for amortization of the premium on Series 2003 A and the reclassification of approximately \$8.6 million in 2003 Series A, B and C principal to short-term debt.

#### **Rate Stabilization Fund**

The Rate Stabilization Fund increased by approximately \$0.6 million, from approximately \$35.1 million in 2004 to approximately \$35.8 million in 2005, due to payments from new Members.

#### **Other Deferred Credits and Liabilities**

Operating reserves and accrued liabilities increased approximately \$0.7 million, from approximately \$9.1 million in 2004 to approximately \$9.7 million in 2005. Increases included Renewal and Replacement Fund deposits for South Fond du Lac 1 of approximately \$0.7 million, South Fond du Lac 4 of approximately \$0.4 million, and the Self-Insurance Fund of approximately \$0.1 million, and Post Retirement Obligation and other miscellaneous accruals of approximately \$0.2 million. Decreases included use of approximately \$0.5 million in the Renewal and Replacement Fund for Boswell 4 for repairs during 2005, and Employee Retention Plan Fund payments.

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The fair value of interest rate swap agreements decreased approximately \$0.9 million, from approximately negative \$0.3 million to approximately negative \$1.2 million as a result of a combination of swap value changes and recording of the 2005 B swap. The 2003 B swap increased in market value by approximately \$0.6 million, from approximately negative \$1.2 million in 2004 to approximately negative \$0.6 million in 2005. The 2003 C swap increased in market value by approximately \$0.3 million, from approximately \$0.9 million in 2004 to approximately \$1.2 million in 2005. The 2005 B swap was recorded at an initial value of approximately negative \$1.9 million on December 31, 2005. The value of the swaps to WPPI reflects changes in interest rates. If interest rates rise, the swaps will generally gain value, and if interest rates fall, the swaps will generally lose value.

The asset retirement obligation, which is the accrual of funds for retirement of the ash ponds at Boswell 4, increased approximately \$0.1 million as a result of monthly deferrals to the fund from ongoing revenue, plus interest earnings on the funds that remain in the fund.

#### **Current Liabilities**

Current maturities of long-term debt increased approximately \$3.0 million, from approximately \$5.6 million in 2004 to approximately \$8.6 million in 2005. Increases in the account reflected reclassification of approximately \$8.6 million in 2003 Series A, B and C maturities from long-term debt to short-term debt, and retirement of approximately \$5.6 million in 2003 Series A, B and C maturities.

Interest accrued increased by approximately \$1.1 million, from approximately \$2.3 million in 2004 to approximately \$3.4 million in 2005. This amount increased by approximately \$1.5 million for interest expense for 2005 Series A and B, offset by a decrease of approximately \$0.4 million for interest expense due on 2003 Series A, B and C.

The line of credit balance outstanding increased by \$6.5 million, from \$0.0 million in 2004 to \$6.5 million in 2005. WPPI established a \$5.0 million line of credit in June 2004 with Chase Bank, and increased it to \$10.0 million in March 2005.

Accounts payable increased by approximately \$6.5 million, from approximately \$16.2 million in 2004 to approximately \$22.3 million in 2005. The increase was attributable to the higher purchased power expense in the second half of 2005. WPPI also accrued approximately \$0.3 million for the Prairie State Energy Campus project for payment required with the Initial Interest Acquisition Notice, which was issued on December 30, 2005.

Other current liabilities decreased by approximately \$2.7 million, from approximately \$3.9 million in 2004 to approximately \$1.1 million in 2005. The majority of the decrease was due to the payment in 2005 of \$2.5 million to Menasha Utilities for the buyout of an output contract, and a lowering of the SEP-IRA Retirement Plan contribution liability of approximately \$0.2 million due to a shift in 2005 to monthly deposits from biannual deposits.

#### **Net Assets**

Net Assets invested in capital assets, net of related debt decreased by approximately \$44.6 million, from approximately negative \$30.5 million in 2004 to approximately negative \$75 million in 2005. The change was a result of a decrease in net electric plant and equipment of approximately \$6.0 million, an increase in unamortized bond issuance costs of \$3.3 million, and an increase in long-term debt of approximately \$236.1 million, offset by

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an increase in construction work in progress of approximately \$28.7 million and an increase in funds available for construction of approximately \$167.8 million.

Restricted net assets increased by approximately \$54.6 million, from approximately \$53.2 million in 2004 to approximately \$107.9 in 2005. The change was a result of an increase in total noncurrent restricted cash and investments of approximately \$175.6 million, an increase in restricted interest receivable of approximately \$1.5 million, and an increase in current restricted cash and investments of approximately \$45.3 million, less an increase for construction funds of approximately \$167.8 million, which must be subtracted because it is used to calculate net assets invested in capital assets, net of related debt.

Unrestricted net assets decreased by approximately \$3.5 million, from approximately \$28.4 million in 2004 to approximately \$24.9 million in 2005. This amount is the remainder of retained earnings after computing the value of net assets invested in capital assets, net of related debt and restricted net assets.

Total net assets increased by approximately \$6.6 million, from approximately \$51.1 million in 2004 to approximately \$57.7 million in 2005. The increase was a result of the change in net assets during 2005 from continuing operations. The change in net assets is described in further detail in the discussion of the Condensed Statements of Revenues, Expenses and Changes in Net Assets for 2005 and 2004.

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The following table summarizes the changes in financial position for WPPI for the years ended December 31, 2005 and 2004:

#### Condensed Statements of Revenues, Expenses, and Changes in Net Assets for the Periods Ended December 31, 2005 and 2004

	<u>2005</u>	<u>2004</u>	<u>Dollar change</u>	<u>Percentage change</u>
Operating revenues	\$ 306,111,928	223,028,979	83,082,949	37.3%
Operating expenses	<u>296,977,487</u>	<u>214,692,925</u>	<u>82,284,562</u>	38.3
Operating income	9,134,441	8,336,054	798,387	9.6
Net investment income, equity in earnings of ATC, and unrealized loss on interest rate swap agreements	7,846,430	5,344,627	2,501,803	46.8
Interest expense and debt-related expenses	(10,920,999)	(9,989,948)	(931,051)	9.3
Other nonoperating expenses	<u>(81,129)</u>	<u>(147,092)</u>	<u>65,963</u>	(44.8)
Change in net assets before future recoverable costs	5,978,743	3,543,641	2,435,102	68.7
Future recoverable costs	<u>650,610</u>	<u>556,359</u>	<u>94,251</u>	16.9
Change in net assets	6,629,353	4,100,000	2,529,353	61.7
Net assets, beginning of year	<u>51,113,300</u>	<u>47,013,300</u>	<u>4,100,000</u>	8.7
Net assets, end of year	<u>\$ 57,742,653</u>	<u>51,113,300</u>	<u>6,629,353</u>	13.0

#### Operating Revenues

2005 was a year that saw rapidly rising purchased power costs, particularly in the second half of the year. As WPPI purchased more expensive power to meet member demand, revenues increased correspondingly with those costs as WPPI billed members for the cost of purchased power. Total operating revenues increased approximately \$83.1 million, or approximately 37.3%, from approximately \$223.0 million in 2004 to approximately \$306.1 million in 2005.

Included in operating revenues are sales to members, sales to others, and other income. All amounts have been rounded to the nearest \$0.1 million.

Sales to members increased approximately \$57.5 million, or approximately 29.2%, from approximately \$196.4 million in 2004 to approximately \$254.0 million in 2005. Megawatt hour sales to members increased approximately 7.8%, from 4,585,942 in 2004 to a total of 4,941,385 in 2005. New Members Juneau, New Glarus and Mt. Horeb accounted for approximately 2.0% of the megawatt hour increase, with the remaining 5.8% increase in megawatt hours attributable to requirements from existing members. Approximately \$42.0 million, or approximately 21.3%, of the increased revenue was attributable to billing for higher purchased power costs to serve members.

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There was no Rate Stabilization Fund use in 2005, whereas approximately \$3.0 million was utilized in 2004 to offset in part the cost of replacement power purchased during an unplanned outage at Boswell 4.

Sales to others increased approximately \$28.4 million, or approximately 124.8%, from approximately \$22.8 million in 2004 to approximately \$51.2 million in 2005. Sales of generation into the Midwest Independent System Operator Day 2 Market totaled approximately \$27.0 million, and accounted for the bulk of the increase. These sales occurred after the start of the Day 2 Market on April 1, 2005. Total sales to other customers accounted for the remaining approximately \$1.8 million increase in sales to others.

Other income increased approximately \$0.1 million driven primarily by an increase in revenue from the Worthington Wind Turbines of approximately \$0.1 million.

#### **Operating Expenses**

Total operating expenses increased approximately \$82.3 million, or approximately 38.3%, from approximately \$214.7 million in 2004 to approximately \$297.0 million in 2005. The increase in operating expenses was driven primarily by the higher purchased power costs.

Purchased power expense, which includes purchased power and transmission expenses, increased approximately \$64.7 million, or approximately 35.7%, from approximately \$181.2 million in 2004 to approximately \$245.9 million in 2005. The purchased power expense portion of this line item increased approximately \$61.6 million, or approximately 38.4%, from approximately \$160.2 million in 2004 to approximately \$221.8 million in 2005, primarily due to higher fuel prices. The transmission expense portion of this line item increased by approximately \$3.1 million, or approximately 15.0%, from approximately \$20.9 million in 2004 to approximately \$24.0 million in 2005, primarily due to an increase in rates.

Fuel expense increased approximately \$16.6 million, from approximately \$8.5 million in 2004 to approximately \$25.1 million in 2005. Part of the increase was attributable to WPPI's Boswell 4 and South Fond du Lac Units 1 and 4 returning to normal levels of operation in 2005, after experiencing unplanned outages that necessitated major repairs in 2004. Fuel expense was approximately \$18.0 million in 2003, which was a more typical year of operations. The additional increase in 2005 over the 2004 and 2003 levels was attributable to higher costs for natural gas.

Other power production expense decreased by approximately \$0.3 million, or approximately 6.0%, from approximately \$5.3 million in 2004 to approximately \$4.9 million in 2005. The reduction reflected lower maintenance costs at Boswell 4 and South Fond du Lac Units 1 and 4 due to the extensive maintenance performed in 2004.

Administrative and general expense increased by approximately \$0.5 million, or approximately 4.2%, from approximately \$11.3 million in 2004 to approximately \$11.8 million in 2005. Salary and benefits made up approximately 59% of all administrative and general expense. Those categories increased by approximately 7.3% in 2005 over 2004 due to an increase of 2 staff members, increases in salaries, and health insurance premium increases of approximately 19.5%.

Depreciation and amortization expense increased approximately \$0.6 million, from approximately \$6.0 million in 2004 to approximately \$6.6 million in 2005. The increase was due primarily to the Island Street Peaking Plant being in operation for all of 2005—the plant was operational as a new plant for May through December of 2004.

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Island Street depreciation increased approximately \$0.4 million. Boswell 4 had an increase of approximately \$0.1 million, and other WPPI generation units accounted for the remaining approximately \$0.1 million increase.

Tax expense increased approximately \$0.1 million, from approximately \$2.5 million in 2004 to approximately \$2.6 million in 2005. The increase was a result of the Island Street Peaking Plant being in operation for all 12 months of 2005, after being operational as a new plant for only a partial year in 2004.

#### **Nonoperating Revenues (Expenses)**

Investment income increased approximately \$1.9 million, from approximately \$2.2 million in 2004 to approximately \$4.1 million in 2005. The majority of the increase was from the reinvestment of the 2005 A and B bond proceeds for the last two months of 2005. Reinvestment of bond proceeds increased investment income approximately \$1.6 million in 2005. The investment income from the bond proceeds is being used to fund the construction of Elm Road Generating Station Units 1 and 2, and pay for a portion of capitalized interest during construction of the units, as outlined in the plan of finance for the units. The remaining approximately \$0.3 million in increased investment income was attributable to WPPI investment activities. WPPI maintains a laddered portfolio of investments to maximize interest earnings. A portion of the total investments is scheduled to mature each year. In 2005, WPPI was able to reinvest the proceeds from matured investments at higher interest rates than those funds had previously been invested in, which generated additional investment income over the investment income in 2004.

Equity in earnings of ATC (American Transmission Company) increased by approximately \$0.8 million, from approximately \$4.2 million in 2004 to approximately \$5.1 million in 2005. WPPI maintains an ownership share of approximately 5.2%. WPPI's equity in the earnings of ATC increased in 2005 as a result of higher earnings at ATC during 2005 compared with 2004.

Unrealized loss on interest rate swap agreement increased by approximately \$0.1 million, from approximately \$0.8 million in 2004 to approximately \$0.9 million in 2005. The unrealized loss is the net result of mark to market calculations for WPPI's three floating to fixed rate swaps.

WPPI's 2003B transaction, which had an original notional amount of \$65.7 million, had a notional amount of \$65.1 million at the end of 2005. The fair value of this swap increased approximately \$0.6 million, from approximately negative \$1.2 million in 2004 to approximately negative \$0.6 million in 2005.

WPPI's 2003C transaction, which had an original notional amount of \$39.35 million, had a notional amount of \$37.925 million at the end of 2005. The fair value of this swap increased approximately \$0.3 million, from approximately \$0.9 million in 2004 to approximately \$1.2 million in 2005.

WPPI's 2005B transaction, which had an original notional amount of \$93.9 million, had a notional amount of \$93.9 million at the end of 2005. The fair value of this swap was recorded for the first time in 2005 at approximately negative \$1.9 million.

The net result of marking the three swap transactions to market as of December 31, 2005 was the recognition of an unrealized loss of approximately \$0.9 million in 2005.

Net decrease in fair value of investments increased by approximately \$0.1 million, from approximately \$0.3 million in 2004 to approximately \$0.4 million in 2005. WPPI has an investment policy of purchasing highly

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rated investments and holding them to maturity. The investment portfolio is structured in a laddered format to have investments of varying maturity dates.

Interest expense increased approximately \$1.1 million, from approximately \$7.9 million in 2004 to approximately \$9.0 million in 2005. The increase was due to interest expense of approximately \$1.8 million on WPPI's Series 2005 A and B bonds, which were issued on November 2, 2005 to fund the Elm Road Generating Station construction project. This amount was offset by a slight decline in interest expense on WPPI's Series 2003 A, B and C issues due to scheduled retirement of bond principal, and approximately \$0.5 million in allowance for funds used during construction attributable to the Elm Road Generation Station construction.

Amortization of debt related costs decreased by approximately \$0.1 million, from approximately \$2.1 million in 2004 to approximately \$2.0 million in 2005. The decrease was in accordance with amortization schedules for the Series 2003 A, B and C debt related costs.

#### **Future Recoverable Costs**

Future recoverable costs increased approximately \$0.1 million, from approximately \$0.6 million in 2004 to approximately \$0.7 million in 2005. Future recoverable costs is a calculation designed to ensure that rate payers are not charged for both depreciation on an asset and principal payments on the bonds issued to acquire the asset in the same year. The calculation ensures that the combination of interest payments, principal payments, and depreciation expense are leveled over the life of an asset. In that manner, rates to pay for the asset are relatively level from year to year. In the early years of an asset, the calculation will result in an addition to income and assets. As principal is retired, the calculation will result in a reduction to income and a reduction in the accrued asset. WPPI added new debt service accruals in 2005 for the 2005A and 2005B bonds, resulting in an increase in future recoverable costs of approximately \$0.1 million.

#### **Change in Net Assets**

Change in net assets increased by approximately \$2.5 million, from \$4.1 million in 2004 to approximately \$6.6 million in 2005. The change is the net result of revenues and other income minus expenses and other costs as described in the sections above.

Total net assets at the end of 2005 were approximately \$57.7 million, up from approximately \$51.1 million at the end of 2004.

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**Financial Changes in 2004 from 2003**

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

**Condensed Balance Sheets**

Assets	2004	2003	Dollar change	Percentage change
Capital assets, net of accumulated depreciation	\$ 129,727,892	127,825,548	1,902,344	1.5%
Noncurrent assets	82,119,841	86,179,456	(4,059,615)	(4.7)
Deferred costs	27,171,118	23,834,684	3,336,434	14.0
Current assets	44,639,286	53,661,048	(9,021,762)	(16.8)
Total assets	<u>\$ 283,658,137</u>	<u>291,500,736</u>	<u>(7,842,599)</u>	(2.7)
<b>Liabilities and Net Assets</b>				
Long-term debt	\$ 158,273,732	162,034,567	(3,760,835)	(2.3)
Rate stabilization	35,127,846	37,694,606	(2,566,760)	(6.8)
Other deferred credits and liabilities	11,168,980	16,489,572	(5,320,592)	(32.3)
Current liabilities	27,974,279	28,268,691	(294,412)	(1.0)
Total liabilities	<u>232,544,837</u>	<u>244,487,436</u>	<u>(11,942,599)</u>	(4.9)
Net assets:				
Invested in capital assets, net of related debt	(30,460,234)	(47,255,272)	16,795,038	(35.5)
Restricted	53,218,725	61,219,993	(8,001,268)	(13.1)
Unrestricted	28,354,809	33,048,579	(4,693,770)	(14.2)
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>\$ 283,658,137</u>	<u>291,500,736</u>	<u>(7,842,599)</u>	(2.7)

Total assets decreased approximately \$7.8 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 Renewal & Replacement Fund was utilized to perform accelerated maintenance during the outages in addition to required repairs. Approximately \$3.0 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 \$11.9 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 \$3.0 million use of the fund described above, followed by a partial replenishment of approximately \$450,000 at year-end.

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Other deferred credits and liabilities decreased by approximately \$5.6 million due primarily to utilization of Self-Insurance and Renewal & Replacement funds as described above.

Net assets of WPPI totaled approximately \$51.1 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 Renewal & Replacement 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 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 \$1.0 million insurance deductible. WPPI paid for its 20% share of the deductible

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utilizing monies in the Self-Insurance Fund. These actions reduced the Self-Insurance Fund from approximately \$3.7 million to approximately \$2.0 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 \$3.0 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 8–10 years. The accelerated maintenance was paid for utilizing the Renewal & Replacement 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 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 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 Renewal & Replacement 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. \$4,100,000 was retained 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 \$3.0 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

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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, WI 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 \$25.0 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 for the Periods Ended December 31, 2004 and 2003**

	<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>	100.0
Change in net assets	4,100,000	10,716,252	(5,990,578)	(55.9)
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

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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 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 & Replacement 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, WI 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 returned to a more typical level of approximately \$800,000 in 2004 compared to 2003 when approximately \$12.0 million was received due to over \$11.0 million in one-time revenues from the negotiated buyout of a power supply contract in the amount of \$8.65 million plus approximately \$2.4 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 Inter Bank Offering Rate (LIBOR). Overall interest expense is approximately \$3.0 million less than would otherwise have been incurred as a result of the refinancing and defeasance of higher rate fixed rate debt accomplished in 2003.

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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.

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 \$567,967.25. 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.

#### **Contact Information**

This financial report is designed to provide a general overview of WPPI's finances. Questions or requests for additional information should be addressed to the VP Corporate Services, 1425 Corporate Center Drive, Sun Prairie, WI 53590.