

MANAGEMENT DISCUSSION AND ANALYSIS

WISCONSIN PUBLIC POWER INC.

Management Discussion and Analysis

December 31, 2007 and 2006

Financial Statement Overview

Wisconsin Public Power Inc. (WPPI) discusses and analyzes the condensed financial statements for the years ended December 31, 2007 and 2006 in this overview. 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 following. The Statement of Net Assets 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 reports revenues and expenses for the current year. The Statement of Cash Flows reports cash receipts, cash payments, and net changes in cash.

Condensed Statement of Net Assets

(dollars in millions)

	2007	2006	2005	2007-2006 Change	2006-2005 Change
Assets					
Current assets	\$128.6	\$127.6	\$102.9	\$1.0	\$24.7
Noncurrent assets	180.5	218.7	256.9	-38.2	-38.2
Deferred costs	32.1	30.9	30.0	1.2	0.9
Capital assets, net	237.5	182.0	152.4	55.5	29.6
Total assets	<u>\$578.7</u>	<u>\$559.2</u>	<u>\$542.2</u>	<u>\$19.5</u>	<u>\$17.0</u>
Liabilities and Net Assets					
Current liabilities	\$46.9	\$34.4	\$42.3	\$12.5	-\$7.9
Deferred credits and other liabilities	55.3	51.7	48.6	3.6	3.1
Long-term debt	381.2	389.0	393.6	-7.8	-4.6
Total liabilities	483.4	475.1	484.5	8.3	-9.4
Net assets	95.3	84.1	57.7	11.2	26.4
Total liabilities and net assets	<u>\$578.7</u>	<u>\$559.2</u>	<u>\$542.2</u>	<u>\$19.5</u>	<u>\$17.0</u>

Assets

Total assets of WPPI, on December 31, 2007 were \$578.7 million, which is an increase of \$19.5 million compared to 2006. Total assets on December 31, 2006 were \$559.2 million, which is an increase of \$17.0 million compared to 2005. During 2007 and 2006 the major contributors to the change in total assets were the changes in capital assets and noncurrent assets.

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The largest increase in WPPI's assets is capital assets. Capital assets increased by \$55.5 million in 2007 and \$29.6 million in 2006 largely as a result of construction work in progress which increased \$60.0 million in 2007 and \$34.4 million in 2006, offset by normal depreciation. The increase is due to the construction of the Elm Road Project located in Oak Creek, Wisconsin. WPPI has an 8.33% ownership or approximately 51 MW in each of the two 615 MW supercritical coal-fired generators being built by Wisconsin Energy Corporation. The first unit has a guaranteed in-service date of September 29, 2009 and the second unit has a guaranteed in-service date of September 29, 2010. The Elm Road Project is on schedule at this time and is within budget. Please refer to Footnote 11 of WPPI's 2007 financials for a discussion of the current permit status of the Elm Road Project.

Noncurrent assets decreased by \$38.2 million in both 2007 and 2006. These decreases in noncurrent assets are primarily related to moving construction and funds for debt service during construction from noncurrent to current assets. The construction funds and borrowed debt service funds for the Elm Road Project are split between funds that are anticipated to be needed in the coming year (current assets) and funds needed more than one year into the future (noncurrent assets). Each year funds are moved to current assets from noncurrent assets to cover the coming year's construction needs and interest payments. WPPI moved \$54.1 million in 2007 and \$57.0 million in 2006 from noncurrent to current assets to meet the upcoming obligations associated with Elm Road.

Noncurrent assets also include WPPI's investment in the American Transmission Company LLC (ATC). WPPI continues to increase its investment in ATC. In 2007, investment in ATC increased by \$6.5 million due to capital contributions of \$4.5 million and \$2.0 million of earnings retained by ATC. Investment in ATC increased by \$11.0 million in 2006 due to \$9.4 million in capital contributions by WPPI and \$1.6 million in earnings remaining invested in ATC. WPPI had approximately a 5.5% ownership in ATC as of December 31, 2007.

Another impact on noncurrent assets in 2007 and 2006 was additions to the Renewals and Replacements Fund. In 2007, WPPI had a net increase of \$3.4 million in the Renewals and Replacements Fund. WPPI contributed \$5.0 million to the Renewals and Replacements Fund, with \$3.7 million for future capital improvements and \$1.3 million related to future long-term maintenance. The contributions were offset by \$1.6 million WPPI used in 2007 primarily for capital projects at Boswell 4. The 2007 balance in the Renewal and Replacements Fund of \$15.4 million is composed of \$8.1 million for capital projects and \$7.3 million for future long-term maintenance projects. In 2006, the Renewals and Replacements Fund increased by \$6.1 million primarily from the addition of \$5.8 million of net earnings to the Fund for future capital projects.

Current assets increased by \$1.0 million in 2007 and \$24.7 million in 2006. Moving construction and debt service funds to current assets for Elm Road as discussed above is the primary reason for the increase of \$24.7 million in 2006.

Deferred Costs increased by \$1.2 million in 2007 and \$0.9 million in 2006. The increase in both years is primarily related to the fair market value of WPPI's interest rate swaps discussed in the Liabilities section.

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Liabilities

During 2007 current liabilities increased by \$12.5 million primarily due to a \$7.5 million increase in accounts payable related to accrued purchased power expenses and Elm Road project expenditures, as well as a \$3.2 million increase in the current maturities of long-term debt. In 2006, current liabilities decreased by \$7.9 million primarily related to \$6.5 million line of credit that was paid in full and the decrease of \$2.5 million in current maturities of long-term debt.

Deferred costs (assets) and deferred credits and other liabilities (liabilities) are both impacted by the mark-to-market value of the interest rate swaps. WPPI entered into variable-to-fixed interest rate swaps to hedge the variable interest rate bond series 2003B, 2003C, and 2005B ("swaps"). In 2006, WPPI adopted the principles of regulatory asset and liability accounting in accordance with SFAS No. 71 to record the unrealized gains or losses from the annual mark-to-market calculations on interest rate swaps. In 2007, the interest rate swaps had a negative fair market value of \$3.9 million which is shown as a deferred credit. The corresponding regulatory asset is shown in deferred costs. In 2006, the interest rate swaps had a positive fair market value of \$1.7 million which is shown as a deferred cost. The regulatory liability in the same amount is shown in deferred credits. Since the fair market value went from positive to negative the net impact on deferred costs and deferred liabilities in 2007 compared to 2006 was \$2.3 million. In 2006 the net impact compared to 2005 was \$1.7 million.

Over time, WPPI has deferred revenues for the purpose of stabilizing future rates to the Rate Stabilization Fund. There were no revenues deferred to the Rate Stabilization Fund in 2007. The balance of the Rate Stabilization was \$36.6 million at the end of 2007. In 2006 new members contributed \$0.8 million to the Rate Stabilization Fund, which increased the Rate Stabilization Fund to \$36.6 million in 2006 from \$35.8 million at the end of 2005.

Long-term debt decreased by \$7.8 million in 2007 and by \$4.6 million in 2006 due to the reclassification of long-term debt to current maturities and amortizations of the premiums and losses on reacquired debt.

Change in Net Assets

The change in net assets was \$11.2 million in 2007. The increase in 2007 is primarily due to the additional revenue collected through WPPI's rates to members that were designed to collect 145% of debt service, the increase in equity in ATC that is retained in ATC and other investment income. The change in net assets was \$26.4 million in 2006. The increase in 2006 was a result of the increase in net assets from continuing operations, including \$15.4 million of one-time revenues from refunds related to the sale of the Kewaunee Nuclear Power Plant by Wisconsin Power and Light (WPL) and Wisconsin Public Service Corporation (WPS) and a refund from a WPL rate case that WPPI's Board of Directors has directed be used, in ways that will provide long term benefits for WPPI members and their customers.

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Condensed Statement of Revenues, Expenses, and Changes in Net Assets (dollars in millions)

	2007	2006	2005	2007-2006 Change	2006-2005 Change
Operating revenues	\$339.0	\$294.7	\$306.1	\$44.3	-\$11.4
Operating expenses	334.7	272.5	297.0	62.2	-24.5
Operating income	4.3	22.2	9.1	-17.9	13.1
Nonoperating revenues (expenses)	0.5	4.1	-3.1	-3.6	7.2
Future costs to be (returned) recovered	6.0	-1.1	0.6	7.1	-1.7
Cum effect of change in accounting principle	0.4	1.2	0.0	-0.8	1.2
Change in net assets	<u>\$11.2</u>	<u>\$26.4</u>	<u>\$6.6</u>	<u>-\$15.2</u>	<u>\$19.8</u>
Beginning year net assets	84.1	57.7	51.1	26.4	6.6
End of year net assets	95.3	84.1	57.7	11.2	26.4

Operating Revenue

Total operating revenues in 2007 were \$339.0 million which is a \$44.3 million or 15.0% increase from 2006. The increase in total operating revenues in 2007 was driven by the increase in revenue from sales to members¹ and sales to others, which was offset by a decrease in other income as discussed below.

Total operating revenues in 2006 were \$294.7 million which is an \$11.4 million or 3.7% decrease from 2005. The decrease in operating revenues in 2006 is the result of decreased sales to members and sales to others, offset by an increase in other income as a result of one-time revenues received in 2006 as discussed below.

Revenue from sales to members increased by \$54.8 million or 21.8% in 2007 from 2006 as a result of higher operating expenses, primarily purchased power expenses, that were collected from members and an increase in the megawatt hours sold to members. Revenue from sales to members decreased \$2.3 million or 0.9% in 2006 from 2005, primarily as a result of lower purchased power and fuel expenses in 2006 compared to 2005.

Energy sales to members were 5,290,102 MWh in 2007, 5,024,694 MWh in 2006 and 4,941,385 MWh in 2005. Energy sales to members in 2007 increased by 265,408 MWh or 5.3% from 2006 as a result of new members, weather and load growth. WPPI had two new members in 2007 and six new members in 2006. These new members accounted for 158,416 MWh or approximately 60% of the increase in energy sales to members in 2007 compared to 2006. Energy sales in 2006 increased 83,309 MWh or 1.7% from 2005. Energy sales to new members in 2006 was 90,421 MWh. Without the new members' energy sales in 2006, energy sales to members would have decreased slightly in 2006 compared to 2005 primarily as a result of weather.

¹ Any reference to members refers to both WPPI Members and Non-Member Purchasers. See Footnote 1.

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Sales to others increased by \$5.3 million or 19.8% in 2007 from 2006 primarily from increased revenue from energy sales into the Midwest Independent System Operator (MISO) market. Sales to others in 2006 decreased \$24.7 million, or 48.3%, from 2005. Revenue associated with the MISO Day 2 Market was \$8.7 million lower in 2006 than 2005, in part reflecting lower market energy prices in 2006 compared to 2005. Revenue from WPPI's power sales to WPL under the Combustion Turbine Agreements was \$8.4 million lower in 2006 due to MISO dispatching the South Fond du Lac units less frequently as discussed below. The remaining decrease in sales in 2006 is a cumulative effect of fewer power sales to various other companies.

Other income in 2006 was unusually high compared to 2007 and 2005 due to the \$15.4 million in one-time refunds WPPI received related to the sale of the Kewaunee Nuclear Power Plant by WPS and WPL and a rate refund from WPL in 2006 discussed above.

Operating Expenses

Operating expenses were \$334.7 million in 2007 which is a \$62.2 million or 22.8% increase from 2006. Increased purchased power expense in 2007 is the primary reason for the increase in operating expenses. Total operating expenses decreased \$24.5 million, or 8.2%, in 2006 from 2005. In 2006, the decrease in operating expenses was driven primarily by lower purchased power expenses.

Purchased power expenses, including transmission expenses, accounted for \$57.4 million of the increase in operating expenses in 2007. Purchased power expenses increased in 2007 due to the following factors: the expiration of a 50 MW low cost (below market) contract in April 2007, significant rate increases that became effective in 2007 for WPPI's purchases from Wisconsin Electric Power Company (WEPCO) and WPL, increased expenses from the MISO market including increased energy purchases, higher market energy prices and increased uplift expenses, and increased transmission expenses primarily related to higher network service charges from ATC related to the expansion of the ATC system.

Purchased power expenses, including transmission expenses, decreased \$14.3 million, or 5.8%, in 2006 from 2005. Excluding transmission expenses, purchased power expenses decreased \$17.1 million, or 7.7%, in 2006 from 2005, primarily due to lower fuel adjustment clause charges from WPPI's power suppliers. Transmission expenses increased \$2.8 million, or 11.7%, from \$24.0 million in 2005 to \$26.8 million in 2006, primarily due to an increase in network service rates from ATC.

Fuel expenses were \$1.7 million or 11.6% higher in 2007 compared to 2006 primarily as a result of increased generation at WPPI's gas-fired Island Street Peaking Plant. Fuel expense decreased \$10.5 million, from \$25.1 million in 2005 to \$14.6 million in 2006. The decrease is attributable to a decrease in megawatt production from WPPI generation units in 2006 from 2005 as discussed below.

Boswell 4 produced 709,714 MWh in 2007, 744,197 MWh in 2006 and 798,177 MWh in 2005. The decrease in production at Boswell 4 in 2006 and 2007 is due to scheduled outages for duty cycle maintenance in 2006 and a seven week unplanned outage during the spring of 2007 as a result of a generator rewind. South Fond du Lac Units 1 and 4 (SFDL) produced a combined 29,594 MWh in 2007, 21,551 MWh in 2006 and 79,344 MWh in 2005. Production at SFDL was unusually high in 2005 due to the start of the MISO Day 2 market. The Island Street Peaking Plant produced 40,663 MWh in 2007, 24,661 MWh in 2006, and 37,094 MWh in 2005 due in part to improved reliability of the unit in 2007.

Administrative and general expenses were \$1.7 million or 13.1% higher in 2007 compared to 2006. Administrative and general expenses increased \$1.1 million in 2006 from 2005. The primary factors driving the increases over the past two years were the costs of additional energy conservation programs, growth in number of employees, and salary and benefits adjustments.

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Non-Operating Revenues (Expenses)

The change in investment income since 2005 is primarily related to the change in the earnings on the unspent portion of the Series 2005 A and B bond proceeds held in the construction and debt service funds. Investment income decreased by \$1.2 million or 10.3% in 2007 from 2006 as WPPI continued to use funds for construction of the Elm Road project. Investment income increased \$7.6 million, from \$4.1 million in 2005 to \$11.7 million in 2006 primarily as a result of holding the unspent bond proceeds for a full year in 2006.

As a result of WPPI's increased investment in ATC and corresponding increase in ATC's rate base, equity earnings in ATC have continued to increase. Equity earnings in ATC increased \$1.8 million or 27.8% in 2007 from 2006 and increased \$1.5 million or 29.7% in 2006 from 2005.

WPPI experienced an unrealized loss on the interest rate swaps of \$5.6 million in 2007 due to the change in mark-to-market value of the swaps compared to an unrealized gain of \$1.7 million in 2006. This change does not impact WPPI's overall change in net assets because WPPI utilizes SFAS 71 for the mark-to-market gain or losses on the swaps to match the rate making principles that WPPI utilizes.

Interest expense decreased by \$2.7 million in 2007 compared to 2006 primarily due to the increase in AFUDC associated with the Elm Road project. Interest expense increased \$5.3 million in 2006 due to a full year of interest expense on WPPI's Series 2005 A and B bonds.

Future Costs to Be (Returned) Recovered

Future recoverable costs increased by \$7.1 million in 2007 compared to 2006 primarily due to the SFAS 71 treatment of the 2007 mark-to-market loss on the interest rate swaps as described above. WPPI also applies SFAS 71 to depreciation and amortization expenses for assets that are funded with bond proceeds to insure ratepayers are not charged for both depreciation of an asset and principal payments on the bonds issued to acquire the asset in the same year.

Future costs to be returned or recovered decreased \$1.8 million in 2006 compared to 2005 primarily as a result of the \$1.7 million mark-to-market gain on the swaps in 2006.

Cumulative Effect of Change in Accounting Principle

Prior to 2007, WPPI had been accruing a liability for other post employment benefits (OPEB) under FASB 106. In 2007, WPPI implemented GASB 45 and set the beginning OPEB liability to zero. The 2007 cumulative effect of the change in accounting principle was \$0.4 million.

As noted above, WPPI adopted the principle of regulatory asset and liability accounting in accordance with SFAS 71 to record unrealized gains and losses from the annual mark-to-market calculations on the interest rate swaps. In 2006, \$1.2 million that was expensed in prior years was included in income.

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: WPPI, Attn: CFO, 1425 Corporate Center Drive, Sun Prairie, Wisconsin 53590.