

CADENCE DESIGN SYSTEMS INC

Form DEF 14A

March 26, 2010

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
SCHEDULE 14A
(RULE 14a-101)
SCHEDULE 14A INFORMATION
Proxy Statement Pursuant To Section 14(a) of the Securities
Exchange Act of 1934 (Amendment No.)**

Filed by the Registrant

Filed by a Party other than the Registrant

Check the appropriate box:

Preliminary Proxy Statement

Confidential, for use of the Commission Only (as permitted by Rule 14a-6(e)(2))

Definitive Proxy Statement

Definitive Additional Materials

Soliciting Material Pursuant to § 240.14a-12

CADENCE DESIGN SYSTEMS, INC.

(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement, if Other Than the Registrant)

Payment of Filing Fee (Check the appropriate box):

No fee required.

Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11.

(1) Title of each class of securities to which transaction applies:

(2) Aggregate number of securities to which transaction applies:

(3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):

(4) Proposed maximum aggregate value of transaction:

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(1) Amount Previously Paid:

(2) Form, Schedule or Registration Statement No.:

(3) Filing Party:

(4) Date Filed:

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**CADENCE DESIGN SYSTEMS, INC.
2655 SEELY AVENUE
SAN JOSE, CALIFORNIA 95134**

**NOTICE OF ANNUAL MEETING OF STOCKHOLDERS
To Be Held on May 12, 2010**

TO THE STOCKHOLDERS OF CADENCE DESIGN SYSTEMS, INC.:

NOTICE IS HEREBY GIVEN that the Annual Meeting of Stockholders of CADENCE DESIGN SYSTEMS, INC., a Delaware corporation, will be held on May 12, 2010, at 1:00 p.m. Pacific time, at Cadence's offices located at 2655 Seely Avenue, Building 10, San Jose, California 95134 for the following purposes:

1. To elect directors to serve until the 2011 Annual Meeting of Stockholders and until their successors are elected and qualified, or until the directors' earlier death, resignation or removal.
2. To ratify the selection of KPMG LLP as the independent registered public accounting firm of Cadence for its fiscal year ending January 1, 2011.
3. To transact such other business as may properly come before the meeting or any adjournment or postponement thereof.

These items of business are more fully described in the proxy statement accompanying this notice.

Cadence's Board of Directors has fixed the close of business on March 16, 2010 as the record date for the determination of stockholders entitled to notice of, and to vote at, this Annual Meeting of Stockholders and at any adjournment or postponement thereof.

By Order of the Board of Directors

James J. Cowie
Secretary

San Jose, California
March 26, 2010

ALL STOCKHOLDERS ARE CORDIALLY INVITED TO ATTEND THE MEETING IN PERSON. WHETHER OR NOT YOU EXPECT TO ATTEND THE MEETING, PLEASE CAST YOUR VOTE VIA THE INTERNET OR BY TELEPHONE AS INSTRUCTED IN THE NOTICE OF INTERNET AVAILABILITY OF PROXY MATERIALS AS PROMPTLY AS POSSIBLE. IF YOU CHOSE TO RECEIVE PAPER COPIES OF YOUR PROXY MATERIALS, INCLUDING THE PROXY CARD, PLEASE COMPLETE, DATE, SIGN AND RETURN THE PROXY CARD IN THE RETURN ENVELOPE PROVIDED (WHICH HAS PREPAID POSTAGE IF MAILED IN THE UNITED STATES) AS PROMPTLY AS POSSIBLE TO ENSURE YOUR REPRESENTATION

AT THE MEETING. EVEN IF YOU HAVE GIVEN YOUR PROXY, YOU MAY STILL VOTE IN PERSON AT THE MEETING. PLEASE NOTE, HOWEVER, THAT IF YOUR SHARES ARE HELD OF RECORD BY A BROKER, BANK OR OTHER NOMINEE AND YOU WISH TO VOTE AT THE MEETING, YOU MUST OBTAIN A PROXY ISSUED IN YOUR NAME FROM THE RECORD HOLDER.

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**CADENCE DESIGN SYSTEMS, INC.
2655 SEELY AVENUE
SAN JOSE, CALIFORNIA 95134**

**PROXY STATEMENT
FOR ANNUAL MEETING OF STOCKHOLDERS
MAY 12, 2010**

INFORMATION CONCERNING SOLICITATION AND VOTING

GENERAL

The enclosed proxy is solicited on behalf of the Board of Directors of Cadence Design Systems, Inc., a Delaware corporation, which is referred to in this proxy statement as Cadence, for use at its Annual Meeting of Stockholders to be held on May 12, 2010, at 1:00 p.m. Pacific time, or at any adjournment or postponement thereof, for the purposes set forth in this proxy statement and in the accompanying notice of annual meeting. The annual meeting will be held at Cadence's offices located at 2655 Seely Avenue, Building 10, San Jose, California 95134. Cadence intends to publish this proxy statement on the investor relations page of its website at http://www.cadence.com/company/investor_relations on or about March 26, 2010.

INTERNET AVAILABILITY OF PROXY MATERIALS

Pursuant to the rules adopted by the U.S. Securities and Exchange Commission, which is referred to in this proxy statement as the SEC, Cadence is furnishing proxy materials to its stockholders primarily via the Internet, rather than mailing paper copies of these materials to each stockholder. We believe that this process expedites stockholders receipt of the proxy materials, lowers the costs of our annual meeting and helps conserve natural resources. On or about March 26, 2010, we will mail to each stockholder (other than those who previously requested electronic or paper delivery) a Notice of Internet Availability of Proxy Materials containing instructions on how to access and review the proxy materials, including our proxy statement and annual report, on the Internet and how to access a proxy card to vote on the Internet or by telephone. The Notice of Internet Availability of Proxy Materials also contains instructions on how to request a paper copy of the proxy materials. If you received a Notice of Internet Availability of Proxy Materials by mail, you will not receive a paper copy of the proxy materials unless you request one. If you received a Notice of Internet Availability of Proxy Materials by mail and would like to receive a paper copy of the proxy materials, please follow the instructions included in the Notice of Internet Availability of Proxy Materials. We may choose to mail or deliver a paper copy of the proxy materials, including our proxy statement and annual report, to one or more stockholders.

An audio webcast of the annual meeting will also be available on the investor relations page of Cadence's website at http://www.cadence.com/company/investor_relations. The webcast will allow investors to listen to the proceedings of the annual meeting, but stockholders accessing the annual meeting using the Internet will not be considered present at the annual meeting by virtue of this access and will not be able to vote on matters presented at the annual meeting or

ask any questions of Cadence's directors, management or independent registered public accounting firm. For a description of how to vote on matters presented at the annual meeting, see "Voting" below. The webcast will begin promptly at 1:00 p.m. Pacific time on the day of the annual meeting and may be accessed on Cadence's website for 30 days thereafter.

VOTING RIGHTS AND OUTSTANDING SHARES

Only holders of record of Cadence's outstanding common stock, \$0.01 par value per share, at the close of business on March 16, 2010, which is referred to in this proxy statement as the record date, will be entitled to notice of and to vote at the annual meeting. At the close of business on the record date, Cadence had 270,413,071 shares of common stock outstanding and entitled to vote. Each holder of record of common stock outstanding at the close of business on the record date will be entitled to one vote for each share held on all matters to be voted on at the annual meeting.

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QUORUM; ABSTENTIONS; BROKER NON-VOTES

The presence in person or by proxy of a majority of the shares of Cadence common stock outstanding and entitled to vote on the record date is required for a quorum at the annual meeting. Both abstentions and broker non-votes are counted as present for purposes of determining the presence of a quorum, but broker non-votes will not be counted towards the tabulation of votes cast on proposals presented to stockholders.

Broker non-votes include shares for which a bank, broker or other nominee holder (i.e., record holder) has not received voting instructions from the beneficial owner and for which the record holder does not have discretionary power to vote on a particular matter. Under the rules that govern brokers who are record holders of shares that are held in brokerage accounts for the beneficial owners of the shares, brokers who do not receive voting instructions from their clients have the discretion to vote uninstructed shares on routine matters but have no discretion to vote such uninstructed shares on non-routine matters. Due to recent changes in applicable law, brokers are not permitted to vote on the election of directors without instructions from the beneficial owner, because the election of directors is considered a non-routine matter. Therefore, if your shares are held through a broker, bank or other nominee holder, such shares will not be voted in the election of directors unless you affirmatively provide instructions to your broker on how to vote your shares. The proposal regarding the ratification of Cadence's independent registered public accounting firm is considered a routine matter and brokers are therefore permitted to vote shares held by them without instruction.

ANNUAL MEETING ADMISSION

Stockholders at the close of business on the record date or holders of a valid proxy for the annual meeting are entitled to attend the annual meeting. Such individuals should be prepared to present photo identification, such as a valid driver's license or passport, and verification of Cadence stock ownership for admittance. For stockholders at the close of business on the record date, proof of ownership as of the record date will be verified prior to admittance into the annual meeting. For stockholders who were not stockholders of record at the close of business on the record date but hold shares through a bank, broker or other nominee holder, proof of beneficial ownership at the close of business on the record date, such as an account statement or similar evidence of ownership, will be verified prior to admittance into the annual meeting. Stockholders will be admitted to the annual meeting if they comply with these procedures. Please allow ample time for admittance procedures.

VOTE REQUIRED

The election of directors at the annual meeting requires that each director receive a majority of the votes cast with respect to that director at the annual meeting (number of shares voted for a director must exceed the number of votes cast against that director), provided that in a contested election, each director shall be elected by the affirmative vote of a plurality of the votes cast at the annual meeting.

All other items to be voted on at the annual meeting require the affirmative vote of a majority of the shares present in person or represented by proxy and entitled to vote at the annual meeting.

BNY Mellon Shareowner Services has been appointed as the inspector of elections for this year's annual meeting. All votes will be tabulated by a representative of BNY Mellon Shareowner Services. This representative will also separately tabulate affirmative and negative votes, abstentions and broker non-votes.

VOTING

Stockholders at the close of business on the record date have three options for submitting their vote prior to the annual meeting: (i) vote via the Internet by following the instructions provided in the Notice of Internet Availability of Proxy Materials, (ii) vote via telephone by following the instructions provided in the Notice of Internet Availability of Proxy Materials, or (iii) vote via mail by completing, signing, dating and mailing a paper proxy card in a pre-addressed envelope, which a stockholder can request as outlined in the Notice of Internet Availability of Proxy Materials.

If a stockholder attends the annual meeting, he or she may also submit his or her vote in person, and any votes that were previously submitted whether via the Internet, by telephone or by mail will be superseded by the

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vote that is cast at the annual meeting. Whether the proxy is submitted via the Internet, by telephone or by mail, if it is properly completed and submitted and if it is not revoked prior to the annual meeting, the shares will be voted at the annual meeting in the manner set forth in this proxy statement or as otherwise specified by the stockholder.

REVOCABILITY OF PROXIES

Whether the proxy is submitted via the Internet, by telephone or by mail, any person giving a proxy pursuant to this solicitation has the power to revoke it at any time before it is voted. A proxy may be revoked by providing a written notice of revocation or a duly executed proxy bearing a later date to Cadence's Corporate Secretary at Cadence's corporate offices located at 2655 Seely Avenue, Building 5, San Jose, California 95134, or it may be revoked by attending the meeting and voting in person. Attendance at the annual meeting will not, by itself, be sufficient to revoke a proxy. Accessing the webcast of the annual meeting will not, by itself, constitute attendance at the annual meeting and will not enable a stockholder to revoke his, her or its proxy via the Internet.

SOLICITATION

Cadence will bear the entire cost of soliciting proxies, including the preparation, assembly, printing and mailing of this proxy statement, the proxy card and any additional information furnished to stockholders by Cadence in connection with the matters to be voted on at the annual meeting. Copies of solicitation materials will be furnished to banks, brokerage houses, fiduciaries and custodians holding shares of Cadence common stock beneficially owned by others for forwarding to the beneficial owners. Cadence will reimburse persons representing beneficial owners of its common stock for their costs of forwarding solicitation materials to the beneficial owners. The solicitation of proxies through this proxy statement may be supplemented by telephone, facsimile, use of the Internet or personal solicitation by directors, officers or other employees of Cadence and by Georgeson Inc., which is referred to in this proxy statement as Georgeson. Cadence has retained Georgeson to solicit proxies and to separately prepare a stockholder vote analysis of certain proposals for an aggregate fee of approximately \$10,000, plus reasonable expenses. No additional compensation will be paid to directors, officers or other employees of Cadence or any of its subsidiaries for their services in soliciting proxies.

HOUSEHOLDING INFORMATION

SEC rules permit companies and intermediaries, such as brokers, to deliver a single copy of certain proxy materials to certain stockholders who share the same address, a practice referred to as householding. Some banks, brokers and other nominees will be householding Cadence's Notice of Internet Availability of Proxy Materials and proxy materials for stockholders who do not participate in electronic delivery of proxy materials, unless contrary instructions are received from the affected stockholders. Once you have received notice from your broker or other nominee holder of your Cadence common stock that the broker or other nominee holder will be householding the Notice of Internet Availability of Proxy Materials or proxy materials to your address, householding will continue until you are notified otherwise or until you revoke your consent. If, at any time, you no longer wish to participate in householding and would prefer to receive a separate Notice of Internet Availability of Proxy Materials and proxy materials, or if you are receiving multiple copies of the Notice of Internet Availability of Proxy Materials and proxy materials and wish to receive only one copy, please notify your broker or other nominee holder of your Cadence common stock. You may also request additional copies of Cadence's Notice of Internet Availability of Proxy Materials and proxy materials by writing to Cadence's Corporate Secretary at Cadence's corporate offices located at 2655 Seely Avenue, Building 5, San Jose, California 95134, or by calling Cadence's Investor Relations Group at (408) 944-7100 or e-mailing the Investor Relations Group at investor_relations@cadence.com. Please note, however, that if you wish to receive a paper copy of the proxy or other proxy materials for purposes of this year's annual meeting, you should follow the instructions provided in the Notice of Internet Availability of Proxy Materials. Copies of Cadence's SEC filings and certain other submissions are made available free of charge on the investor relations page of Cadence's website at

http://www.cadence.com/company/investor_relations as soon as practicable after Cadence electronically files or furnishes these documents with the SEC. Information on Cadence's website is not incorporated by reference in this proxy statement unless expressly noted.

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CORPORATE GOVERNANCE

Cadence common stock is listed on the NASDAQ Global Select Market, which is referred to in this proxy statement as NASDAQ.

Cadence and its Board of Directors, which is referred to in this proxy statement as the Board, regularly review and evaluate Cadence's corporate governance practices. Cadence's corporate governance documents are posted on the investor relations page of its website at http://www.cadence.com/company/investor_relations. Paper copies of these documents are also available to stockholders upon written request directed to Cadence's Corporate Secretary at Cadence's corporate offices located at 2655 Seely Avenue, Building 5, San Jose, California 95134.

CORPORATE GOVERNANCE GUIDELINES

The Board has adopted Corporate Governance Guidelines of the Board of Directors, which are referred to in this proxy statement as the Corporate Governance Guidelines. The Corporate Governance Guidelines cover various topics relating to the Board and its activities including, but not limited to, the selection and composition of the Board, Board leadership, compensation of directors, responsibilities of directors, Board access to senior management and outside advisors, meeting procedures, board and committee responsibilities and other matters. The Corporate Governance and Nominating Committee of the Board periodically reviews the Corporate Governance Guidelines, which may be amended by the Board at any time.

CODE OF BUSINESS CONDUCT

Cadence has adopted a Code of Business Conduct to provide standards for ethical conduct in dealing with customers, suppliers, agents, government officials, political entities and others, which is referred to in this proxy statement as the Code of Business Conduct. The Code of Business Conduct applies to all Cadence directors, officers and employees (and those of its subsidiaries), including Cadence's President and Chief Executive Officer, who is referred to in this proxy statement as the CEO, and Cadence's Chief Financial Officer, who is referred to in this proxy statement as the CFO. Compliance with the Code of Business Conduct is a condition of continued service to or employment with Cadence. The Code of Business Conduct covers topics including, but not limited to, integrity and confidentiality of assets and information, conflicts of interest, compliance with federal and state securities laws, employment practices, payment practices, and compliance with competition, anti-corruption and other laws and regulations.

Except as otherwise provided by applicable law, each person subject to the Code of Business Conduct has the responsibility to report any possible misconduct, including unethical business practices, violations of the Code of Business Conduct and apparent or suspected illegal activities and any concerns regarding corporate governance, accounting, internal accounting controls or auditing matters, in the following manner:

Employees must report to the Office of the General Counsel or, in the event the report concerns a Cadence executive officer, to the General Counsel or the chair of the Corporate Governance and Nominating Committee (employees may report possible misconduct on an anonymous basis);

Executive officers must report to the General Counsel or, if the report concerns the General Counsel, to the chair of the Corporate Governance and Nominating Committee, or, if the report concerns the chair of that committee, to another member of that committee; and

Directors must report to the chair of the Corporate Governance and Nominating Committee or, if the report concerns the chair of that committee, to another member of the committee.

Any waiver of a provision of the Code of Business Conduct with respect to a director or an executive officer may only be made by the Board or the Corporate Governance and Nominating Committee. Any waivers for other employees may be granted only by the CEO or the General Counsel, or their respective designees. To the extent required under applicable SEC rules, Cadence will disclose material amendments to the Code of Business Conduct and any waiver of its provisions with respect to any director or executive officer by filing a Current Report on Form 8-K with the SEC or posting such information on its website at www.cadence.com.

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STOCK OWNERSHIP GUIDELINES

The Board has adopted Stock Ownership Guidelines for its members and Cadence's executive officers to align the interests of its directors and executive officers with the interests of stockholders and to further promote Cadence's commitment to sound corporate governance. Each member of the Board is encouraged to hold at least 5,000 shares of Cadence common stock within the first two years of his or her election to the Board, and Cadence's executive officers are encouraged to hold at least the following number of shares of Cadence common stock no later than five years after the date of his or her designation to the following offices: CEO 100,000 shares; CFO 50,000 shares; and Senior Vice Presidents 25,000 shares. All directors and executive officers met the Stock Ownership Guidelines as of the record date.

CADENCE'S BOARD OF DIRECTORS

DIRECTOR INDEPENDENCE

Cadence's Corporate Governance Guidelines require that at least a majority of the Board be independent directors within the meaning of the listing standards of NASDAQ, as determined by the Board. To be independent a director must not have a relationship that, in the opinion of the Board, would interfere with his or her exercise of independent judgment in carrying out the responsibilities of a Cadence director. In making these determinations, the Board considers all relevant facts and circumstances and applies the following standards:

A director who is employed by Cadence or any of its subsidiaries, or whose family member is employed as an executive officer of Cadence or any of its subsidiaries, is not independent until three years after the end of the employment relationship;

A director who accepts, or whose family member accepts, more than \$120,000 in compensation from Cadence or any of its subsidiaries, other than compensation for Board or Board committee service, compensation paid to a family member who is a non-executive employee of Cadence or any of its subsidiaries, benefits under a tax-qualified retirement plan or non-discretionary compensation and payments arising solely from investment in Cadence stock, during any twelve month period within the past three fiscal years, until three years after the date of payment;

A director who is, or whose family member is, a current partner or employee of Cadence's independent registered public accounting firm is not independent;

A director who was, or whose family member was, a partner or employee of Cadence's independent registered public accounting firm who worked on Cadence's audit during that time is not independent until three years after the end of the employment relationship;

A director who is, or whose family member is, employed as an executive officer of another entity for which at any time during the past three years any of Cadence's executive officers served on the compensation committee of such entity is not independent; and

A director who is, or whose family member is, a partner in, or a controlling stockholder or an executive officer of, any organization to which Cadence made, or from which Cadence received, payments for property or services in the current fiscal year or any of the past three fiscal years that exceed in such year the greater of 5% of the recipient's consolidated gross revenues or \$200,000, other than payments arising solely from investments in Cadence securities or payments under non-discretionary charitable contribution matching programs, is not independent until three years after the conclusion of the fiscal year in which such payments are made or

received.

The Board has determined that Dr. Shoven and Messrs. Lucas, Scalise, Siboni and Swainson, who constitute a majority of the Board, are independent directors within the meaning of the listing standards of NASDAQ.

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BOARD MEETINGS

During the fiscal year ended January 2, 2010, the Board held five meetings, in addition to taking actions by unanimous written consent in lieu of a meeting. Each director attended more than 75% of the meetings of the Board and of the committees on which he served that were held during the period for which he was a director or committee member during fiscal 2009. The Corporate Governance Guidelines encourage directors to attend the annual meeting of stockholders. All of Cadence's directors, except Mr. Swainson, attended the 2009 Annual Meeting of Stockholders.

Under the Corporate Governance Guidelines, Cadence's independent directors meet separately at least twice each year. Pursuant to the Corporate Governance Guidelines, Dr. Shoven, as the Chairman of the Board and an independent director, presides over meetings of the independent directors.

CONTACTING THE BOARD OF DIRECTORS

Stockholders interested in communicating directly with the Board may do so by sending a letter to the Board, or to any individual director, group of directors or committee of the Board, c/o the Office of the Corporate Secretary, Cadence Design Systems, Inc., 2655 Seely Avenue, Building 5, San Jose, California 95134. Inquiries and other communications may be submitted anonymously and confidentially. The Corporate Secretary will review the correspondence and will transmit such communications as soon as practicable to the identified director addressee(s), unless there are legal or other considerations that mitigate against further transmission of the communication, as determined by the Corporate Secretary. In that regard, certain items that are unrelated to the duties and responsibilities of the Board will not be forwarded by the Corporate Secretary, such as business solicitations or advertisements, junk mail and mass mailings, new product suggestions, product complaints, product inquiries, resumes and other forms of job inquiries, spam and surveys. In addition, material that the Corporate Secretary determines is unduly hostile, threatening, illegal or similarly unsuitable will be excluded, with the provision that the Board or individual directors so addressed shall be advised of any communication withheld for legal or other considerations as soon as practicable.

COMMITTEES OF THE BOARD OF DIRECTORS

The Board currently has the following committees:

Audit Committee;

Compensation Committee;

Corporate Governance and Nominating Committee;

Finance Committee; and

Technology Committee.

Each of the above committees has a written charter approved by the Board. The charters of the Audit Committee, the Compensation Committee and the Corporate Governance and Nominating Committee are posted

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on the investor relations page of Cadence's website at http://www.cadence.com/company/investor_relations. The members and chairs of the current committees are identified in the following table.

Director	Audit	Compensation	Corporate Governance and Nominating Chair	Finance Chair	Technology
Donald L. Lucas	ü	ü			
Dr. Alberto Sangiovanni-Vincentelli					Chair
George M. Scalise		ü	ü		ü
Dr. John B. Shoven	ü	Chair	ü	ü	
Roger S. Siboni	Chair		ü	ü	
John A.C. Swainson			ü		
Lip-Bu Tan					ü

Audit Committee

The Board has determined that all members of the Audit Committee are independent as defined by the NASDAQ listing standards and Rule 10A-3 of the Securities Exchange Act of 1934, as amended, which is referred to in this proxy statement as the Exchange Act. The Board has also determined that each of the members of the Audit Committee is an audit committee financial expert as defined in rules promulgated by the SEC. In addition, the Board has determined that each Audit Committee member is able to read and understand fundamental financial statements and, other than strictly in his capacity as a member of the Board or a committee of the Board, has not participated in preparing Cadence's financial statements in any of the past three years.

The Audit Committee charter was amended in February 2010 and complies with the NASDAQ listing standards. The duties and responsibilities of the Audit Committee include:

Appointing, retaining, compensating, evaluating, overseeing and terminating Cadence's independent registered public accounting firm and annually evaluating the qualifications, performance and independence of the independent registered public accounting firm, including an evaluation of the lead partner of the independent registered public accounting firm;

Pre-approving all audit and permissible non-audit services to be provided by the independent registered public accounting firm and establishing policies and procedures for such pre-approval;

Reviewing and discussing with the independent registered public accounting firm their report regarding all relationships or services between Cadence and the independent registered public accounting firm and any other relationship or services that may impact the objectivity and independence of the independent registered public accounting firm;

Reviewing with the independent registered public accounting firm their audit procedures, including the scope and timing of the audit, the results of the annual audit and any audit problems or difficulties and management's response to any such problems or difficulties;

Meeting to review with management and the independent registered public accounting firm Cadence's annual and quarterly financial statements, reports and specific disclosures, and recommending to the Board whether the financial statements should be included in Cadence's Annual Report on Form 10-K;

Reviewing and discussing the adequacy and effectiveness of Cadence's internal controls, disclosure controls and procedures and practices with respect to risk assessment and risk management as they relate to financial reporting; and

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Establishing and overseeing procedures for the receipt, retention and treatment of complaints regarding accounting, internal controls or auditing matters, including a system for the confidential anonymous submission of accounting or auditing concerns by Cadence employees.

The Audit Committee held nine meetings during fiscal 2009. See [Report of the Audit Committee](#) below for more information.

Compensation Committee

The Compensation Committee of the Board is comprised of three non-employee directors of Cadence, each of whom the Board has determined to be independent as defined by the listing standards of NASDAQ. In addition, all Compensation Committee members are outside directors within the meaning of Section 162(m) of the Internal Revenue Code of 1986, as amended (which is referred to in this proxy statement as the Code), to allow Cadence a tax deduction for certain employee compensation exceeding \$1,000,000 for an individual. All Compensation Committee members are also outside directors within the meaning of Rule 16b-3 of the Exchange Act to allow Cadence to exempt certain option grants and similar transactions from the short-swing profits prohibition of Section 16 of the Exchange Act. As provided in its charter, the Compensation Committee acts on behalf of the Board to identify, review and approve corporate goals and objectives relevant to the compensation of Cadence's CEO and any director who is also a Cadence employee, evaluate the performance of the CEO and any director who is also a Cadence employee in light of those goals and objectives, and determine and approve the compensation of the CEO and any director who is also a Cadence employee. Although the Compensation Committee may delegate its authority to management when it deems it to be appropriate and in the best interests of Cadence, the Compensation Committee did not delegate any authority with respect to the consideration and determination of executive officer and director compensation in fiscal 2009 and does not currently expect to delegate any such authority in the future. At or near the beginning of each fiscal year, the Compensation Committee typically establishes base salary levels and target bonuses for the CEO and other executive officers of Cadence. In addition, the Compensation Committee administers and, if deemed necessary, may amend the Senior Executive Bonus Plan, which is referred to in this proxy statement as the Bonus Plan, Cadence's equity-based compensation plans and stock purchase plans, and Cadence's deferred compensation plans. The Compensation Committee also reviews and recommends to the Board the compensation of Cadence's directors.

The Compensation Committee charter was amended in February 2010. The duties and responsibilities of the Compensation Committee include:

Identifying, reviewing and approving corporate goals and objectives relevant to the compensation of Cadence's CEO and any director who is also a Cadence employee, evaluating the performance of the CEO and any employee director in light of those goals and objectives and determining and approving, either as a committee or together with the independent directors of the Board, the compensation of the CEO and any employee director based on such evaluation;

Overseeing the evaluation of the executive officers of Cadence;

Reviewing periodically Cadence's management succession planning in consultation with the CEO and reporting to the Board, at least annually, on CEO succession planning;

Reviewing compensation programs and determining the compensation of Cadence's executive officers;

Reviewing and discussing with management Cadence's Compensation Discussion and Analysis and related disclosures that are required be included in Cadence's annual report and proxy statement, recommending to the

Board, based on the review and discussions, whether the Compensation Discussion and Analysis should be included in the annual report and the proxy statement, and preparing the compensation committee report that SEC rules require to be included in the annual report and the proxy statement;

Overseeing Cadence's overall compensation practices, policies and programs, assessing whether Cadence's compensation structure establishes appropriate incentives for management and employees, and assessing the risks associated with such practices, policies and programs; and

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Reviewing and, in certain cases, amending and administering Cadence's general compensation plans including:

Equity incentive and stock purchase plans;

Benefit programs; and

Bonus plans.

In fiscal 2009, the Compensation Committee retained the services of an independent compensation consultant, Semler Brossy Consulting Group, LLC, or Semler Brossy, for advice regarding the compensation of Cadence's executive officers. The Compensation Committee believes that having an independent evaluation of executive officer salary, bonus and equity compensation is a valuable tool for the Compensation Committee and Cadence's stockholders. Semler Brossy has not been engaged to perform any other work for Cadence.

The Compensation Committee retained Semler Brossy for a number of purposes, including:

Constructing and reviewing peer groups for compensation comparison purposes;

Performing a competitive assessment of Cadence's compensation programs, practices and levels for its executive officers and other select employees; and

Providing information on typical industry practices concerning employment, severance and change in control agreements.

The Compensation Committee made a number of compensation decisions, including decisions with respect to Cadence's Named Executive Officers (as defined below in Compensation of Executive Officers), based on the competitive assessments provided by and through consultation with Semler Brossy. In addition, Cadence's CEO typically makes assessments and recommendations to the Compensation Committee on whether there should be adjustments to the annual base salary, annual cash incentive compensation and long-term equity incentive compensation of executive officers other than himself based upon an assessment of certain factors described further in Compensation Discussion and Analysis below. The Compensation Committee reviews such assessments and recommendations and determines whether or not to approve or modify the CEO's recommendations. The Compensation Committee's decisions are made, however, by the Compensation Committee in its sole discretion. See Compensation Discussion and Analysis below for more information.

The Compensation Committee, in consultation with Semler Brossy, reviews Cadence's compensation practices, policies and programs for all employees, including the Named Executive Officers, to assess the risks associated with such practices, policies and programs. The risk-mitigating factors considered by the Compensation Committee include:

the use of different types of compensation that provide a balance of short-term and long-term incentives with fixed and variable components;

Cadence's Stock Ownership Guidelines;

Cadence's Clawback Policy which, in the event of a restatement of Cadence's financial results, allows Cadence to seek to recover or cancel performance-based bonuses and awards to the extent that performance goals would not have been met under such restated financial results;

caps on bonus awards to limit windfalls;

the Named Executive Officers must obtain permission from Cadence's General Counsel before the sale of any shares of Cadence common stock, even during an open trading period; and

the Compensation Committee's consideration of ethical behavior as integral in assessing the performance of all executive officers, including the Named Executive Officers.

The Compensation Committee held three meetings during fiscal 2009.

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Corporate Governance and Nominating Committee

The Board has determined that all Corporate Governance and Nominating Committee members are independent as defined by the NASDAQ listing standards.

The Corporate Governance and Nominating Committee charter was amended in February 2010. The duties and responsibilities of the Corporate Governance and Nominating Committee include:

Determining any criteria for selecting new directors;

Interviewing and evaluating candidates for Board membership;

Evaluating director nominees recommended by stockholders;

Reviewing, at least annually, the appropriate skills and characteristics required for directors in the context of the composition of the Board;

Reviewing periodically the size of the Board and recommending any changes to the Board;

Recommending to the Board director nominees for election at the next annual or special meeting of stockholders or to fill any vacancies or newly created directorships that may occur between such meetings;

Making a recommendation to the Board as to whether to accept or reject the resignation of an incumbent director who receives a greater number of votes cast against than votes cast for at an annual or special meeting of stockholders;

Reviewing, at least annually, the Corporate Governance Guidelines and the Code of Business Conduct;

Overseeing the administration of the Code of Business Conduct and administering the Code of Business Conduct with respect to Cadence's directors and executive officers;

Reviewing and approving any related person transactions involving Cadence directors and executive officers and establishing policies and procedures for the review, approval and ratification of such transactions;

Reviewing whether it is appropriate for a director to continue service if his or her business responsibilities or personal circumstances change and make a recommendation to the Board as to any action to be taken with respect to such change; and

Overseeing the annual evaluation of the Board and its committees.

The Corporate Governance and Nominating Committee uses a variety of methods to identify and evaluate director nominees. The committee periodically assesses the appropriate size of the Board, and whether any vacancies on the Board are expected due to retirement of directors or otherwise, and the need for particular expertise on the Board. If vacancies are anticipated or otherwise arise, the committee considers potential director candidates. Additionally, candidates may come to the attention of the committee through current directors, officers, professional search firms, stockholders or other persons. These candidates are evaluated at regular or special meetings of the committee, and may be considered at any point during the year. In connection with this evaluation, the Corporate Governance and Nominating Committee determines whether to interview the prospective nominee and, as warranted, one or more members of the committee, and others as appropriate, interview prospective nominees in person or by telephone. After

completing this evaluation and interview, the committee makes a recommendation to the full Board as to the persons who should be nominated or elected by the Board, and the Board determines whether to reject, elect or nominate the candidate, as the case may be, after considering the recommendation of the committee.

The Corporate Governance and Nominating Committee will consider individuals recommended by stockholders for nomination as a director pursuant to the provisions of Cadence's Bylaws relating to stockholder nominations. A stockholder who wishes to recommend a prospective nominee for the Board should notify Cadence's Corporate Secretary or the Corporate Governance and Nominating Committee in writing with the supporting material required by Cadence's Bylaws as described under Other Matters Stockholder Proposals and Nominations below, and any other material the stockholder considers necessary or appropriate.

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Although the Board currently has no defined minimum criteria for consideration or continued service as a director, the Corporate Governance and Nominating Committee evaluates prospective nominees against the standards and qualifications set out in the Corporate Governance Guidelines and other relevant factors as it deems appropriate. Among the factors the Board may consider are the current composition of the Board, the need for particular expertise, a prospective nominee's experience, judgment, integrity, diversity of background, independence, ability to commit sufficient time and attention to Board activities, skills, such as an understanding of electronic design and semiconductor technologies, international background and other relevant characteristics. At least a majority of directors on the Board must be independent as defined by the NASDAQ listing standards and as determined by the Board.

The Corporate Governance and Nominating Committee held three meetings during fiscal 2009.

Finance Committee

The Finance Committee, on behalf of the Board, evaluates and approves financings, mergers, acquisitions, divestitures and other financial commitments of Cadence to unaffiliated third parties that involve amounts greater than \$30 million and up to \$60 million.

The Finance Committee held four meetings during fiscal 2009.

Technology Committee

The Technology Committee monitors trends in technology that may affect Cadence's strategic plans, advises the Board regarding Cadence's research and development activities and reviews and makes recommendations to management regarding Cadence's leading technologists and researchers.

The Technology Committee held five meetings during fiscal 2009.

Board Leadership Structure

Currently, Mr. Tan serves as CEO and Dr. Shoven, an independent director, serves as Chairman of the Board. The Board believes that Cadence and its stockholders are best served at this time by this leadership structure because it is valuable to have strong independent leadership to assist the Board in fulfilling its role of overseeing the management of Cadence and its risk management practices, separate from the CEO. However, the Corporate Governance Guidelines permit the roles of the Chairman of the Board and the CEO to be filled by the same or different individuals. This provides the Board with flexibility to determine whether the two roles should be combined in the future based on Cadence's needs and the Board's assessment of Cadence's leadership from time to time. The Corporate Governance Guidelines provide for a lead independent director if the roles are combined.

Risk Oversight

The Board exercises its risk oversight function through the Board as a whole and through certain of its committees. The Board and the relevant committees seek to understand and oversee the most critical risks facing Cadence. The Board does not view risk in isolation, but considers risk as part of its regular consideration of business decisions and business strategy. The Board as a whole has the ultimate responsibility for the oversight of risk management, but has delegated the oversight of certain risks to the Audit Committee and the Compensation Committee. The Audit Committee is responsible for overseeing risk management as it relates to Cadence's financial condition, financial statements, financial reporting process and accounting matters. The Compensation Committee is responsible for overseeing Cadence's overall compensation practices, policies and programs and assessing the risks associated with

such practices, policies and programs. The Board and the relevant committees review with Cadence's management the risk management practices for which they have oversight responsibility. Since overseeing risk is an ongoing process and inherent in Cadence's strategic decisions, the Board and the relevant committees also discuss risk throughout the year in relation to specific proposed actions.

Table of Contents**COMPENSATION OF DIRECTORS**

Directors who are Cadence employees do not receive additional compensation for their service on the Board. The following table sets forth the compensation earned by Cadence's non-employee directors (as defined below) for their service on the Board in fiscal 2009:

DIRECTOR COMPENSATION FOR FISCAL 2009

Name	Fees Earned or Paid in	Option	All Other	Total
	Cash (\$)	Awards \$(1)(2)	Compensation \$(3)	
Donald L. Lucas	\$ 173,000	\$ 63,625	\$ 7,355	\$ 243,980
Dr. Alberto Sangiovanni-Vincentelli	136,000	63,625	8,843	208,468
George M. Scalise	108,000	63,625	0	171,625
Dr. John B. Shoven	215,000	127,250	4,101	346,351
Roger S. Siboni	151,000	63,625	11,602	226,227
John A.C. Swainson	89,000	63,625	0	152,625

- (1) As of January 2, 2010, the aggregate number of outstanding stock options held by each director was as follows: Mr. Lucas 240,000; Dr. Sangiovanni-Vincentelli 285,000; Mr. Scalise 245,000; Dr. Shoven 392,500; Mr. Siboni 257,500; and Mr. Swainson 100,000.
- (2) In accordance with SEC rules, the amount shown reflects the grant date fair value of stock options granted during fiscal 2009 calculated pursuant to Financial Accounting Standards Board Codification (ASC) 718, *Compensation - Stock Compensation*, which is referred to in this proxy statement as FASB ASC 718. The grant date fair value is based on the price of Cadence common stock on the date the stock option was granted and does not reflect any fluctuations in the price of Cadence common stock subsequent to the grant date. The amount shown therefore does not reflect the financial benefit that the holder of the stock option will actually realize upon the vesting of the stock option nor whether the stock option will be exercised or exercisable prior to its expiration. The assumptions used to calculate the valuation of the stock options for fiscal 2009 are set forth in Note 9 to the Notes to Consolidated Financial Statements in Cadence's Annual Report on Form 10-K for the fiscal year ended January 2, 2010.
- (3) All Other Compensation for Drs. Sangiovanni-Vincentelli and Shoven and Messrs. Lucas and Siboni consists of reimbursements pursuant to the director health care and prescription drug insurance coverage plan described below.

A non-employee director is a Cadence director who is not an employee of Cadence. As of the beginning of fiscal 2009, the annual retainer for non-employee directors was \$80,000, with an additional annual retainer of \$80,000 for a non-employee director serving as Chairman of the Board. In May 2009, the Board temporarily reduced the retainer fees payable to the non-employee directors and the retainer fee payable to the Chairman of the Board by 10% each, effective July 1, 2009 through March 31, 2010 and, in February 2010, extended the duration of the reduction through June 30, 2010. A non-employee director serving as Chairman of the Audit Committee, the Finance Committee or the Technology Committee receives an annual retainer of \$40,000 per year and a non-employee director serving as Chairman of the Corporate Governance and Nominating Committee or the Compensation Committee receives an

annual retainer of \$20,000 per year. A non-employee director serving as Chairman of the Board is also eligible to receive fees for service as the Chairman of these committees of the Board.

Each non-employee director of Cadence earned a \$76,000 retainer for his service on the Board in fiscal 2009. Dr. Shoven earned an additional \$76,000 retainer for his service as Chairman of the Board and a retainer of \$20,000 for his service as Chairman of the Compensation Committee. Mr. Siboni and Dr. Sangiovanni-Vincentelli each earned a retainer of \$40,000 for his service as Chairman of the Audit Committee and Chairman of the Technology Committee, respectively. Mr. Lucas earned a retainer of \$20,000 for his service as the Chairman of the Corporate Governance and Nominating Committee and a retainer of \$40,000 for his service as the Chairman of the Finance Committee. Each non-employee director also received meeting fees of \$2,000 for each meeting attended in person and \$1,000 for each meeting attended via telephone. No additional compensation was paid when the Board or a

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committee acted by unanimous written consent in lieu of a meeting. Non-employee directors were also eligible for reimbursement of their expenses incurred in connection with attending Cadence's Board meetings in accordance with Cadence's policy.

Each non-employee director also receives stock option grants under Cadence's 1995 Directors Stock Option Plan, as amended, which is referred to in this proxy statement as the Directors Plan. Only non-employee directors are eligible to receive stock options under the Directors Plan.

Under the Directors Plan, each non-employee director, upon joining the Board, is automatically granted a one-time option to purchase the number of shares of Cadence common stock equal to 6,250 multiplied by the number of full calendar quarters between the date the director's service begins and the next April 1st. A director is considered to have served the entire calendar quarter if he or she becomes a director at any time during the first half of the quarter. These initial grants vest and become exercisable in full on the March 31st following the grant date and have an exercise price equal to the average closing price of Cadence common stock for the 20 trading days prior to the grant date.

In addition, every April 1st, each non-employee director is automatically granted an option to purchase 25,000 shares of Cadence common stock and a non-employee director serving as Chairman of the Board is automatically granted an option to purchase an additional 25,000 shares of common stock. These annual stock option grants vest and become exercisable in full on the March 31st following the grant date and have an exercise price equal to the average closing price of Cadence common stock for the 20 trading days prior to the grant date.

Directors may elect to defer compensation payable to them under Cadence's deferred compensation plan. These deferred compensation payments are held in accounts with values indexed to the performance of selected mutual funds, self-directed accounts or money market accounts. Cadence does not match contributions made under Cadence's deferred compensation plan.

Furthermore, a health care and prescription drug insurance coverage plan is available for active non-employee directors, eligible retired directors and their dependents. All non-employee directors and their dependents are eligible for coverage under the plan during their term of service on the Board. Retired employee and non-employee directors and their dependents are eligible for continuing coverage under the plan after the director's termination of service for a term not to exceed such director's term of service on the Board. Under the plan, Cadence reimburses 100% of the premiums for participants and their dependents up to a maximum of \$20,000 per calendar year, which maximum amount may be adjusted for future changes in health care costs. Benefits under the plan are fully taxable to the participants and Cadence does not defray any such taxes. Messrs. Lucas and Siboni and Drs. Sangiovanni-Vincentelli and Shoven maintained health insurance coverage under this plan in fiscal 2009.

PROPOSAL 1

ELECTION OF DIRECTORS

The Corporate Governance and Nominating Committee of the Board has recommended, and the Board has nominated, the seven nominees named below for election to the Board. Each director elected at the 2010 Annual Meeting of Stockholders will hold office until the 2011 Annual Meeting of Stockholders and until his successor is elected and qualified, or until the director's earlier death, resignation or removal. Each nominee listed below is currently a Cadence director. All of the nominees have previously been elected by Cadence's stockholders.

THE BOARD OF DIRECTORS RECOMMENDS A VOTE IN FAVOR OF EACH NAMED NOMINEE.

DIRECTOR QUALIFICATIONS AND DIVERSITY

The Board believes that the Board, as a whole, should possess a combination of skills, professional experience and diversity of backgrounds necessary to oversee Cadence's business. In addition, the Board believes that there are certain attributes that every director should possess, as reflected in the Board's membership criteria. Accordingly, the Board and the Corporate Governance and Nominating Committee consider the qualifications of directors and

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director candidates individually and in the broader context of the Board’s overall composition and Cadence’s current and future needs.

The Corporate Governance and Nominating Committee is responsible for developing and recommending Board membership criteria to the Board for approval. The criteria, which are set forth in the Corporate Governance Guidelines, include a prospective nominee’s integrity, experience, judgment, diversity of background, independence, ability to commit sufficient time and attention to Board activities, skills such as an understanding of electronic design and semiconductor technologies, international background and other relevant characteristics. The Corporate Governance and Nominating Committee considers all of these criteria in the context of the perceived needs of the Board at that point in time. In addition, the Corporate Governance and Nominating Committee annually reviews with the Board the appropriate skills and characteristics required of directors in the context of the current composition of the Board. In seeking a diversity of background, the Corporate Governance and Nominating Committee seeks a variety of occupational and personal backgrounds on the Board in order to obtain a range of viewpoints and perspectives. This annual assessment enables the Board to update the skills and experience it seeks in the Board as a whole, and in individual directors, as Cadence’s needs evolve and change over time, and also enables the Board to assess the effectiveness of its policy to seek a diversity of background on the Board. In identifying director candidates from time to time, the Corporate Governance and Nominating Committee and the Board may establish specific skills and experience that it believes Cadence should seek in order to have an effective board of directors.

In evaluating director candidates, and considering incumbent directors for renomination to the Board, the Corporate Governance and Nominating Committee has considered all of the criteria described above and, for incumbent directors, past performance on the Board. Among other things, the Corporate Governance and Nominating Committee has determined that it is important to have individuals with the following skills and experiences on the Board:

Strong technologists with in-depth understanding of electronic design and semiconductor technologies, which is vital in understanding and reviewing Cadence’s strategy, including product development and the acquisition of businesses that offer complementary products, services or technologies;

Current or former executives with significant operating experience that gives them specific insight into developing, implementing and assessing our operating plan and business strategy;

Substantial international experience, which is particularly important given our global presence;

Financial expertise with which to evaluate our financial statements and capital structure; and

Corporate governance experience from publicly traded companies to support our goals of accountability for management and the Board, and protection of stockholder interests.

The Corporate Governance and Nominating Committee believes that all of the seven director nominees listed below are highly qualified and have the skills and experience required for service on our Board. The biographies below contain information regarding each of their experiences, qualifications and skills.

NOMINEES

The names of the nominees and certain information about them, including term of service as a Cadence director and age as of the 2010 Annual Meeting of Stockholders, are set forth below:

Name and Principal Occupation

Business Experience and Directorships

Donald L. Lucas

80 Years Old

Director Since 1988

Private venture capital investor

Donald L. Lucas served as Chairman of the Board of Cadence from 1988 to 2004. From its inception in 1983 to 1987, Mr. Lucas served as Chairman of the Board and a director of SDA Systems, Inc., a predecessor of Cadence. Mr. Lucas has been a private venture capital investor since 1960. Mr. Lucas also serves as a director of 51job, Inc., DexCom, Inc., Oracle Corporation, Spansion, Inc. and Vimicro International Corporation.

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Name and Principal Occupation

Business Experience and Directorships

Mr. Lucas served as a director of Macromedia, Inc. from 2003 to 2005 and PDF Solutions, Inc. from 1999 to 2005.

As a private venture capital investor and long-time director for a range of technology companies, Mr. Lucas has broad industry and business experience, as well as financial and corporate governance expertise.

Dr. Alberto Sangiovanni-Vincentelli
62 Years Old
Director Since 1992
Professor of Electrical Engineering and
Computer Sciences, University
of California, Berkeley

Dr. Alberto Sangiovanni-Vincentelli is a co-founder of SDA Systems, Inc., a predecessor of Cadence, and served as a consultant to Cadence, or one of its predecessor corporations, from 1983 to 2008. Since 1976, Dr. Sangiovanni-Vincentelli has been a professor of electrical engineering and computer sciences at the University of California, Berkeley, where he holds the Edgar L. and Harold H. Buttner Chair of Electrical Engineering. Dr. Sangiovanni-Vincentelli was elected to the National Academy of Engineering in 1998 and received the Kaufman Award from the Electronic Design Automation Consortium in 2001, the IEEE/RSE Wolfson James Clerk Maxwell Medal for his impact on the development of electronics and electrical engineering or related fields in 2008 and the ACM/IEEE A. Richard Newton Technical Impact Award in Electronic Design Automation in 2009.

As a co-founder of one of Cadence's predecessor companies, a professor of electrical engineering at the University of California, Berkeley and a well-known expert in electrical engineering, Dr. Sangiovanni-Vincentelli is a strong technologist with significant industry expertise, as well as substantial international experience.

George M. Scalise
76 Years Old
Director Since 1989
President, Semiconductor Industry
Association

George M. Scalise has served as President of the Semiconductor Industry Association, an association of semiconductor manufacturers and suppliers, since 1997. Mr. Scalise served on the Board of Directors of the Federal Reserve Bank of San Francisco from 2000 to 2005, including as Deputy Chairman from 2001 to 2003 and as Chairman from 2003 to 2005. Mr. Scalise served as Executive Vice President and Chief Administrative Officer of Apple Computer, Inc. (now Apple, Inc.), a company that designs and manufactures consumer electronics and software products, from 1996 to 1997. Mr. Scalise also served as Senior Vice President of Planning and Development and Chief Administrative Officer of National Semiconductor Corporation, a semiconductor company, from 1991 to 1996. Mr. Scalise served on President George W. Bush's Council of Advisors on Science and Technology from 2001 to 2009. Mr. Scalise also serves as a director of

MindTree Ltd.

As the President of the Semiconductor Industry Association, a former board member of the Federal Reserve and a former Chief Administrative Officer of Apple Computer, Inc. (now Apple, Inc.), Mr. Scalise has significant semiconductor and financial expertise and substantial international experience.

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Name and Principal Occupation

Business Experience and Directorships

Dr. John B. Shoven

62 Years Old

Director Since 1992

Professor of Economics, Stanford University

Dr. John B. Shoven has served as Chairman of the Board since 2005. Dr. Shoven is the Charles R. Schwab Professor of Economics at Stanford University and the Wallace R. Hawley Director of the Stanford Institute for Economic Policy Research. He is also a senior fellow at the Hoover Institution, a fellow of the American Academy of Arts and Sciences and a research associate at the National Bureau of Economic Research. Dr. Shoven has been a member of the faculty at Stanford University since 1973, serving as Chairman of the Economics Department from 1986 to 1989, director of the Center for Economic Policy Research from 1988 to 1993 and as Dean of the School of Humanities and Sciences from 1993 to 1998. Dr. Shoven also serves as a director of Exponent, Inc., Financial Engines, Inc. and the Mountain View Board of American Century Funds.

Dr. Shoven served as a director of PalmSource, Inc. from 2002 to 2005 and Watson Wyatt Worldwide, Inc. from 2002 to 2006.

As a professor of economics at Stanford University, the director of the Stanford Institute for Economic Policy Research and a director of a number of companies, Dr. Shoven has strong financial and corporate governance expertise.

Roger S. Siboni

55 Years Old

Director Since 1999

Independent Investor

Roger S. Siboni served as Chairman of the Board, from 2003 to 2005, and as President and Chief Executive Officer, from 1998 to 2003, of Epiphany, Inc., a software company that provided customer relationship management solutions. Prior to joining Epiphany, Inc., Mr. Siboni spent more than 20 years at KPMG LLP, most recently as its Deputy Chairman and Chief Operating Officer. Mr. Siboni also serves as a director of ArcSight, Inc., Dolby Laboratories, Inc. and infoGroup, Inc.

Mr. Siboni served as a director of Classmates Media Corporation from 2007 to 2010 and FileNet Corporation from 1998 to 2006.

As a former Chairman of the Board and Chief Executive Officer of Epiphany, Inc., a former Chief Operating Officer of and accountant at KPMG LLP and a director of a number of software companies, Mr. Siboni has significant operating experience, as well as financial, accounting and corporate governance expertise.

John A.C. Swainson

55 Years Old

John A.C. Swainson served as Chief Executive Officer of CA, Inc., an information technology management software company, from 2005

Director Since 2006
Former Chief Executive Officer,
CA, Inc.

through 2009 and as a director of CA, Inc. from November 2004 through 2009. Prior to joining CA, Inc., Mr. Swainson was Vice President of Worldwide Sales and Marketing of the Software Group at International Business Machines Corporation (IBM), a computer hardware and software company, during 2004 and General Manager of the Application Integration and Middleware division of IBM's Software Group from 1997 to 2004. Mr. Swainson also serves as a director of Visa, Inc., where he has been Lead Independent Director since 2007.

Mr. Swainson served as a director of Visa U.S.A., the predecessor of Visa, Inc., from 2006 to 2007.

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Name and Principal Occupation

Business Experience and Directorships

Lip-Bu Tan

50 Years Old

Director Since 2004

President and Chief Executive Officer,
Cadence Design Systems, Inc.

As a former Chief Executive Officer and director of CA, Inc., as well as a former General Manager and Vice President of Worldwide Sales and Marketing of IBM, Mr. Swainson has significant management, international operating and sales and marketing experience, as well as substantial corporate governance expertise.

Lip-Bu Tan has served as President and Chief Executive Officer of Cadence since January 2009. In 1987, Mr. Tan founded Walden International, an international venture capital firm, and since its founding has served as its Chairman. Mr. Tan also serves as a director of Flextronics International Ltd., Semiconductor Manufacturing International Corporation and SINA Corporation.

Mr. Tan served as a director of Centillum Communications, Inc. from 1997 to 2007, Creative Technology, Ltd. from 1990 to 2009, Integrated Silicon Solution, Inc. from 1990 to 2007, Leadis Technology, Inc. from 2002 to 2006 and MindTree Ltd. from 2006 to 2009.

As a Chairman of an international venture capital firm and a director of a number of technology companies, Mr. Tan has extensive experience in the electronic design and semiconductor industries, as well as international operations and corporate governance expertise.

VOTE REQUIRED AND BOARD OF DIRECTORS RECOMMENDATION

Shares represented by executed proxies will be voted **FOR** the election of the seven nominees named above, if authority to do so is not withheld.

The Board recommends a vote **FOR** the election of each of the seven nominees. The election of directors at the annual meeting requires that each director receive a majority of the votes cast with respect to that director, which means that the number of shares voted for a director must exceed the number of shares voted against that director; provided, however, that in a contested election, the directors shall be elected by the affirmative vote of a plurality of the votes cast at the annual meeting. The election this year is not contested and the majority voting standard applies.

In order for an incumbent Cadence director to become a nominee at the annual meeting, such director must submit an irrevocable resignation that becomes immediately effective if (i) the votes cast for such director does not exceed the votes cast against such director in an election that is not a contested election, and (ii) the Board accepts the resignation in accordance with the policies and procedures adopted by the Board for such purpose. If a nominee who is currently serving as a Cadence director is not elected at the annual meeting, the Corporate Governance and Nominating Committee will make a recommendation to the Board as to whether to accept or reject such director's resignation, or whether to take other action. The Board will act on the Corporate Governance and Nominating Committee's recommendation and publicly disclose (as required by applicable law) its decision and the reasons behind it within

90 days from the date the election results are certified.

If any nominee should be unavailable for election as a result of unexpected circumstances, shares will be voted for the election of any substitute nominee named by the Board. Each person nominated for election has agreed to be named in this proxy statement and to serve if elected, and Cadence has no reason to believe that any nominee will be unable to serve.

Abstentions will be treated as being present and entitled to vote on the proposal, however, abstentions are not counted as votes for or against directors and will not have an effect on the election of directors. Unless marked to the contrary, proxies received will be voted **FOR** the election of each of the seven director nominees.

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PROPOSAL 2

**RATIFICATION OF APPOINTMENT OF THE INDEPENDENT REGISTERED
PUBLIC ACCOUNTING FIRM**

The Audit Committee has selected KPMG LLP as Cadence's independent registered public accounting firm for the fiscal year ending January 1, 2011. Pursuant to the Audit Committee charter, the Board has directed management to submit the selection of the independent registered public accounting firm for ratification by the stockholders at the annual meeting. KPMG LLP has audited Cadence's financial statements since fiscal 2002. Representatives from KPMG LLP are expected to be present at the 2010 Annual Meeting of Stockholders, will have an opportunity to make a statement, if they so desire, and will be available to respond to appropriate questions.

Stockholder ratification of the selection of KPMG LLP as Cadence's independent registered public accounting firm is not required by Cadence's Bylaws or otherwise. However, the Board is submitting the selection of KPMG LLP to the stockholders for ratification as a matter of good corporate practice. If Cadence's stockholders fail to ratify the selection, the Audit Committee will reconsider whether or not to retain KPMG LLP. Even if the selection is ratified, the Audit Committee, in its discretion, may direct the appointment of a different independent registered public accounting firm at any time during the year, if it determines that such a change would be in the best interests of Cadence and its stockholders.

VOTE REQUIRED AND BOARD OF DIRECTORS RECOMMENDATION

The Board recommends a vote **FOR** ratification of the selection of KPMG LLP. The affirmative vote of a majority of the shares present in person or represented by proxy and entitled to vote on the proposal is required for approval of this proposal. Abstentions will be treated as being present and entitled to vote on the proposal and, therefore, will have the effect of votes against the proposal. Unless marked to the contrary, proxies received will be voted **FOR** ratification of the selection of KPMG LLP.

THE BOARD OF DIRECTORS RECOMMENDS A VOTE IN FAVOR OF PROPOSAL 2.

REPORT OF THE AUDIT COMMITTEE

The Audit Committee of the Board is comprised of three non-employee directors of Cadence who are independent as defined by the listing standards of NASDAQ and as defined under the Exchange Act. During fiscal 2009, the Audit Committee was comprised of Dr. Shoven and Messrs. Lucas and Siboni, with Mr. Siboni serving as its Chairman. The Audit Committee met nine times in fiscal 2009.

The Audit Committee operates under a charter that was amended by the Board in February 2010. The Audit Committee charter is posted on the investor relations page of Cadence's website at http://www.cadence.com/company/investor_relations. As more fully described in its charter, the Audit Committee appoints and retains the independent registered public accounting firm and oversees the quality and integrity of Cadence's financial statements, Cadence's compliance with legal and regulatory requirements, the independent registered public accounting firm's qualifications and independence, and the performance of Cadence's internal audit function, the independent registered public accounting firm, Cadence's accounting and financial reporting processes and the audits of Cadence's financial statements on behalf of the Board.

In this context, the Audit Committee has reviewed and discussed the audited financial statements included in Cadence's Annual Report on Form 10-K for the fiscal year ended January 2, 2010 with Cadence's management and KPMG LLP, Cadence's independent registered public accounting firm. The Audit Committee has also discussed with KPMG LLP the matters required to be discussed by the Statement on Auditing Standards No. 61 (Communication with Audit Committees), as amended. In addition, the Audit Committee has received from KPMG LLP the written disclosures and the letter required by the applicable requirements of the Public Company Accounting Oversight Board regarding KPMG LLP's communications with the Audit Committee concerning independence, and has discussed with KPMG LLP its independence from Cadence and its management. The Audit Committee has

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also considered whether the provision of other non-audit services by KPMG LLP to Cadence is compatible with KPMG LLP's independence.

In reliance on the reviews and discussions referred to above, the Audit Committee recommended to the Board, and the Board approved, the inclusion of the audited financial statements in Cadence's Annual Report on Form 10-K for the fiscal year ended January 2, 2010 for filing with the SEC.

AUDIT COMMITTEE

Roger S. Siboni, Chairman
Donald L. Lucas
John B. Shoven

The foregoing Audit Committee report is not soliciting material, is not deemed filed with the SEC and is not to be incorporated by reference in any filing of Cadence under the Securities Act of 1933, as amended, or under the Exchange Act, whether made before or after the date of this proxy statement and irrespective of any general incorporation language in any such filing.

FEES BILLED TO CADENCE BY KPMG LLP DURING FISCAL 2009 AND 2008

The following table presents fees incurred by Cadence for professional services rendered by KPMG LLP for the fiscal years ended January 2, 2010 and January 3, 2009.

	Fiscal Year Ended January 2, 2010	Fiscal Year Ended January 3, 2009
	(In thousands)	
Audit Fees(1)	\$ 3,150	\$ 5,108
Audit-Related Fees(2)	1(3)	
Total Audit and Audit-Related Fees	3,151	5,108
Tax Fees(4)	40(5)	33(6)
All Other Fees		
Total Fees	\$ 3,191	\$ 5,141

- (1) Includes fees for the audit of Cadence's consolidated financial statements in Cadence's Annual Report on Form 10-K, fees for the audit of Cadence's internal control over financial reporting in accordance with Section 404 of the Sarbanes-Oxley Act of 2002, fees for the review of the interim condensed consolidated financial statements in Cadence's Quarterly Reports on Form 10-Q and fees for services that are normally provided by KPMG LLP in connection with statutory and regulatory filings or other engagements. The amount for fiscal 2009 also includes estimated fees of \$587,064, not yet paid as of the date of this filing, which includes fees for services rendered in connection with Cadence's year-end financial statement audit and the audit of Cadence's internal control over financial reporting in accordance with Section 404 of the Sarbanes-Oxley Act of

2002 of \$272,062 and fees for statutory and regulatory filings related to fiscal 2009 of \$315,002. The amount for fiscal 2008 also includes fees for the services rendered in connection with the restatements of the interim condensed consolidated financial statements for the first and second quarters of fiscal 2008.

- (2) Includes fees for assurance and related services that are reasonably related to the performance of the audit or review of Cadence's consolidated financial statements that are not reported under Audit Fees.
- (3) Audit-Related Fees for fiscal 2009 consisted of fees for a statutory compliance engagement in India associated with the certification of certain financial data for a regulatory filing.
- (4) Includes fees for tax compliance, tax advice and tax planning.
- (5) Tax Fees for fiscal 2009 consisted of tax compliance fees of \$40,218.
- (6) Tax Fees for fiscal 2008 consisted of tax compliance fees of \$26,383 and tax planning and consulting fees of \$6,596.

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AUDIT COMMITTEE PRE-APPROVAL OF AUDIT AND PERMISSIBLE NON-AUDIT SERVICES OF THE INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Audit Committee pre-approves all audit and permissible non-audit services provided by KPMG LLP prior to the engagement of KPMG LLP with respect to such services. Pursuant to the Audit Committee's pre-approval policy, these services may include specified audit services, audit-related services, tax compliance services and tax planning and related tax services.

However, engagements for these pre-approved audit-related and tax services with an estimated cost of more than \$250,000 or that exceed the applicable budgeted amount for the pre-approved services must be pre-approved on a case-by-case basis by the Audit Committee or the Chairman of the Audit Committee, or, if the Chairman is unavailable, another member of the Audit Committee. In addition, any proposed engagement of KPMG LLP for services that are not pre-approved audit-related and tax services as described above must also be pre-approved on a case-by-case basis by the Audit Committee or the Chairman of the Audit Committee, or, if the Chairman is unavailable, another member of the Audit Committee. The members to whom such authority is delegated must report any approval decisions to the full Audit Committee at its next scheduled meeting. None of the services described in the table above entitled "Fees Billed to Cadence by KPMG LLP During Fiscal 2009 and 2008" were approved by the Audit Committee under the *de minimis* exception provided by Rule 2-01(c)(7)(i)(C) of Regulation S-X.

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**SECURITY OWNERSHIP OF
CERTAIN BENEFICIAL OWNERS AND MANAGEMENT**

The following table sets forth certain information regarding the ownership of Cadence common stock as of March 16, 2010, the record date, unless otherwise indicated below, by:

All those known by Cadence to be beneficial owners of more than 5% of its common stock;

Each of the executive officers named in the Summary Compensation Table presented below under Compensation of Executive Officers;

All directors and director nominees; and

All current executive officers and directors of Cadence as a group.

Beneficial Owner	Beneficial Ownership(1) Number of Shares	Percent of Total
<i>Five Percent Stockholders:</i>		
Dodge & Cox(2) 555 California Street, 40th Floor San Francisco, CA 94104	46,518,050	17.20%
T. Rowe Price Associates, Inc.(3) 100 E. Pratt Street Baltimore, Maryland 21202	21,349,558	7.90
BlackRock, Inc.(4) 40 East 52nd Street New York, NY 10022	16,011,440	5.92
<i>Directors and Executive Officers:</i>		
Donald L. Lucas(5)(6)	200,000	*
Alberto Sangiovanni-Vincentelli(5)	292,993	*
George M. Scalise(5)	232,500	*
John B. Shoven(5)	473,750	*
Roger S. Siboni(5)	240,000	*
John A.C. Swainson(5)	115,000	*
Lip-Bu Tan(5)(7)	1,391,814	*
Kevin S. Palatnik(5)	610,890	*
Charlie Huang(5)(8)	658,451	*
John J. Bruggeman II(5)	75,934	*
Thomas A. Cooley(5)	193,927	*
James J. Cowie(5)	261,181	*
All current executive officers and directors as a group (14 persons)(9)	5,526,408	2.02

* Less than 1%

- (1) This table is based upon information provided by principal stockholders pursuant to Schedules 13G filed with the SEC and the executive officers and directors. Unless otherwise indicated in the footnotes to this table and subject to community property laws where applicable, Cadence believes that each of the stockholders named in this table has sole voting and investment power with respect to the shares indicated as beneficially owned by such stockholder. Beneficial ownership of greater than 5% of Cadence's outstanding common stock reflects ownership as of the most recent date indicated under filings with the SEC as noted below, while beneficial ownership of the executive officers and directors is as of the record date. Applicable percentages are based on 270,413,071 shares of Cadence common stock outstanding on the record date, adjusted as required by rules promulgated by the SEC.
- (2) Dodge & Cox filed an amended Schedule 13G with the SEC on February 12, 2010, indicating that it beneficially owns 46,518,050 shares for which it has sole voting power with respect to 44,238,700 shares, shared voting power with respect to 53,400 shares and sole dispositive power with respect to 46,518,050 shares.

(footnotes continue on following page)

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- (3) T. Rowe Price Associates, Inc. filed a Schedule 13G with the SEC on February 11, 2010, indicating that it beneficially owns 21,349,558 shares for which it has sole voting power with respect to 2,866,328 shares and sole dispositive power with respect to 21,111,339 shares.
- (4) BlackRock, Inc. filed an amended Schedule 13G with the SEC on January 29, 2010, indicating that it acquired, on December 1, 2009, Barclays Global Investors. As a result, Barclays Global Investors is now included as a subsidiary of BlackRock, Inc. for purposes of Schedule 13G filings. BlackRock, Inc. indicated that it beneficially owns 16,011,440 shares for which it has sole voting and dispositive power.
- (5) Includes shares which executive officers named in the Summary Compensation Table presented under Compensation of Executive Officers and directors of Cadence have the right to acquire within 60 days after the record date upon exercise of outstanding stock options as follows:

Donald L. Lucas	195,000	Lip-Bu Tan	804,687
Alberto Sangiovanni-Vincentelli	262,500	Kevin S. Palatnik	331,562
George M. Scalise	222,500	Charlie Huang(8)	282,334
John B. Shoven	358,750	John J. Bruggeman II	8,125
Roger S. Siboni	235,000	Thomas A. Cooley	84,584
John A.C. Swainson	100,000	James J. Cowie	142,709

- (6) Includes 5,000 shares held by Donald L. Lucas, TTEE, Donald L. & Lygia S. Lucas Trust dtd 12/3/84, of which Mr. Lucas is the trustee.
- (7) Includes 122,795 shares held by Lip-Bu Tan and Ysa Loo Trust dated 2/3/1992, of which Mr. Tan and his spouse are trustees and for which Mr. Tan shares voting and investment power with his spouse, and 5,000 shares held by A&E Investment LLC, the sole member of which is the Lip-Bu Tan and Ysa Loo Trust dated 2/3/1992. Also includes 1,000 shares held by L Tan & N Lee & W Lee Trustees, Pacven Walden Inc. 401(k) PSP FBO Lip-Bu Tan for which Mr. Tan has sole voting and investment power. Mr. Tan disclaims beneficial ownership of these shares except to the extent of his pecuniary interest therein.
- (8) Includes 244,488 shares held by Huang-Zhang Trust U/A DTD 6/12/96, of which Mr. Huang and his spouse are trustees and for which Mr. Huang shares voting and investment power with his spouse. Also includes 11,420 shares held in custodial accounts by Mr. Huang's spouse for their minor children and 10,680 shares held by Mr. Huang's spouse (including 3,959 shares that may be acquired within 60 days after the record date upon exercise of outstanding stock options) for which Mr. Huang may be deemed to share voting and investment power. Mr. Huang disclaims beneficial ownership of these shares except to the extent of his pecuniary interest therein.
- (9) Includes 3,590,182 shares which all current executive officers and directors in the aggregate have the right to acquire within 60 days after the record date upon exercise of outstanding stock options.

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COMPENSATION DISCUSSION AND ANALYSIS

OVERALL OBJECTIVES OF EXECUTIVE COMPENSATION

Compensation of Cadence's executive officers is intended to attract, motivate and retain highly qualified individuals with the leadership skills necessary to achieve Cadence's annual and long-term business objectives and to create stockholder value. Cadence's executive officer compensation is based on the following principles:

Executive officers' total direct compensation (consisting of salary, annual cash incentive compensation and long-term equity incentive compensation) should be competitive with market practice;

Compensation of the executive officers should align the interests of the executive officers with the interests of Cadence's stockholders by providing the executive officers with long-term equity incentive compensation opportunities and promoting stock ownership, and thereby discourage behavior that leads to excessive risk; and

A substantial portion of the compensation of executive officers should be at risk and should vary based on Cadence's financial and operational performance as well as the executive officers' level of responsibility and individual performance at Cadence.

The Compensation Committee assesses the compensation of the executive officers annually to monitor Cadence's adherence to these principles.

FISCAL 2009 COMPENSATION HIGHLIGHTS

In light of the challenging economic environment in fiscal 2009, and taking into consideration the objectives listed above, the following compensation decisions were made with respect to fiscal 2009:

The Compensation Committee accepted the voluntary temporary reduction of the base salaries of each Named Executive Officer (as defined in "Compensation of Executive Officers" below) who was an executive officer of Cadence in May 2009;

The Compensation Committee accepted the recommendation of management to withhold bonus opportunities from executive officers, including the Named Executive Officers, for performance in fiscal 2009 under the Bonus Plan; and

The Compensation Committee determined that a relatively higher ratio of long-term equity incentive compensation to cash compensation would provide the appropriate alignment with stockholders during difficult economic times.

DETERMINING EXECUTIVE COMPENSATION

Competitive Compensation Levels

Each year the Compensation Committee benchmarks the competitiveness of the elements of the executive officers' total direct compensation. The Compensation Committee also periodically reviews the competitiveness of the executive officers' severance and change in control arrangements and the broad-based employee benefit plans in which the executive officers participate.

In July 2008, the Compensation Committee identified two separate peer groups for benchmarking purposes to be used in connection with compensation decisions for fiscal 2009. One peer group was used to understand market trends with respect to pay programs and practices among business and talent competitors and other industry bellwethers, and is referred to in this proxy statement as the Direct Practices Peer Group. The other peer group was used to assess the competitiveness of the executive officers' total direct compensation compared to executives with similar titles and responsibilities at companies with which Cadence competes for talent, and is referred to in this proxy statement as the Primary Compensation Peer Group.

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The Direct Practices Peer Group was determined qualitatively by the Compensation Committee with the assistance of its independent compensation consultant, Semler Brossy, and is comprised of technology bellwether companies, as well as companies in nearby or adjacent markets and other business and talent competitors. Although the Compensation Committee monitors the compensation practices of the companies in this group to understand the compensation landscape in the technology market, it does not generally consider the level of compensation that these companies pay their executive officers (other than the companies that are also in the Primary Compensation Peer Group) when determining the compensation of Cadence's executive officers, because of differences in the scope of job responsibilities or the breadth of the organizations managed by executives holding the same or similar titles.

The following companies (three of which were also included in the Primary Compensation Peer Group, as indicated by an asterisk (*) below) comprised the Direct Practices Peer Group for fiscal 2009:

Adobe Systems Incorporated	Intel Corporation	Oracle Corporation
Applied Materials, Inc.	KLA-Tencor Corporation*	Synopsys, Inc.*
Broadcom Corporation	Mentor Graphics Corporation	VMware, Inc.
Cisco Systems, Inc.	NVIDIA Corporation*	

Primary Compensation Peer Group

In order to reflect more accurately the pool from which executive talent is drawn and to which it is lost, the Primary Compensation Peer Group is not limited to Cadence's direct business competitors. Rather, the Compensation Committee included companies that have a technology emphasis, are located in the San Francisco Bay Area (where Cadence is headquartered), compete in the same talent market as Cadence and fall within a relevant revenue and market capitalization range (i.e., technology companies with revenue between 0.5 and 2.5 times that of Cadence's fiscal 2007 revenue and two-year average market capitalization between 0.25 and 4 times that of Cadence's two-year average market capitalization as of July 2008). The resulting group of 28 companies was used to assess the competitiveness of the executive officers' base salaries, target and actual annual cash incentive compensation, long-term equity incentive opportunities and total direct compensation.

The following companies (three of which were also included in the Direct Practices Peer Group, as indicated by an asterisk (*) below) comprised the Primary Compensation Peer Group for fiscal 2009 for determining competitive compensation levels:

Altera Corporation	Lam Research Corporation	NVIDIA Corporation*
Atmel Corporation	Linear Technology Corporation	Palm, Inc.
Autodesk, Inc.	Logitech International S.A.	Polycom Inc.
Brocade Communications Systems, Inc.	LSI Corporation	SanDisk Corporation
Cypress Semiconductor Corporation	Maxim Integrated Products, Inc.	Sybase, Inc.
Electronic Arts Inc.	McAfee, Inc.	Synopsys, Inc.*
Intuit Inc.	National Semiconductor Corporation	Trimble Navigation Limited
JDS Uniphase Corporation	Network Appliance Inc.	VeriSign, Inc.
Juniper Networks Inc.	Novellus Systems, Inc.	Xilinx Inc.
KLA-Tencor Corporation*		

Compensation Determinations

Consistent with the principles of Cadence's executive officer compensation outlined above, after the Compensation Committee determines the market levels of each executive officer's compensation based on the compensation paid by the companies in the Primary Compensation Peer Group, the Compensation Committee assesses the appropriateness of each executive officer's compensation relative to executives with similar titles and responsibilities at the companies in the Primary Compensation Peer Group. Cadence does not target executive officer compensation at a specific level or percentage relative to compensation provided by the companies in the

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Primary Compensation Peer Group, whether for total direct compensation or any element of total direct compensation. Instead, when determining compensation for the executive officers, the Compensation Committee takes into account not only the information regarding compensation paid to executives with similar titles and responsibilities at the companies in the Primary Compensation Peer Group, but also each of the following factors, without prescribing particular weightings:

Cadence Factors

Cadence's financial and operational performance as compared to the performance of the companies in the Primary Compensation Peer Group; and

Cadence's relative size and scope of business as compared to the companies in the Primary Compensation Peer Group.

Individual Factors

Strategic importance of the position;

Scarcity in the market of the individual's skills and talents;

Individual performance over the preceding year;

Expected future contributions;

Historical compensation;

Ability to impact corporate and/or business unit results;

Retention risks; and

Relative positioning/performance versus other executives.

For each executive officer other than the CEO, the CEO typically makes assessments and recommendations to the Compensation Committee on whether there should be adjustments to an executive officer's annual base salary, annual cash incentive compensation and long-term equity incentive compensation based upon an assessment of each of the Cadence Factors and the Individual Factors outlined above, which are collectively referred to in this proxy statement as the Compensation Factors. The Compensation Committee then reviews these assessments and recommendations and determines whether or not to approve and/or modify the CEO's recommendations.

The Compensation Committee evaluates each of the Cadence Factors as well as the CEO's performance with respect to each of the Individual Factors described above, and the assessment from such evaluation is used to determine whether or not to adjust the CEO's compensation. The Compensation Committee, in its sole discretion, makes all decisions related to the CEO's compensation.

ELEMENTS OF EXECUTIVE COMPENSATION

The Named Executive Officers' compensation is comprised of the following elements:

Total direct compensation, consisting of:

Base salary;

Annual cash incentive compensation; and

Long-term equity incentive compensation (including stock options and shares of restricted stock).

Other compensation and benefits, consisting of:

Participation in Cadence's broad-based benefit plans;

Participation in Cadence's nonqualified deferred compensation plans; and

Limited perquisites.

Severance benefits.

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Consistent with the principles of Cadence's executive officer compensation outlined above, an executive officer's total direct compensation is based upon Cadence's performance as well as the performance of the individual executive officer. Cadence does not have a pre-established policy or target for allocating between fixed and variable compensation or among the different types of variable compensation, although the allocation is influenced by the Compensation Committee's assessment of the compensation practices of the companies in the Primary Compensation Peer Group and Cadence's short-term and long-term strategic objectives. Instead, the Compensation Committee aims to provide total direct compensation at levels sufficient to attract and retain qualified executives. Variable compensation generally consists of annual cash incentive compensation and long-term equity incentives, and represents the majority of the total direct compensation opportunity for each executive officer. As discussed in further detail below, for fiscal 2009, the Compensation Committee accepted the recommendation of management to withhold bonus opportunities from executive officers, including the Named Executive Officers, under the Bonus Plan, and determined that variable compensation would consist entirely of long-term equity incentives. The Compensation Committee believes that the executive officers' consistent and sustained performance can have a direct and significant impact on long-term stockholder value.

Base Salaries

Cadence offers its executive officers an annual base salary to compensate them for services rendered during the year. Base salaries are essential for the attraction and retention of talented executive officers and are determined as described above under Compensation Determinations. The executive officers' base salaries are reviewed annually by the Compensation Committee, but do not automatically increase each year. Changes to the executive officers' base salaries, if any, are typically made in the first quarter of the year or in connection with an executive officer's promotion or change in responsibilities.

In February 2009, the Compensation Committee approved the following base salary increases for certain Named Executive Officers as a result of changes in Cadence's organizational structure and in recognition of each executive's increased responsibilities: (i) Mr. Palatnik's base salary was increased to \$450,000; (ii) Mr. Huang's base salary was increased to \$400,000; and (iii) Mr. Cooley's base salary was increased to \$425,000.

In May 2009, in support of Cadence's cost-reduction strategy and commitment to operational efficiency, Cadence's executive officers volunteered a temporary reduction of the base salaries of each of the executive officers, including the Named Executive Officers who were then executive officers, effective July 1, 2009 through March 31, 2010, and the Compensation Committee accepted this voluntary reduction. During this period, the base salary of Mr. Tan was reduced by 20% and the base salary of each of Cadence's Senior Vice Presidents (which include all of the other Named Executive Officers who were executive officers at the time) was reduced by 10%. In February 2010, Mr. Tan requested to reduce his base salary, effective March 1, 2010, by another 6.25%, without any limitation on the duration of such additional salary reduction, and the Compensation Committee accepted this voluntary reduction. At the same time, Cadence's other executive officers, including each of the other Named Executive Officers, volunteered to continue the temporary reductions to their base salaries through June 30, 2010, and the Compensation Committee accepted such extension.

Annual Cash Incentive Compensation

Cadence generally provides its executive officers with the opportunity to earn variable cash compensation under the Bonus Plan. The purpose of the Bonus Plan is to reward executive officers for performance during a single fiscal year and to provide incentives for them to achieve Cadence's annual financial and operational goals, as measured against specific performance criteria relative to their respective business groups and Cadence's overall business results. In light of the challenging economic environment and in support of Cadence's cost reduction strategy, in early 2009, the

Compensation Committee accepted the recommendation of management to withhold bonus opportunities from executive officers, including the Named Executive Officers, for fiscal 2009. The Compensation Committee believed that a relatively higher ratio of long-term equity incentive compensation to cash compensation would provide appropriate alignment with stockholders during this challenging period and would reward the executive officers for building and sustaining long-term stockholder value.

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In February 2010, the Compensation Committee determined that the executive officers, including the Named Executive Officers, would be eligible for bonus opportunities under the Bonus Plan for fiscal year 2010, subject to the satisfaction of the financial and operational goals set forth in the Bonus Plan. Under the Bonus Plan for fiscal 2010, Cadence will provide its executive officers with the opportunity to earn variable cash compensation in two independent semi-annual performance measurement and payment periods.

Other Discretionary Bonuses

The Compensation Committee has the discretion to reward executive officers with additional cash compensation, including in connection with their performance, contribution, promotion or retention. As an inducement for Mr. Bruggeman to join Cadence and in connection with the negotiation of the terms of his employment, the Compensation Committee approved a one-time hiring bonus of \$40,000, payable upon the commencement of his employment in August 2009. Mr. Bruggeman must repay a pro-rated amount of the bonus if he voluntarily terminates his employment within 24 months of his hire date: 100% in the first 12 months after his hire date, 70% in the subsequent 12-18 months after his hire date, and 40% in the remaining 18-24 months after his hire date. In December 2008, the Compensation Committee approved a discretionary cash payment of \$250,000 to Mr. Tan in recognition of his service as a member of the Interim Office of the Chief Executive, referred to as the IOCE in this proxy statement, which became payable upon his appointment as CEO. Mr. Tan was a member of the IOCE from October 15, 2008 through the beginning of fiscal 2009, and therefore \$11,765 of the discretionary cash payment he received for his service as a member of the IOCE was considered earned in fiscal 2009.

Long-Term Equity Incentive Compensation

Consistent with the principles of Cadence's compensation for its executive officers outlined above, long-term equity incentives are designed to provide executive officers with an equity stake in Cadence, promote stock ownership to align the executive officers' interests with those of Cadence's stockholders and create significant incentives for executive retention. Specifically, stock options provide an opportunity for Cadence to reward its executive officers if Cadence's stock price increases and the executive officers remain employed at Cadence during the period required for the stock options to vest. Furthermore, awards of restricted stock align the interests of executive officers with the interests of stockholders through stock ownership, and the value of the executive officers' reward increases when Cadence's stock price increases.

When the Compensation Committee determines and approves individual equity grants to executive officers, it considers compensation paid to executives with similar titles and responsibilities at the companies in the Primary Compensation Peer Group and each of the Compensation Factors, without prescribing particular weightings to any of the Compensation Factors. In addition, the Compensation Committee reviews the CEO's assessments and recommendations as to the long-term equity compensation for all of the executive officers except himself.

In fiscal 2010, the Compensation Committee adopted a policy that, in determining the compensation of executive officers, including the Named Executive Officers, a portion of their stock awards granted be performance-based. The performance-based stock awards may take either of the following forms:

Performance-Vesting Stock Awards stock awards that do not vest or become exercisable unless certain specific business performance goals established by the Compensation Committee are met.

Performance-Accelerated Stock Awards stock awards for which vesting is accelerated upon achievement of specific business performance goals established by the Compensation Committee.

In consideration of the other elements of his compensation package and as an inducement for Mr. Tan to accept appointment as CEO in January 2009, Mr. Tan received an option to purchase shares of Cadence common stock at its fair market value on the grant date, 25% of which vests on the first anniversary of the grant date and the remainder of which vests monthly over a period of three years thereafter, and an award of shares of restricted stock, 25% of which vests on each of the first four anniversaries of the grant date, subject to the achievement of performance goals intended to qualify the awards as performance-based compensation under Section 162(m) of the Code. Mr. Tan's January 2009 equity grant reflected the Compensation Committee's determination that long-term equity incentives

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align the CEO's incentives with stockholder interests. Please refer to the Grants of Plan-Based Awards in Fiscal Year 2009 table below for more detail regarding Mr. Tan's grants.

In February 2009, 65% to 80% of the long-term equity incentives provided to the Named Executive Officers at the time, in terms of grant date fair value, consisted of stock options and the remaining 20% to 35% consisted of restricted stock. The Compensation Committee intended this long-term equity incentive mix to provide the appropriate level of stockholder alignment, reward its executives for building and sustaining long-term stockholder value, and balance between stock options (which provide value only if the stock price increases) and restricted stock (which provide more certain retention value). The Compensation Committee and the CEO continue to believe that equity-based compensation is an important component of Cadence's compensation program and essential to motivate executives and align their interests with those of its stockholders.

As an inducement for Mr. Bruggeman to join Cadence and in connection with the negotiation of the terms of his employment, the Compensation Committee approved an equity grant to Mr. Bruggeman in September 2009 that included stock options and restricted stock. Please refer to the Grants of Plan-Based Awards in Fiscal Year 2009 table below for more detail regarding Mr. Bruggeman's grants.

The February 2009 stock options (which were 65% to 80% of the February 2009 grants based on the total grant date fair value) vest monthly over four years from the date of grant and expire seven years from the date of grant. The February 2009 restricted stock awards (which were 20% to 35% of the February 2009 grants based on the total grant date fair value), vest in equal semi-annual installments over three years from the date of grant, subject to the achievement of performance goals intended to qualify the awards as performance-based compensation under Section 162(m) of the Code. This vesting schedule reflects a change from the restricted stock granted during fiscal 2008, which vests 25% on each of the first four anniversaries of the grant date, subject to the achievement of certain specified performance goals intended to qualify the awards as performance-based compensation under Section 162(m) of the Code. The Compensation Committee determined that a shorter vesting schedule with more frequent vesting dates would be appropriate given the lower overall compensation opportunities provided to the Named Executive Officers in fiscal 2009, and would serve to more effectively bolster the ownership stake the Named Executive Officers would have in Cadence, given the proportion of past stock option grants that continue to be underwater.

In February 2010, the Compensation Committee made annual equity grants in the form of stock options and restricted stock to each of the Named Executive Officers. Consistent with the February 2009 equity grants, the February 2010 equity grants are allocated more heavily towards stock options than restricted stock. The Compensation Committee awarded approximately 80% of the total grant date fair value of Mr. Tan's equity grant in the form of stock options, with the remainder consisting of restricted stock. For the other Named Executive Officers, approximately 60% of the total grant date fair value of the equity grants is in the form of stock options. The terms and vesting schedules of February 2010 stock option grants are consistent with the stock option grants made in fiscal 2009. The February 2010 restricted stock awards vest in equal semi-annual installments over three years from the date of grant, subject to the achievement of performance goals intended to qualify the awards as performance-based compensation under Section 162(m) of the Code.

Grant Timing Policy

The Compensation Committee and senior management monitor Cadence's stock option and restricted stock grant policies to ensure that such policies comply with governing regulations and are consistent with good corporate practice. Grants to the executive officers are generally made at the Compensation Committee meeting held in February of each year, after results for the preceding fiscal year become publicly available, enabling the Compensation Committee to consider both the prior year's performance and expectations for the succeeding year in making grant decisions. However, the Compensation Committee may make grants at any time of the year it deems

appropriate.

Deferred Compensation

In fiscal 2009, each of the Named Executive Officers was eligible to defer compensation payable to them under a nonqualified deferred compensation plan maintained by Cadence, which is referred to in this proxy statement as

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the Deferred Compensation Plan. The Deferred Compensation Plan is designed to allow for savings above the limits imposed by the Code for 401(k) plans on an income tax-deferred basis for Cadence employees at the level of vice president (or its equivalent) and above who choose to participate. Amounts deferred into the Deferred Compensation Plan are held in accounts with values indexed to the performance of selected mutual funds or money market accounts. The investment options made available under the Deferred Compensation Plan are substantially similar to those available under Cadence's tax-qualified 401(k) plan. Cadence does not match contributions made under the Deferred Compensation Plan. Cadence maintains the Deferred Compensation Plan for the purposes of providing a competitive benefit and allowing all participants, including the Named Executive Officers, an opportunity to defer income tax payments on their cash compensation.

Other Employee Benefit Plans

The Named Executive Officers are eligible for the same benefits available to Cadence employees generally. These include participation in a tax-qualified 401(k) plan, employee stock purchase plan, and group life, health, dental, vision and disability insurance plans. Cadence also periodically benchmarks its broad-based employee benefit plans based upon a review of the benefits survey conducted by the Silicon Valley Employers' Forum. Cadence aims to provide benefits to its employees that are consistent with market practice.

Perquisites

The only material perquisite provided to any Named Executive Officer in fiscal 2009 was a payment of \$15,792 made to outside counsel for legal services provided to Mr. Tan in connection with the negotiation of his employment agreement.

Severance Benefits

The Compensation Committee periodically reviews typical industry practices concerning severance and change in control agreements and Cadence's severance and change in control agreements. Cadence has entered into agreements with Messrs. Tan, Palatnik, Cooley, Cowie and Huang that provide for benefits upon termination of employment under certain circumstances, including in connection with a change in control of Cadence. Cadence provides these benefits as a means of remaining competitive, retaining executive officers, focusing executive officers on stockholder interests when considering strategic alternatives and providing income protection in the event of involuntary loss of employment. In general, these arrangements provide for severance benefits upon Cadence's termination of the executive's employment without cause or resignation by the executive for good reason (constructive termination). In the event of a change in control of Cadence, and if the executive's employment is terminated without cause or for good reason (constructive termination), the executive will receive enhanced severance benefits. Accordingly, Cadence provides for enhanced severance benefits only in the event of a "double trigger" because it believes that the executive officers would be materially harmed only if a change in control results in reduced responsibilities or compensation or loss of employment.

Please refer to the discussion under "Potential Payments upon Termination or Change in Control and Employment Contracts" below for a more detailed discussion of the severance and change in control arrangements with the Named Executive Officers.

STOCK OWNERSHIP GUIDELINES

Cadence maintains stock ownership guidelines for its executive officers. These guidelines are designed to promote alignment with the interests of stockholders and Cadence's commitment to sound corporate governance. The Compensation Committee reviewed industry standard practices when it established the guidelines below. All of the

Named Executive Officers satisfy Cadence's stock ownership guidelines.

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Position	Shares(1)	Years to Meet Guidelines
Chief Executive Officer	100,000	
Chief Financial Officer	50,000	5 years
Senior Vice Presidents	25,000	

- (1) For purposes of determining stock ownership levels, the following forms of equity interests in Cadence count towards satisfaction of the stock ownership guidelines: restricted or incentive shares (whether vested or unvested), shares obtained through the Amended and Restated Employee Stock Purchase Plan, which is referred to in this proxy statement as the ESPP, shares acquired and held through the exercise of stock options, shares purchased on the open market, shares owned outright by the executive officer or his or her immediate family members residing in the same household, and shares held in trust for the benefit of the executive officer or his or her family.

CLAWBACK POLICY

Cadence has adopted a clawback policy, which provides that if Cadence restates its reported financial results, the Board will review all bonuses and other awards made after January 1, 2010 that were made to senior executive officers on the basis of having met or exceeded performance goals during the period covered by the restatement and will, to the extent practicable and in the best interests of stockholders, instruct Cadence to seek to recover or cancel such bonuses or awards to the extent that performance goals would not have been met under such restated financial results.

TAX CONSIDERATIONS**Section 162(m) of the Internal Revenue Code of 1986**

Section 162(m) of the Code limits deductions for certain executive compensation in excess of \$1,000,000 in any fiscal year. Certain types of compensation are deductible only if performance criteria are specified in detail and payments are contingent on stockholder approval of the compensation arrangement. Cadence attempts to structure its compensation arrangements to achieve deductibility under Section 162(m) of the Code, unless the benefit of such deductibility is outweighed by the need for flexibility or the attainment of other corporate objectives. The Compensation Committee will continue to monitor issues concerning the deductibility of executive compensation and will take appropriate action if and when it is warranted. Since corporate objectives may not always be consistent with the requirements for full deductibility, the Compensation Committee is prepared, if it deems appropriate, to enter into compensation arrangements under which payments may not be deductible under Section 162(m) of the Code. Thus, deductibility will not be the sole factor used by the Compensation Committee in ascertaining appropriate levels or modes of compensation.

In fiscal 2009, all stock option and restricted stock grants to Messrs. Tan, Palatnik, Cooley, Cowie and Huang were structured with the intent to qualify them as performance-based compensation under Section 162(m) of the Code, and should be fully deductible.

Section 280G of the Internal Revenue Code of 1986

Section 280G of the Code disallows a company's tax deduction for certain payments in connection with a change in control, defined as excess parachute payments, and Section 4999 of the Code imposes a 20% excise tax on certain persons who receive excess parachute payments. Messrs. Tan, Palatnik, Cooley, Cowie and Huang are not provided with tax gross-up payments in the event their payments become subject to this excise tax, but instead are entitled to the best after-tax alternative. In other words, they are entitled to whichever of the following payments results in the largest after-tax amount:

The full payout including any portion that would be classified as an excess parachute payment; or

The maximum payout that would result in no portion of the payout being subject to the excise tax.

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Cadence chose to provide Messrs. Tan, Palatnik, Cooley, Cowie and Huang with the best after-tax alternative to maximize the benefits provided to each executive in connection with a change in control while allowing Cadence to avoid making any gross-up payments.

In the event that a portion of the payout would be classified as an excess parachute payment, Cadence's tax deduction would be disallowed under Section 280G of the Code and an excise tax would be imposed on the Named Executive Officer under Section 4999 of the Code. Please refer to the discussion below under "Potential Payments upon Termination or Change in Control and Employment Contracts" for more detail on the potential lost tax deductions.

COMPENSATION COMMITTEE REPORT

The Compensation Committee has reviewed and discussed the Compensation Discussion and Analysis above with management. In reliance on the review and discussions referred to above, the Compensation Committee recommended to the Board, and the Board approved, the inclusion of the Compensation Discussion and Analysis in this proxy statement and incorporation by reference into Cadence's Annual Report on Form 10-K for the fiscal year ended January 2, 2010.

COMPENSATION COMMITTEE

John B. Shoven, Chairman
Donald L. Lucas
George M. Scalise

COMPENSATION COMMITTEE INTERLOCKS AND INSIDER PARTICIPATION

No member of the Compensation Committee is, or was during or prior to fiscal 2009, an officer or employee of Cadence or any of its subsidiaries. None of Cadence's executive officers serves or served as a director or member of the compensation committee of another entity where an executive officer of such other entity serves or served as a director or member of the Compensation Committee of Cadence.

Table of Contents**COMPENSATION OF EXECUTIVE OFFICERS**

The following table shows the compensation awarded or paid to, or earned by, Cadence's CEO and CFO as of the end of fiscal 2009, Cadence's Senior Vice President who performed functions similar to a principal executive officer until Cadence's CEO was appointed on January 8, 2009 and Cadence's three most highly compensated executive officers other than those three officers as of the end of fiscal 2009 (collectively referred to herein as the Named Executive Officers).

SUMMARY COMPENSATION TABLE

Name and Principal Position	Year	Salary (\$)(1)	Bonus (\$)(1)	Stock Awards (\$)(2)	Option Awards (\$)(2)	All Other Compensation (\$)(3)	Total (\$)
Lip-Bu Tan President and Chief Executive Officer	2009	\$ 531,692	\$ 11,765(4)	\$ 2,076,000	\$ 3,636,609	\$ 26,029	\$ 6,282,095
	2008	0	238,235	0	163,900	0	402,135
Kevin S. Palatnik Senior Vice President and Chief Financial Officer	2009	423,135	0	210,000	625,873	10,261	1,269,269
	2008	383,269	0	562,000	410,520	6,992	1,362,781
Charlie Huang Senior Vice President and Chief Strategy Officer	2009	375,692	0	147,000	455,180	9,168	987,040
	2008	350,000	0	318,300	256,212	8,135	932,647
John J. Bruggeman II(5) Senior Vice President and Chief Marketing Officer	2009	125,192	40,000(6)	212,100	653,140	4,369	1,034,801
Thomas A. Cooley Senior Vice President, Worldwide Field Operations	2009	401,337	0	126,000	455,180	9,386	991,903
James J. Cowie	2009	332,096	0	168,000	455,180	8,788	964,064
	2008	333,846	100,000(7)	327,900	239,514	8,135	1,009,395

Senior Vice
President,
General Counsel
and Secretary

- (1) Includes amounts deferred pursuant to Section 401(k) of the Code and the Deferred Compensation Plan.
- (2) In accordance with SEC rules, the amount shown reflects the grant date fair value of stock awards and option awards granted during fiscal 2009 calculated pursuant to FASB ASC 718. The grant date fair value is based on the price of Cadence common stock on the date the award was granted and does not reflect any fluctuations in the price of Cadence common stock subsequent to the grant date. The amount shown therefore does not reflect the financial benefit that the holder of the award will actually realize upon the vesting of the award, nor, with respect to stock options, whether the stock option will be exercised or exercisable prior to its expiration. The assumptions used to calculate the valuation of the stock awards and option awards for fiscal 2009 are set forth in Note 9 to the Notes to Consolidated Financial Statements in Cadence's Annual Report on Form 10-K for the fiscal year ended January 2, 2010.

In accordance with the new SEC rules, the amount shown for fiscal 2008 was recalculated to reflect the grant date fair value of stock awards and option awards and is therefore different than the amounts shown in Cadence's 2008 proxy statement.

- (3) The payments listed in the All Other Compensation column above reflect the following and, unless noted below, are based upon the actual cost expended by Cadence in connection with the following amounts:

For Mr. Tan, the amount shown includes (for fiscal 2009): \$7,350 for 401(k) matching contributions, \$2,847 for term life insurance premium payments, \$15,792 paid to outside counsel for legal services provided in connection with the negotiation of his employment agreement and a sales incentive gift.

(footnotes continue on following page)

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For Mr. Palatnik, the amount shown includes (for fiscal 2009): \$7,350 for 401(k) matching contributions and \$2,911 for term life insurance premium payments.

For Mr. Huang, the amount shown includes (for fiscal 2009): \$7,350 for 401(k) matching contributions and \$1,818 for term life insurance premium payments.

For Mr. Bruggeman, the amount shown includes (for fiscal 2009): \$3,982 for 401(k) matching contributions and \$387 for term life insurance premium payments.

For Mr. Cooley, the amount shown includes (for fiscal 2009): \$7,350 for 401(k) matching contributions and \$2,036 for term life insurance premium payments.

For Mr. Cowie, the amount shown includes (for fiscal 2009): \$7,350 for 401(k) matching contributions and \$1,438 for term life insurance premium payments.

- (4) Mr. Tan received a discretionary cash payment of \$250,000 that was approved by the Compensation Committee on December 15, 2008 in recognition of Mr. Tan's service as a member of the IOCE. The amount of \$11,765 represents the prorated portion earned by Mr. Tan in fiscal 2009 and \$238,235 represents the prorated portion earned by Mr. Tan in fiscal 2008.
- (5) Mr. Bruggeman commenced his employment as Senior Vice President and Chief Marketing Officer on August 26, 2009.
- (6) As an inducement for Mr. Bruggeman to join Cadence, Mr. Bruggeman received a one-time discretionary bonus of \$40,000, in connection with the commencement of his employment as Senior Vice President and Chief Marketing Officer on August 26, 2009.
- (7) Mr. Cowie received a discretionary bonus of \$100,000 in connection with his promotion to Senior Vice President and General Counsel.

GRANTS OF PLAN-BASED AWARDS IN FISCAL YEAR 2009

Name	Grant Date	Possible Payments Under Non-Equity Incentive Plan Awards			All Other Stock Awards:	All Other Option Awards:	Exercise or Base Price of Option Awards	Grant Date Fair Value of Stock and Option Awards
		Threshold (\$)	Target (\$)	Maximum (\$)				
Lip-Bu Tan	1/08/09 2/05/09	\$	\$	\$	Number of Shares of Stock or Units (#)(1)	Number of Securities (#)	(\$/Sh)(2)	\$ 1,236,000 840,000

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	1/08/09		900,000(4)	4.12	2,009,340
	2/05/09		715,000(5)	4.20	1,627,269
	N/A				
Kevin S. Palatnik	2/05/09	50,000			210,000
	2/05/09		275,000(5)	4.20	625,873
	N/A				
Charlie Huang	2/05/09	35,000			147,000
	2/05/09		200,000(5)	4.20	455,180
	N/A				
John J. Bruggeman II	9/15/09	30,000			212,100
	9/15/09		200,000(6)	7.07	653,140
	N/A				
Thomas A. Cooley	2/05/09	30,000			126,000
	2/05/09		200,000(5)	4.20	455,180
	N/A				
James J. Cowie	2/05/09	40,000			168,000
	2/05/09		200,000(5)	4.20	455,180
	N/A				

(footnotes continue on following page)

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- (1) The stock awards granted to Messrs. Cooley, Cowie, Huang, Palatnik and Tan on February 5, 2009 were granted under the 1987 Stock Incentive Plan, as amended and restated, which is referred to in this proxy statement as the 1987 Plan, and vest over three years, with 1/6th of the shares subject to such stock award vesting every six months after the date of grant, subject to the achievement of certain specified performance goals intended to qualify the stock awards as performance-based compensation under Section 162(m) of the Code. The stock award granted to Mr. Tan on January 8, 2009 was granted under the 1987 Plan as an inducement for him to accept appointment as CEO and vests over four years, with 1/4th of the shares subject to such stock award vesting on each anniversary of the date of grant, subject to the achievement of certain specified performance goals intended to qualify the stock awards as performance-based compensation under Section 162(m) of the Code. The stock award granted to Mr. Bruggeman on September 15, 2009 was granted under the 2000 Nonstatutory Equity Incentive Plan, as amended and restated, which is referred to in this proxy statement as the 2000 Plan, as an inducement for him to accept employment as Senior Vice President and Chief Marketing Officer. Mr. Bruggeman's award vests over three years, with 1/6th of the shares subject to such stock award vesting every six months after the date of grant.
- (2) The exercise price of the stock options is equal to the closing price of Cadence common stock on the date of grant.
- (3) In accordance with SEC rules, the amount shown reflects the grant date fair value of stock awards and option awards calculated pursuant to FASB ASC 718. The grant date fair value is based on the price of Cadence common stock on the date the award was granted and does not reflect any fluctuations in the price of Cadence common stock subsequent to the grant date. The amount shown therefore does not reflect the financial benefit that the holder of the award will actually realize upon the vesting of the award, and with respect to option awards, such amount does not reflect whether the option award will be exercised or exercisable prior to its expiration. The assumptions used to calculate the valuation of the stock awards and option awards for fiscal 2009 are set forth in Note 9 to the Notes to Consolidated Financial Statements in Cadence's Annual Report on Form 10-K for the fiscal year ended January 2, 2010.
- (4) The stock option was granted as an inducement for Mr. Tan to accept appointment as CEO and under the 1987 Plan and vests over four years, with 1/4th of the shares subject to such stock option vesting on the first anniversary after the date of grant and 1/36th of the remaining shares vesting monthly thereafter.
- (5) The stock options were granted under the 1987 Plan and vest over four years, with 1/48th of the shares subject to such option vesting at the end of each month after the date of grant.
- (6) The stock option was granted as an inducement for Mr. Bruggeman to accept employment as Senior Vice President and Chief Marketing Officer and under the 2000 Plan and vests over four years, with 1/4th of the shares subject to such stock option vesting on the first anniversary after the date of grant and 1/36th of the remaining shares vesting monthly thereafter.

**NARRATIVE DISCLOSURE TO SUMMARY COMPENSATION TABLE AND
GRANTS OF PLAN-BASED AWARDS IN FISCAL YEAR 2009 TABLE**

EMPLOYMENT TERMS

Certain elements of compensation set forth in the Summary Compensation Table and Grants of Plan-Based Awards in Fiscal Year 2009 table reflect the terms of an employment agreement or an offer letter between Cadence and each of the Named Executive Officers that were in effect as of January 2, 2010.

Lip-Bu Tan. Cadence is a party to an employment agreement with Mr. Tan pursuant to which Mr. Tan serves as President and Chief Executive Officer. The agreement provides for an initial base salary of \$600,000 per year and for Mr. Tan's participation in the Bonus Plan at an annual target bonus of 100% of his base salary. Effective July 1, 2009 through March 1, 2010, Mr. Tan's base salary was subject to a voluntary salary reduction whereby his salary was reduced by 20%. Effective March 1, 2010, Mr. Tan's employment agreement was further amended to reflect Mr. Tan's request to further reduce his base salary to \$450,000, without any limitation on the duration of such further reduction.

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Kevin S. Palatnik. Cadence is a party to an employment agreement with Mr. Palatnik pursuant to which Mr. Palatnik serves as Senior Vice President and Chief Financial Officer. The agreement provides for an initial base salary of \$400,000 per year and for Mr. Palatnik's participation in the Bonus Plan at an annual target bonus of 75% of his base salary. In February 2009, Mr. Palatnik's base salary was increased to \$450,000. Effective July 1, 2009 through June 30, 2010, Mr. Palatnik's base salary was voluntarily reduced by 10%.

Charlie Huang. Cadence is a party to an employment agreement with Mr. Huang pursuant to which Mr. Huang serves as Senior Vice President and Chief Strategy Officer. The agreement provides for an initial base salary of \$350,000 per year and for Mr. Huang's participation in the Bonus Plan at an annual target bonus of 75% of his base salary. In February 2009, Mr. Huang's base salary was increased to \$400,000. Effective July 1, 2009 through June 30, 2010, Mr. Huang's base salary was voluntarily reduced by 10%.

John J. Bruggeman II. Cadence is a party to an offer letter with Mr. Bruggeman pursuant to which Mr. Bruggeman serves as Senior Vice President and Chief Marketing Officer. The offer letter provides for an initial base salary of \$350,000 per year and for Mr. Bruggeman's participation in the Bonus Plan at an annual target bonus of 75% of his base salary. Effective April 1, 2010 through June 30, 2010, Mr. Bruggeman's base salary was voluntarily reduced by 10%.

Thomas A. Cooley. Cadence is a party to an employment agreement with Mr. Cooley pursuant to which Mr. Cooley serves as Senior Vice President, Worldwide Field Operations. The agreement provides for an initial base salary of \$425,000 per year and for Mr. Cooley's participation in the Bonus Plan at an annual target bonus of 75% of his base salary. Effective July 1, 2009 through June 30, 2010, Mr. Cooley's base salary was voluntarily reduced by 10%.

James J. Cowie. Cadence is a party to an employment agreement with Mr. Cowie pursuant to which Mr. Cowie serves as Senior Vice President, General Counsel and Secretary. The agreement provides for an initial base salary of \$350,000 per year and for Mr. Cowie's participation in the Bonus Plan at an annual target bonus of 75% of his base salary. Effective July 1, 2009 through June 30, 2010, Mr. Cowie's base salary was voluntarily reduced by 10%.

The proportion of salary to total compensation of the Named Executive Officers is explained above under Compensation, Discussion and Analysis Elements of Executive Compensation.

EQUITY PLAN AWARDS

The stock awards granted in fiscal 2009 to the Named Executive Officers were granted under the 1987 Plan or the 2000 Plan and vest over three years, with 1/6th of the shares subject to vesting every six months after the date of grant, except for the January 8, 2009 grant to Mr. Tan, which was granted as an inducement for him to accept appointment as CEO, vests over four years and is described in footnote (6) to the Outstanding Equity Awards at 2009 Fiscal Year End table below. The stock awards granted on January 8, 2009 and February 5, 2009 under the 1987 Plan are also subject to the achievement of certain specified performance goals intended to qualify the stock awards as performance-based compensation under Section 162(m) of the Code. The stock options granted in fiscal 2009 to the Named Executive Officers were granted under the 1987 Plan or the 2000 Plan and vest over four years, with 1/48th of the shares subject to vesting at the end of each month after the date of grant, except for the grant to Messrs. Bruggeman and Tan, which are described in footnote (4) to the Outstanding Equity Awards at 2009 Fiscal Year End table below. The exercise price of stock options granted under the 1987 Plan and the 2000 Plan in fiscal 2009 was the closing price of Cadence common stock on the date of grant. Dividends, if any, are payable to the holders of restricted stock issued under Cadence's equity plans.

Table of Contents**OUTSTANDING EQUITY AWARDS AT 2009 FISCAL YEAR END**

Name	Option Awards				Stock Awards	
	Number of Securities	Number of Securities			Market Value of	
	Underlying	Underlying			Number of	Shares of
	Unexercised Options (#)	Unexercised Options (#)	Option Exercise Price (\$)	Option Expiration Date	Shares of Stock that have not Vested (#)	Stock that have not Vested (\$)(2)
	Exercisable(1)	Unexercisable				
Lip-Bu Tan	6,250	0	\$ 18.30	2/04/14		\$
	25,000	0	14.87	4/01/14		
	25,000	0	14.59	4/01/15		
	25,000	0	18.08	4/01/16		
	25,000	0	20.53	4/02/17		
	25,000	0	10.94	4/01/18		
	100,000(3)	0	2.61	12/15/15		
	0	900,000(4)	4.12	1/08/16		
	148,958	566,042(5)	4.20	2/05/16		
					300,000(6)	1,797,000
					166,666(7)	998,329
Kevin S. Palatnik	125,000	0	21.99	6/15/11		
	25,000	0	22.35	12/28/11		
	32,291	17,709(5)	21.58	5/15/14		
	41,666	58,334(5)	11.24	4/23/15		
	57,291	217,709(5)	4.20	2/05/16		
					7,500(8)	44,925
					8,750(9)	52,413
					12,500(10)	74,875
					41,666(7)	249,579
Charlie Huang	20,000	0	24.00	3/09/11		
	53,500	0	15.49	9/21/11		
	8,000	0	12.63	7/31/12		
	5,000	0	9.59	2/07/13		
	32,291	17,709(5)	21.58	5/15/14		
	28,750	31,250(5)	10.61	2/01/15		
	41,666	158,334(5)	4.20	2/05/16		
	48,958	1,042(11)	16.80	2/15/16		
					5,000(12)	29,950
					22,500(13)	134,775
					29,166(7)	174,704
John J. Bruggeman II	0	200,000(4)	7.07	9/15/16		
					30,000(14)	179,700
Thomas A. Cooley	5,937	9,063(5)	11.25	5/15/15		
	6,459	0	17.89	12/09/15		

41,666	158,334(5)	4.20	2/05/16	3,000(15)	17,970
				18,750(16)	112,313
				25,000(7)	149,750

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Name	Option Awards				Stock Awards	
	Number of Securities	Number of Securities				
	Underlying	Underlying	Option Exercise Price (\$)	Option Expiration Date	Number of Shares of Stock that have not Vested (#)	Market Value of Shares of Stock that have not Vested (\$)(2)
	Unexercised Options (#) Exercisable(1)	Unexercised Options (#) Unexercisable				
James J. Cowie	25,000	0	20.19	8/25/10		
	5,834	0	13.04	4/30/14		
	10,000	0	17.89	12/09/15		
	26,250	33,750(5)	10.93	4/01/15		
	41,666	158,334(5)	4.20	2/05/16		
					2,500(15)	14,975
					7,500(8)	44,925
					12,500(10)	74,875
					33,333(7)	199,665

- (1) Unless otherwise indicated, these stock options were granted on the date ten years prior to the expiration date and were fully vested on January 2, 2010.
- (2) The market value of the stock awards that have not vested is calculated by multiplying the number of shares that have not vested by the closing price of Cadence common stock on December 31, 2009 (the last business day of Cadence's fiscal 2009) of \$5.99 per share.
- (3) Stock option was granted on the date seven years prior to the expiration date and was fully vested on January 2, 2010.
- (4) Stock option was granted on the date seven years prior to the expiration date and 1/4th of the shares vests on the first anniversary of the date of grant and 1/36th of the remaining shares vests monthly thereafter.
- (5) Stock option was granted on the date seven years prior to the expiration date and vests at a rate of 1/48th per month each month after the date of grant.
- (6) Restricted stock was granted on January 8, 2009 and vests at a rate of 1/4th on each anniversary of the date of grant, subject to the achievement of certain specified performance goals.
- (7) Restricted stock was granted on February 5, 2009 and vests at a rate of 1/6th every six months from the date of grant over three years, subject to the achievement of certain specified performance goals.
- (8) Restricted stock was granted on August 15, 2007 and vests at a rate of 1/4th on each anniversary of the date of grant.
- (9)

Restricted stock was granted on May 15, 2006 and vests at a rate of 1/4th on each March 15th following the date of grant.

- (10) Restricted stock was granted on February 15, 2007 and vests at a rate of 1/4th on each anniversary of the date of grant.
- (11) Stock option was granted on the date ten years prior to the expiration date and vests at a rate of 1/48th per month each month after the date of grant.
- (12) Restricted stock was granted on February 15, 2006 and vests at a rate of 1/4th on each January 23rd following the date of grant.
- (13) Restricted stock was granted on February 1, 2008 and vests at a rate of 1/4th on each anniversary of the date of grant.
- (14) Restricted stock was granted on September 15, 2009 and vests at a rate of 1/6th every six months from the date of grant over three years.
- (15) Restricted stock was granted on December 7, 2006 and vests at a rate of 1/4th on each anniversary of the date of grant.
- (16) Restricted stock was granted on May 15, 2008 and vests at a rate of 1/4th on each anniversary of the date of grant.

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The following table sets forth information with respect to the stock awards vested during fiscal 2009.

OPTION EXERCISES AND STOCK VESTED IN FISCAL YEAR 2009(1)

Name	Stock Awards	
	Number of Shares Acquired on Vesting (#)	Value Realized on Vesting (\$)(2)
Lip-Bu Tan	33,334	\$ 190,004
Kevin S. Palatnik	47,084	220,304
Charlie Huang	18,334	79,854
John J. Bruggeman II		
Thomas A. Cooley	16,750	96,023
James J. Cowie	29,167	146,977

(1) No stock options were exercised by the Named Executive Officers during fiscal 2009.

(2) Value based on the closing price of Cadence common stock on the date of vesting.

NONQUALIFIED DEFERRED COMPENSATION FOR FISCAL YEAR 2009

Executive Contributions in Last FY (\$)	Registrant Contributions in Last FY (\$)	Aggregate Earnings in Last FY (\$)	
	\$	\$	512
9,383			596,907
7,348	192,417	192,480	71
		33,835	141,993
			544,30
			17,935
			51,77
	(35)		(35)

(19,921)					(19,921)
					888 88
					(43,000) (43,000)
7,348\$	192,417\$	206,394\$	36\$		117,816\$ 534,01
7,348\$	192,417\$	203,114\$	47\$		114,351\$ 527,27
		35,875			18,305 54,18
		(30)			(30)
		(13,456)			(13,456)
					1,775 1,77
					(15,500) (15,500)
7,348\$	192,417\$	225,533\$	17\$		118,931\$ 554,24

The accompanying notes are an integral part of the above unaudited consolidated financial statements.

MGE Energy, Inc., and Madison Gas and Electric Company

Notes to Consolidated Financial Statements (unaudited)

September 30, 2012

1.

Basis of Presentation - MGE Energy and MGE.

This report is a combined report of MGE Energy and MGE. References in this report to "MGE Energy" are to MGE Energy, Inc., and its subsidiaries. References in this report to "MGE" are to Madison Gas and Electric Company.

MGE Power Elm Road and MGE Power West Campus own electric generating assets and lease those assets to MGE. Both entities are variable interest entities under applicable authoritative guidance. MGE is considered the primary beneficiary of these entities as a result of contractual agreements. As a result, MGE has consolidated MGE Power Elm Road and MGE Power West Campus.

The accompanying consolidated financial statements as of September 30, 2012, and for the three and nine months ended, are unaudited, but include all adjustments that MGE Energy and MGE management consider necessary for a fair statement of their respective financial statements. All adjustments are of a normal, recurring nature except as otherwise disclosed. The year-end consolidated balance sheet information was derived from the audited balance sheet appearing in MGE Energy's and MGE's 2011 Annual Report on Form 10-K, but does not include all disclosures required by accounting principles in the United States of America. These notes should be read in conjunction with the financial statements and the notes on pages 54 through 107 of the 2011 Annual Report on Form 10-K.

2.

Equity and Financing Arrangements.

a.

Common Stock - MGE Energy.

MGE Energy purchases stock in the open market for issuance pursuant to its Stock Plan. All MGE Energy common stock issued under the Stock Plan is sold pursuant to a registration statement that has been filed with the SEC and is currently effective.

MGE Energy can issue new shares of its common stock through the Stock Plan. For both the nine months ended September 30, 2012 and 2011, MGE Energy did not issue any new shares of common stock under the Stock Plan.

b.

Preferred Stock - MGE Energy and MGE.

As of September 30, 2012, and December 31, 2011, MGE has 1,175,000 shares of \$25 par value redeemable preferred stock (cumulative) that is authorized but unissued. On October 25, 2012, MGE amended and restated its existing Restated Articles of Incorporation, which eliminated the previously authorized cumulative preferred stock. There were no shares of cumulative preferred stock issued and outstanding at the date of the amendment.

c.

Dilutive Shares Calculation - MGE Energy.

MGE Energy does not hold any dilutive securities.

d.

Long-term Debt - MGE Energy and MGE.

On April 2, 2012, MGE issued \$28 million in principal amount of its 4.38% senior notes, due April 1, 2042. The Notes were issued pursuant to a Note Purchase Agreement. The Notes are unsecured and are not issued under, or governed by, MGE's Indenture dated as of September 1, 1998, which governs MGE's Medium-Term Notes. MGE used the net proceeds from the sale of the Notes, together with other available corporate funds, to repay and retire on April 3, 2012, its obligations under a Loan Agreement dated as of April 1, 2002 with the City of Madison, Wisconsin, under which MGE received the net proceeds from the issuance of \$28 million aggregate principal amount of 5.875% Series 2002A, Industrial Development Revenue Bonds that were issued by the City of Madison for MGE's benefit. The 5.875% Series 2002A Bonds were redeemed and retired on April 3, 2012, at 100% of their principal amount plus accrued interest with the proceeds of that loan repayment. Any interest savings in 2012 will be deferred.

e.

Remarketing of 4.875% Series 2002B, Industrial Development Revenue Bonds - MGE Energy and MGE.

On April 2, 2012, \$19.3 million of 4.875% Series 2002B, Industrial Development Revenue Bonds were remarketed at an interest rate of 3.45%. The net proceeds of the 4.875% Series 2002B Bonds were originally loaned to MGE pursuant to a Loan Agreement dated as of April 1, 2002 with the City of Madison, which issued the Series 2002B Bonds in 2002. MGE is responsible for the payment of principal, premium, if any, and interest on the Bonds. The 4.875% Series 2002B Bonds were originally issued bearing an interest rate of 4.875% per annum for a period that ended April 1, 2012, at which point the Bonds were subject to mandatory tender by their holders and remarketing. The Series 2002B Bonds were remarketed and carry an interest rate of 3.45% per annum, which is payable semi-annually on April 1 and October 1, until their maturity on October 1, 2027. The Series 2002B Bonds are redeemable on or after April 1, 2017, at a redemption price equal to 100% of the principal amount of the Bonds to be redeemed, plus accrued interest to the redemption date.

3.

Investment in ATC - MGE Energy and MGE.

ATC owns and operates electric transmission facilities primarily in Wisconsin. MGE received an interest in ATC when it, like other Wisconsin electric utilities, contributed its electric transmission facilities to ATC. That interest is presently held by MGE Transco, which is jointly owned by MGE Energy and MGE.

MGE Transco has accounted for its investment in ATC under the equity method of accounting. For the nine months ended September 30, 2012 and 2011, MGE Transco recorded equity earnings from the investment in ATC of \$6.8 million and \$6.4 million, respectively. Dividend income received from ATC was \$5.3 million and \$5.0 million for the nine months ended September 30, 2012 and 2011, respectively. In addition, during the nine months ended September 30, 2012 and 2011, MGE Transco made \$1.8 million and \$0.9 million in capital contributions to ATC, respectively.

MGE Energy and MGE's investment in ATC as of September 30, 2012, and December 31, 2011, was \$60.3 million and \$57.0 million, respectively.

At September 30, 2012, MGE is the majority owner, and MGE Energy, the holding company, is the minority owner of MGE Transco. MGE Energy's proportionate share of the equity and net income of MGE Transco is classified within the MGE financial statements as noncontrolling interest.

ATC's summarized financial data for the three and nine months ended September 30, 2012 and 2011, is as follows:

<i>(In thousands)</i>	Three Months		Nine Months Ended	
	Ended		September 30,	
	September 30,		September 30,	
	2012	2011	2012	2011
Operating revenues	\$ 150,303	\$ 142,741	\$ 450,136	\$ 420,562
Operating expenses	(68,813)	(66,413)	(210,139)	(192,491)
Other expense, net	(5)	(173)	(832)	(665)
Interest expense, net	(20,983)	(19,517)	(61,260)	(60,893)
Earnings before members' income taxes	\$ 60,502	\$ 56,638	\$ 177,905	\$ 166,513

4.

Columbia Environmental Project Construction - MGE Energy and MGE.

MGE and two other utilities jointly own Columbia, a coal-fired generating facility. WPL is the plant operator and permit holder, and owns 46.2% of Columbia. WPSC owns a 31.8% interest, and MGE owns a 22% interest in Columbia. In early 2011, the PSCW issued a *Certificate and Order* authorizing the construction of scrubbers and bag houses and associated equipment on Columbia Units 1 and 2 to reduce SO₂ and mercury emissions. The scrubbers and bag houses are expected to support compliance obligations for current and anticipated air quality regulations, including CAIR or CSAPR, the Utility MACT Rule and the Wisconsin Mercury Rule. The operator's current estimate shows that MGE's share of the capital expenditures required for this project will be approximately \$140 million. As of September 30, 2012, MGE had accumulated \$42.3 million (excluding carrying costs) related to its share of the project, which is reflected in the Construction Work in Progress balance on MGE Energy's and MGE's consolidated balance sheets. MGE expects to incur capital expenditures as follows: \$18 million for the remainder of 2012, \$68 million in 2013, and \$12 million in 2014. These amounts may change as a result of modifications to the project estimate or timing differences. MGE has recognized \$0.7 million (after tax) in AFUDC equity related to this project for the nine months ended September 30, 2012.

MGE expects that the costs pertaining to this project will be fully recoverable through rates. Additionally, MGE is entitled to a carrying cost on the related construction costs at 100% of the determined AFUDC rate.

5.

Taxes - MGE Energy and MGE.

a.

Accounting for Uncertainty in Income Taxes.

MGE Energy and MGE account for the difference between the tax benefit amount taken on prior year tax returns, or expected to be taken on a current year tax return, and the tax benefit amount recognized in the financial statements as an unrecognized tax benefit.

MGE Energy has adopted a tax method of accounting to accelerate tax deductions for repairs in accordance with Treasury Regulations and case law, as compared to the prior method of claiming tax depreciation on project costs. The method change for electric generation and transmission and distribution repairs was included on the 2009 tax return while the change for gas distribution repairs was included on the 2010 return. During 2011, the IRS issued guidance on the treatment of electric transmission and distribution repairs. This guidance prompted the reversal of a portion of the unrecognized tax benefits for these repairs during 2011. MGE Energy and MGE have an unrecognized tax benefit at September 30, 2012, and December 31, 2011, in the amount of \$3.2 million and \$2.4 million, respectively, for the tax uncertainty primarily related to the change in tax method of accounting for electric generation and gas distribution repairs.

b.

Effective Tax Rate.

MGE Energy's effective income tax rate for the three and nine months ended September 30, 2012, is 37.6% and 37.7%, respectively, compared to 37.3% and 37.3% for the same periods in 2011; and MGE's effective income tax rate for the three and nine months ended September 30, 2012, is 37.6% and 37.7%, respectively, compared to 37.1% and 37.3% for the same periods in 2011.

6.

Pension and Other Postretirement Plans - MGE Energy and MGE.

MGE maintains qualified and nonqualified pension plans, health care, and life insurance benefits. Additionally, MGE has defined contribution 401(k) benefit plans.

The following table presents the components of MGE Energy's and MGE's net periodic benefit costs recognized for the three and nine months ended September 30, 2012 and 2011. A portion of the net periodic benefit cost is capitalized within the consolidated balance sheets.

<i>(In thousands)</i>	Three Months Ended September 30, 2012		September 30, 2011	
Pension Benefits				
Components of net periodic benefit cost:				
Service cost	\$ 1,871	\$ 1,527	\$ 5,613	\$ 4,581
Interest cost	3,236	3,055	9,711	9,165
Expected return on assets	(3,917)	(3,502)	(11,756)	(10,507)
Amortization of:				
Prior service cost	111	108	333	324
Actuarial loss	2,058	939	6,177	2,816
Net periodic benefit cost	\$ 3,359	\$ 2,127	\$ 10,078	\$ 6,379
Postretirement Benefits				
Components of net periodic benefit cost:				
Service cost	\$ 626	\$ 500	\$ 1,879	\$ 1,501
Interest cost	1,089	1,010	3,267	3,028
Expected return on assets	(421)	(407)	(1,263)	(1,221)
Amortization of:				
Transition obligation	103	110	309	329
Prior service cost	27	28	81	85
Actuarial loss	601	114	1,802	342
Net periodic benefit cost	\$ 2,025	\$ 1,355	\$ 6,075	\$ 4,064

The PSCW allowed MGE to defer the 2009 incremental pension and OPRB costs above the amounts recovered in rates. During the three months ended September 30, 2012 and 2011, \$0.3 million and \$0.7 million, respectively, has been recovered in rates. During the nine months ended September 30, 2012 and 2011, \$0.9 million and \$2.0 million, respectively, has been recovered in rates. These costs are not reflected in the table above.

7.

Share-Based Compensation - MGE Energy and MGE.

Under MGE Energy's Performance Unit Plan, eligible participants may receive performance units that entitle the holder to receive a cash payment equal to the value of a designated number of shares of MGE Energy's common stock, plus dividend equivalent payments thereon, at the end of the set performance period.

In addition to units granted in 2008 through 2011, on February 17, 2012, 16,693 units were granted based on the MGE Energy closing stock price as of that date. These units are subject to a five-year graded vesting schedule. On the grant date, MGE Energy and MGE measure the cost of the employee services received in exchange for the award based on the current market value of MGE Energy common stock. The fair value of the awards has been subsequently re-measured at September 30, 2012, as required by applicable accounting standards. Changes in fair value have been recognized as compensation cost. Since this amount is re-measured quarterly throughout the vesting period, the compensation cost is subject to variability.

For nonretirement eligible employees, stock based compensation costs are accrued and recognized using the graded vesting method. Compensation cost for retirement eligible employees or employees that will become retirement eligible during the vesting schedule are recognized on an abridged horizon.

In April 2011, the MGE Energy Board approved an amendment to the outstanding awards under the Performance Unit Plan to provide for the continued vesting of those awards in the event of a bona fide retirement, provided the retired individual does not provide services to a competitor. The amendment did not change the number of performance units covered by any outstanding awards currently held by any of the participants. As a result of the changes made by the amendment, the Company accelerated the recognition of costs associated with the outstanding awards resulting in a compensation-related charge of \$0.5 million in the second quarter of 2011.

During the nine months ended September 30, 2012 and 2011, MGE recorded \$1.4 million and \$0.9 million, respectively, in compensation expense as a result of the Performance Unit Plan. In January 2012, cash payments of \$0.6 million were distributed relating to awards that were granted in 2007 and became payable under the Performance Unit Plan. No forfeitures occurred during the nine months ended September 30, 2012 or 2011. At September 30, 2012, \$3.1 million of outstanding awards are vested.

8.

Commitments and Contingencies.

a.

Environmental - MGE Energy and MGE.

Water quality

Water quality regulations promulgated by the EPA and WDNR in accordance with the Federal Water Pollution Control Act, or more commonly known as the Clean Water Act (CWA), impose restrictions on emissions of various pollutants into surface waters. The CWA also regulates surface water quality issues that affect aquatic life, such as water temperatures, intake structures, and wetlands filling. The CWA regulates discharges from "point sources" such as power plants by establishing discharge limits in water discharge permits. MGE's power plants operate under Wisconsin Pollution Discharge Elimination System (WPDES) permits to ensure compliance with these discharge limits.

EPA Cooling Water Intake Rules (Section 316(b))

In April 2011, the EPA proposed and asked for public comment on standards to reduce entrainment (drawing aquatic life into a plant's cooling system) and impingement (trapping aquatic life on screens) from existing structures designed to take in cooling water for plants such as power plants. This rule is commonly referred to as Phase II of Section 316(b) of the CWA. Both our Blount and Columbia generating plants are subject to the impingement and entrainment aspects of the current proposed rule. Our WCCF plant is subject to the impingement aspect only. Under the current proposed rule, equipment would need to be installed at Blount, WCCF and Columbia to meet these new standards. The EPA has until June 27, 2013 to issue the final rule, pursuant to a recently announced settlement agreement. It is not presently possible to estimate the potential costs associated with the implementation of any of these initiatives because the rule has not been finalized.

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WPDES Thermal Discharge Rule

WDNR rules to regulate thermal effluent discharges from point sources in Wisconsin became effective on October 1, 2010. We will need to meet the revised rule requirement as MGE's WPDES permits are issued or renewed. Blount's WPDES permit was renewed effective October 1, 2012, with thermal effluent discharge limits in place. We believe that the thermal limits set are achievable without additional capital expenditures. We will continue to monitor this requirement as our other plant permits come up for renewal. If we, in the case of WCCF, or the plant operator, in the cases of Columbia and Elm Road, are unable to demonstrate that any of these permitted plants are able to comply with its associated WPDES permit requirements, then we may face operational controls and/or incur capital costs associated with plant modifications to meet discharge requirements. Those expenditures could be material, but would be anticipated to be recoverable in rates.

WPDES Phosphorus Nutrient Standards

In December 2010, the WDNR established water quality standards for phosphorus and effluent limitations for permitted discharges into specific waterbodies. Phosphorus limitations will be added to water effluent discharge permits, as applicable, as they are issued or renewed. The WDNR will be developing site-specific phosphorus limits. MGE's facilities subject to these standards include Blount, Columbia, Elm Road and WCCF. Blount's WPDES permit was renewed effective October 1, 2012, with phosphorus discharge limits in place. We believe that the phosphorus limits set are achievable without additional capital expenditures. We will continue to monitor this requirement as our other plant permits come up for renewal. MGE may incur additional capital or operational expenditures and/or need to install additional pollution controls to meet any new phosphorus limits. MGE has, however, identified potential compliance options and believes compliance can be managed without significant capital investments.

Air quality

Air quality regulations promulgated by the EPA and the WDNR in accordance with the Federal Clean Air Act and the Clean Air Act Amendments of 1990 impose restrictions on emission of particulates, sulfur dioxide (SO₂), nitrogen oxides (NO_x), and other pollutants and require permits for operation of emission sources. These permits have been obtained by MGE and must be renewed periodically.

Various initiatives, including the EPA's interstate transport rules, are expected to result in additional operating and capital expenditure costs for electric generating units.

Maximum Achievable Control Technology (MACT) for Utility Boilers (Also Referred to as the Mercury and Air Toxics Standards or MATS)

In December 2011, the EPA finalized its Mercury and Air Toxics Standards for coal and oil-burning electric generating Unit (EGU) boilers. MATS will require emissions standards for mercury, non-mercury HAPs metals, and acid gases. MGE's Columbia and Elm Road Units are subject to MATS. The Elm Road Unit's current pollution controls and Columbia's planned mercury pollution controls are expected to allow both facilities to comply with the

MATS rule (see the discussion regarding Columbia below).

Reciprocating Internal Combustion Engine (RICE) MACT

In December 2011, the EPA finalized its RICE MACT standard. RICE MACT applies to an industrial or electrical engine that is classified as a reciprocating internal combustion engine. Under the current RICE MACT, MGE may have to adjust its dispatching of several small generation units used for emergency and backup generation or install pollution controls. In June 2012, the EPA introduced a proposed rule that revised RICE MACT and introduced an amendment to the New Source Performance Standard for RICE based on a settlement agreement with several power companies. MGE is currently reviewing the proposed rule and evaluating potential impacts associated with complying with the proposed RICE MACT.

Vacation of EPA's Cross State Air Pollution Rule (CSAPR) and Reinstatement of the Clean Air Interstate Rule (CAIR)

EPA has so far promulgated three interstate air pollution rules [the NO_x SIP Call, the Clean Air Interstate Rule (CAIR) and the Cross-State Air Pollution Rule (CSAPR)] which were each designed to reduce nitrogen oxide (NO_x) and/or sulphur dioxide (SO₂) air emissions from electric generating units (EGUs) located in Wisconsin and other states. NO_x and SO₂ interact in the atmosphere to form ambient ozone and fine particulate matter pollution. As explained below, only the CAIR currently affects MGE's generation assets.

In 2000, the U.S. Court of Appeals for the D.C. Circuit held that Wisconsin had been illegally included in a portion of the NO_x SIP Call, but stayed the remaining legal challenges to the rule pending EPA's development of additional interstate transport rules. At this time, the requirements of the NO_x SIP Call and the costs of compliance remain uncertain.

In 2005, EPA promulgated the CAIR imposing additional controls on NO_x and SO₂ emissions from EGUs located in Wisconsin and other states. However, in December 2008, the U.S. Court of Appeals for the D.C. Circuit remanded the CAIR to the EPA with directions to revise or replace the rule. The Court's remand order directed that the CAIR remain in effect until the EPA promulgated a replacement rule. The Court's order did not include a deadline for the EPA to act.

In August 2011, the EPA responded to the remand of the CAIR by promulgating the CSAPR. However, in August, 2012, the U.S. Court of Appeals for the D.C. Circuit vacated CSAPR and instructed the EPA to continue administering the CAIR pending finalizing a valid replacement rule. The EPA has petitioned the U.S. Court of Appeals for the D.C. Circuit to reconsider its decision *en banc*. At this time, the CAIR remains currently effective.

The CAIR, which became effective in 2009 and remains effective currently, generally requires NO_x and SO₂ emission reductions from fossil fuel-fired electric generating units (25 MW or greater) (EGUs) in the eastern half of the United States in two phases and includes a regional cap-and-trade system. The first phase (currently in place) requires annual regional emission reductions from 2003 levels of 55% for NO_x and 40% for SO₂. The second phase (beginning in 2015) reduces regional NO_x and SO₂ emissions further from 2003 levels to 65% and 70%, respectively. MGE owns or has partial ownership in several generation units currently subject to the CAIR: Blount, Columbia, Elm Road, and its combustion turbines located in West Marinette and Fitchburg.

Our evaluation of the CAIR demonstrates that MGE will be in compliance with the CAIR's Phase I requirements without capital expenditures or modifications to our operations. We have also evaluated our potential expenditures if the CAIR remains in place for the Phase II reductions. New SO₂ controls at Columbia are already underway and are planned to be completed by mid to late 2014 (see the discussion regarding the Columbia Environmental Project below). Once the new environmental control project is completed at Columbia, it is expected that the plant will emit below anticipated Phase II CAIR allocation levels. MGE expects that any costs incurred to meet Phase II of the CAIR will be fully recoverable through rates.

MGE will continue monitoring the EPA's actions in response to the August 2012 CSAPR vacature and the stayed NO_x SIP Call litigation, but MGE is unable to predict the outcome of these matters and its impact on its operations or financial condition.

Clean Air Visibility Rule (CAVR)

Air modeling indicates that SO₂ and NO_x emissions (and to a lesser extent particulate matter, or PM) from Columbia may impair visibility at certain Class I Scenic Areas and may therefore be subject to the best available retrofit technology (BART) regulations, a subsection of the EPA's Clean Air Visibility Rule (CAVR), which requires pollution retrofits. The EPA had proposed that Columbia's compliance with emissions limitations in the CAIR and the CSAPR could also serve as compliance with the BART regulations for SO₂ and NO_x emissions. However, this proposal is now uncertain because of the D.C. Circuit remanding the CAIR to EPA and vacating the CSAPR. At this time the BART regulatory obligations, compliance strategies and costs remain uncertain.

Wisconsin State Mercury Rule

Beginning January 1, 2015, phase two of the Wisconsin mercury rule will require large coal-fired electric generating units (larger than 150 MW) to reduce mercury emissions by 90%, or choose a multi-pollutant reduction approach, which allows a stepped approach to mercury reduction while reducing NO_x and SO₂ emissions at prescribed rates. Elm Road currently meets this requirement. The Columbia co-owners expect to meet the 90% reduction option by installing bag houses and scrubbers by mid to late 2014 (see the discussion regarding the Columbia Environmental Project below).

National Ambient Air Quality Standards (NAAQS)

The EPA has developed National Ambient Air Quality Standards (NAAQS) for six compounds currently identified as criteria pollutants: nitrogen dioxide (NO₂), particulate matter (PM), ozone, SO₂, lead and carbon monoxide. The NAAQS for criteria pollutants establish acceptable ambient air levels based on effects to human health and the environment, and changes to those NAAQS can affect compliance requirements and associated capital and operating costs. The EPA is required to review NAAQS every five years. MGE is currently tracking two NAAQS developments: (1) EPA's proposed changes to the PM_{2.5} NAAQS announced in June 2012, which would lower the primary annual limit and add a secondary PM_{2.5} standard pertaining to a measure of visibility, and (2) the WDNR attainment/nonattainment designations associated with the EPA's June 2010 final revisions to its SO₂ NAAQS. Because of uncertainties in how these NAAQS developments will be implemented in Wisconsin, we are tracking developments and evaluating potential costs at our generation facilities. Based on our current evaluation, these two NAAQS developments have the most potential to affect capital and maintenance costs at our Columbia plant. However, the potential impact at any of our plants will not be known until implementation of the rules is finalized.

EPA's Prevention of Significant Deterioration and Title V Greenhouse Gas Tailoring Rule

The EPA's Greenhouse Gas "Tailoring Rule" regulates stationary sources for GHG emissions by "phasing in" over time different types of facilities subject to Prevention of Significant Deterioration (PSD) pre-construction program or Title V permitting (i.e. new facilities and existing facilities with certain qualifying modifications). MGE facilities may become subject to this rule in the future if modifications at any facilities trigger PSD or if MGE invests in new facilities that trigger PSD.

GHG New Source Performance Standards for Electric Generating Units (EGU GHG NSPS)

On March 27, 2012, the EPA proposed greenhouse gas (GHG) New Source Performance Standards (NSPS) for coal fired and natural gas combined cycle (NGCC) electric generation units (EGUs). The proposal applies to new EGUs only; the EPA has stated that it does not intend for these rules to apply to modified or existing units at this time. The proposed NSPS may yet be finalized in 2012, but is not anticipated to significantly affect MGE's existing generation units.

Columbia

MGE and two other utilities jointly own Columbia, a coal-fired generating facility, which accounts for 225 MW (29%) of MGE's net summer generating capability. WPL is the plant operator and permit holder, and owns 46.2% of Columbia. Wisconsin Public Service Corporation (WPSC) owns a 31.8% interest, and MGE owns a 22% interest in Columbia. Based upon current available information, compliance with various environmental requirements and initiatives is expected to result in significant additional operating and capital expenditures at Columbia.

Columbia Environmental Project

In early 2011, the PSCW issued a *Certificate and Order* authorizing the construction of scrubbers and bag houses and associated equipment on Columbia Units 1 and 2 to reduce SO₂ and mercury emissions. The scrubbers and bag houses are expected to support compliance obligations for current and anticipated air quality regulations, including CAIR, CAIR's eventual replacement, the Mercury and Air Toxics Standards and the Wisconsin Mercury Rule. The operator's current estimate shows that MGE's share of the capital expenditures required for this project will be approximately \$140 million. The project is underway and estimated to be completed in mid to late 2014.

As of September 30, 2012, various contractual commitments have been entered for the project. MGE's share of these commitments as of September 30, 2012, is \$89.1 million. These costs are expected to be capitalized and included in the consolidated balance sheets of MGE Energy and MGE. See Footnote 4 for further information regarding the Columbia environmental construction project.

Title V Operating Permit Petition

In September 2008, the WDNR issued a Title V renewal operating permit to WPL for Columbia. A citizen group petitioned the EPA to object to the issuance of the permit renewal. In October 2009, the EPA issued an order granting in part and denying in part the petition and sent the operating permit back to the WDNR for further review based on the EPA order. The WDNR took various preliminary actions but has not yet fully responded to the EPA's order. In February 2011, the citizen group involved filed an action against the EPA in the U.S. District Court for the Western District of Wisconsin seeking to have the EPA take over the permit process. In June 2012, the EPA notified the plant operator of its intent to assume responsibility for issuing the renewed operating permit for Columbia, but agreed to provide the plant operator with more time to potentially resolve the issues raised in the EPA's order. MGE believes the permits currently in effect for Columbia remain in place at this time. MGE continues to follow these developments and is unable to predict the outcome of this matter and its impact on its operations or financial condition.

Columbia Clean Air Act Litigation

In December 2009, the EPA sent a notice of violation (NOV) to MGE as one of the co-owners of the Columbia generating station. The NOV alleges that WPL, as operator, and the co-owners failed to comply with appropriate pre-construction review and permitting requirements and, as a result, violated the PSD program requirements, the Title V operating permit requirements of the CAA and the Wisconsin State Implementation Plan (SIP). In September 2010, Sierra Club filed a lawsuit against WPL alleging violations of the CAA at Columbia and other WPL-operated Wisconsin facilities. WPL has stated it believes the projects at Columbia were routine, or not projected to increase emissions, and therefore did not violate the permitting requirements of the CAA. MGE and the other Columbia co-owners are defending against these allegations while actively pursuing settlement options with the EPA and Sierra Club.

MGE believes that the parties have reached a tentative agreement on the general terms of a settlement with the EPA and Sierra Club regarding various facilities, including Columbia. Sierra Club has stipulated to a dismissal of its lawsuit, without prejudice, while the parties attempt to reach a final settlement. The parties are currently negotiating a consent decree based upon those general terms, which may change during the negotiations. Once the parties agree to final terms, the court must approve the settlement agreement before it becomes final and effective. In accordance with applicable accounting standards, MGE has accrued an amount for this matter representing its best estimate of its probable liability, based upon its assessment of the settlement discussions. That accrued amount is not material to the financial statements. MGE believes the likelihood of a materially greater liability than the accrued amount is remote based upon the current status of the settlement discussions.

b.

Chattel Paper Agreement and Other Guarantees - MGE Energy and MGE.

MGE makes available to qualifying customers a financing program for the purchase and installation of energy-related equipment that will provide more efficient use of utility service at the customer's property. MGE is party to a chattel paper purchase agreement with a financial institution under which it can sell or finance an undivided interest with recourse, in up to \$10.0 million of the financing program receivables, until July 31, 2013. At September 30, 2012,

MGE has outstanding a \$3.9 million interest in these receivables. MGE retains the servicing responsibility for these receivables. As of September 30, 2012, the servicing asset recognized by MGE is \$0.2 million.

MGE accounts for servicing rights under the amortization method. Initial determination of the servicing asset fair value is based on the present value of the estimated future cash flows. The discount rate is based on the PSCW authorized weighted cost of capital.

MGE would be required to perform under its guarantee if a customer defaulted on its loan. The energy-related equipment installed at the customer sites is used to secure the customer loans. The loan balances outstanding at September 30, 2012, approximate the fair value of the energy-related equipment acting as collateral. The length of the MGE guarantee to the financial institution varies from one to ten years depending on the term of the underlying customer loan. Principal payments for the remainder of 2012 and the next four years on the loans are:

<i>(In thousands)</i>	2012	2013	2014	2015	2016
Chattel Paper	\$ 126\$	669\$	484\$	796\$	721

c.

Purchase Power Agreement Contract Dispute - MGE Energy and MGE.

MGE is seeking resolution to a contract dispute regarding its Purchase Power Agreement with Riverside Energy Center LLC, a Calpine subsidiary, for capacity and energy from the Riverside Energy Center located in Beloit, Wisconsin. MGE declared the PPA terminated. Any savings in capacity costs that ultimately result from the termination of the Riverside PPA will flow through to the Company's customers. MGE is currently deferring amounts equal to the capacity payments MGE would be making under the terms of the Riverside PPA if it were still in effect. This deferral will create a liability to MGE's customers for a future credit, assuming MGE's right to terminate the PPA is ultimately upheld. If MGE does not prevail in the dispute, the capacity payment deferred will be paid to Riverside Energy Center, LLC.

d.

Legal Matters - MGE Energy and MGE.

MGE is involved in various legal matters that are being defended and handled in the normal course of business including the Columbia matters discussed above. MGE maintains accruals for such costs that are probable of being incurred and subject to reasonable estimation. The accrued amount for these matters is not material to the financial statements.

e.

Purchase Contracts - MGE Energy and MGE.

MGE Energy and MGE have entered into various commodity supply, transportation and storage contracts to meet their obligations to deliver electricity and natural gas to customers. As of September 30, 2012, the future commitments related to these purchase contracts were as follows:

<i>(In thousands)</i>	2012	2013	2014	2015	2016
Coal ^(a)	\$ 2,483	\$ 21,884	\$ 9,459	\$ 6,340	\$ 1,623
Natural gas supply ^(b)	12,872	13,192	-	-	-
Purchase power ^(c)	39,266	51,455	49,372	47,523	48,491
	\$ 54,621	\$ 86,531	\$ 58,831	\$ 53,863	\$ 50,114

(a)

Total coal commitments for the Columbia and Elm Road Units, including transportation. Fuel procurement for MGE's jointly owned Columbia and Elm Road Units are handled by WPL and WEPCO, respectively, who are the operators of those facilities. If any minimum purchase obligations must be paid under these contracts, management believes these obligations would be considered costs of service and recoverable in rates.

(b)

These commitments include market-based pricing. Management expects to recover these costs in future customer rates.

(c)

MGE has several purchase power agreements to help meet future electric supply requirements. Management expects to recover these costs in future customer rates.

f.

Smart Grid Investment Grant - MGE Energy and MGE.

MGE was approved in 2010 by the U.S. Department of Energy (DOE) under the federal stimulus program for a \$5.5 million grant for smart grid projects. The DOE grant requires MGE to match the grant funding, bringing the total cost of the projects to more than \$11 million. The projects involve the installation of technologies to boost efficiency, enhance service and improve reliability for customers. The stimulus grant is being used to fund the following projects: advanced metering infrastructure, plug-in hybrid electric vehicles support, and distribution management. As of September 30, 2012, MGE has spent \$7.9 million related to these projects and has outstanding agreements to purchase \$0.6 million in smart grid related products for the remainder of 2012 and \$1.3 million in 2013.

g.

Other Commitments - MGE Energy.

On January 31, 2012, MGE Energy entered a subscription agreement to invest in a nonpublic venture capital fund. From time to time, this entity will require capital infusions from its investors. MGE Energy has committed to contribute \$2.0 million in capital for such infusions. The timing of these infusions is dependent on the needs of the investee and is therefore uncertain at this time.

9.

Derivative and Hedging Instruments - MGE Energy and MGE.

a.

Purpose.

As part of its regular operations, MGE enters into contracts, including options, swaps, futures, forwards, and other contractual commitments, to manage its exposure to commodity prices and gas revenues. To the extent that these contracts are derivatives, MGE assesses whether or not the normal purchases or normal sales exclusion applies. For contracts to which this exclusion cannot be applied, MGE Energy and MGE recognize such derivatives in the consolidated balance sheets at fair value. The majority of MGE's derivative activities are conducted in accordance with its electric and gas risk management program, which is approved by the PSCW and limits the volume MGE can hedge with specific risk management strategies. The maximum length of time over which cash flows related to energy commodities can be hedged is four years. If the derivative qualifies for regulatory deferral, the derivatives are marked to fair value and are offset with a corresponding regulatory asset or liability. The deferred gain or loss is recognized in earnings in the delivery month applicable to the instrument. Gains and losses related to hedges qualifying for regulatory treatment are recoverable in gas rates through the PGA or in electric rates as a component of the fuel rules mechanism.

b.

Notional Amounts.

The gross notional volume of open derivatives is as follows:

	September 30, 2012	December 31, 2011
Commodity derivative contracts	440,320 MWh	482,545 MWh
Commodity derivative contracts	4,170,000 Dth	4,030,000 Dth
FTRs	4,069 MW	2,382 MW

c.

Financial Statement Presentation.

MGE Energy and MGE offset fair value amounts recognized for the right to reclaim collateral (a receivable) or the obligation to return collateral (a payable) against fair value amounts recognized for derivative instruments executed with the same counterparty under a master netting agreement. At September 30, 2012, MGE Energy and MGE did not have any cash collateral netted against the net derivative positions. At December 31, 2011, MGE Energy and MGE had \$3.0 million in collateral that was netted against the net derivative positions with counterparties.

MGE purchases and sells exchange-traded and over-the-counter options, swaps, and future contracts. These arrangements are primarily entered into to help stabilize the price risk associated with gas or power purchases. These transactions are employed by both MGE's gas and electric segments. Additionally, as a result of the firm transmission agreements that MGE holds on transmission paths in the MISO market, MGE holds FTRs. An FTR is a financial instrument that entitles the holder to a stream of revenues or charges based on the differences in hourly day-ahead energy prices between two points on the transmission grid. The fair values of these instruments are reflected as a regulatory asset/liability depending on whether they are in a net loss/gain position. Depending on the nature of the instrument, the gain or loss associated with these transactions will be reflected as cost of gas sold, fuel for electric generation, or purchased power expense in the delivery month applicable to the instrument. At September 30, 2012, the fair value of exchange traded derivatives and FTRs exceeded their cost basis by \$1.8 million. At December 31, 2011, the cost basis of exchange traded derivatives and FTRs exceeded their fair value by \$2.8 million.

MGE has also entered into a ten-year purchased power agreement that provides MGE with firm capacity and energy during a base term from June 1, 2012, through May 31, 2022. The agreement also allows MGE an option to extend the contract after the base term. The agreement is accounted for as a derivative contract and is recognized at its fair value on the balance sheet. However, the derivative qualifies for regulatory deferral and is recognized with a corresponding regulatory asset or liability depending on whether the fair value is in a loss or gain position. The fair value of the contract at September 30, 2012, and December 31, 2011, reflects a loss position of \$77.1 million and \$39.5 million, respectively. The actual fuel cost will be recognized in purchased power expense in the month of purchase.

The following table summarizes the fair value of the derivative instruments on the balance sheet. All derivative instruments in this table are presented on a gross basis and are calculated prior to the netting of instruments with the same counterparty under a master netting agreement as well as the netting of collateral. For financial statement purposes, MGE Energy and MGE have netted instruments with the same counterparty under a master netting agreement as well as the netting of collateral.

<i>(In thousands)</i>	Asset Derivatives		Liability Derivatives		Fair Value
	Balance Sheet Location	Fair Value	Balance Sheet Location		
September 30, 2012					
Commodity derivative contracts	Other current assets	\$ 1,463	Derivative liability (current)	\$ 245	
Commodity derivative contracts	Other deferred charges	114	Derivative liability (long-term)	60	
FTRs	Other current assets	561	Derivative liability (current)	-	
Ten-year PPA	N/A	N/A	Derivative liability (current)	9,600	
Ten-year PPA	N/A	N/A	Derivative liability (long-term)	67,490	
December 31, 2011					
Commodity derivative contracts	Other current assets	\$ 177	Derivative liability (current)	\$ 3,060	
Commodity derivative contracts	Other deferred charges	92	Derivative liability (long-term)	231	
FTRs	Other current assets	186	Derivative liability (current)	-	
Ten-year PPA	N/A	N/A	Derivative liability (current)	4,600	
Ten-year PPA	N/A	N/A	Derivative liability (long-term)	34,920	

The following tables summarize the unrealized and realized gains (losses) related to the derivative instruments on the balance sheet at September 30, 2012 and 2011, and the income statement for the three and nine months ended September 30, 2012 and 2011.

<i>(In thousands)</i>	2012		2011	
	Current and		Current and	
	long-term	Other current	long-term	Other current
	regulatory asset	assets	regulatory asset	assets
Three Months Ended September 30:				
Balance at July 1,	\$ 79,362\$	718 \$	22,604\$	1,001
Change in unrealized loss	(468)	-	3,839	-
Realized loss reclassified to a deferred account	(223)	223	(210)	210
Realized gain (loss) reclassified to income statement	(3,414)	(161)	350	(233)
Balance at September 30,	\$ 75,257\$	780 \$	26,583\$	978
Nine Months Ended September 30:				
Balance at January 1,	\$ 42,356\$	1,604 \$	19,230\$	1,411
Change in unrealized loss	42,633	-	7,775	-
Realized loss reclassified to a deferred account	(3,103)	3,103	(1,484)	1,484
Realized gain (loss) reclassified to income statement	(6,629)	(3,927)	1,062	(1,917)
Balance at September 30,	\$ 75,257\$	780 \$	26,583\$	978

Realized losses (gains)
Fuel for electric

<i>(In thousands)</i>	Regulated gas revenues	generation/ purchased power	Cost of gas sold	
Three Months Ended September 30, 2012:				
Commodity derivative contracts	\$	-\$	176\$	-
FTRs		-	(256)	-
Ten-year PPA		-	3,655	-
Three Months Ended September 30, 2011:				
Commodity derivative contracts	\$	-\$	(94)\$	-
FTRs		-	(23)	-
Ten-year PPA		-	-	-
Nine Months Ended September 30, 2012:				
Commodity derivative contracts	\$	-\$	2,685\$	3,090
FTRs		-	(93)	-
Ten-year PPA		-	4,874	-
Nine Months Ended September 30, 2011:				
Commodity derivative contracts	\$	-\$	(465)\$	1,315
FTRs		-	5	-
Ten-year PPA		-	-	-

MGE's commodity derivative contracts, FTRs, and ten-year PPA are subject to regulatory deferral. These derivatives are marked to fair value and are offset with a corresponding regulatory asset or liability. Realized gains and losses are deferred on the balance sheet and are recognized in earnings in the delivery month applicable to the instrument. As a result of the above described treatment, there are no unrealized gains or losses that flow through earnings.

The ten-year PPA has a provision that may require MGE to post collateral if MGE's debt rating falls below investment grade (i.e., below BBB-). The amount of collateral that it may be required to post varies from \$20.0 million to \$40.0 million, depending on MGE's nominated capacity amount. As of September 30, 2012, no collateral has been posted. Certain counterparties extend MGE a credit limit. If MGE exceeds these limits, the counterparties may require collateral to be posted. As of September 30, 2012, and December 31, 2011, no counterparties were in a net liability position.

Nonperformance of counterparties to the non-exchange traded derivatives could expose MGE to credit loss. However, MGE enters into transactions only with companies that meet or exceed strict credit guidelines, and it monitors these counterparties on an ongoing basis to mitigate nonperformance risk in its portfolio. As of September 30, 2012, no counterparties have defaulted.

10.

Rate Matters - MGE Energy and MGE.

a.

Rate Proceedings.

On March 23, 2012, MGE filed an application with the PSCW requesting a 5.8% increase to electric rates and a 2.6% increase to gas rates. The proposed electric increase will cover costs for new environmental equipment at Columbia, final construction costs for the Elm Road Units (including the prudence of construction costs incurred above a previously approved cap), transmission reliability enhancements, and purchased power costs. MGE has requested that these rates become effective January 1, 2013.

On December 15, 2011, under a limited reopener of MGE's last rate order, the PSCW authorized MGE to increase 2012 rates for retail electric customers by 4.3% or \$15.7 million and to increase gas rates by 0.3% or \$0.6 million. The change in retail electric rates was driven by MGE's electric fuel and purchased power costs, increased transmission costs, an update to the Elm Road Units' costs, and an increase for energy efficiency programs. The PSCW also approved deferral of CSAPR costs.

On January 12, 2011, the PSCW authorized MGE to increase 2011 rates for retail electric customers by 2.3% or \$8.0 million and to increase gas rates by 1.0% or \$1.9 million. The increase in retail electric rates is driven by costs for MGE's share of the Elm Road Units. Pursuant to the provisions of this rate order, the fuel rules bandwidth effective January 1, 2011, will be plus or minus 2%. See below for further description of fuel rules. Authorized return on common stock equity was set at 10.3% based on a 58.1% utility common equity.

b.

Fuel Rules.

The PSCW approved new fuel rules that became effective January 1, 2011. The new rules require the PSCW and Wisconsin utilities to defer electric fuel-related costs that fall outside a symmetrical cost tolerance band around the amount approved for a utility in its most recent base rate proceedings. Any over/under recovery of the actual costs is determined on an annual basis and will be adjusted in future billings to electric retail customers. Under fuel rules, MGE would defer costs, less any excess revenues, if its actual electric fuel costs exceeded 102% of the electric fuel costs allowed in its latest rate order. Excess revenues are defined as revenues in the year in question that provide MGE with a greater return on common equity than authorized by the PSCW in MGE's latest rate order. Conversely, MGE is required to defer the benefit of lower costs if actual electric fuel costs were less than 98% of the electric fuel costs allowed in that order. As of September 30, 2012, MGE has deferred \$5.9 million (for credit back to customers) of electric fuel-related savings that are outside the 98% range authorized by the PSCW in the most recent rate order.

11.

Fair Value of Financial Instruments - MGE Energy and MGE.

a.

Fair Value of Financial Assets and Liabilities Recorded at the Carrying Amount.

At September 30, 2012, and December 31, 2011, the carrying amount of cash and cash equivalents approximates fair market value due to the short maturity of those investments and obligations. The estimated fair market value of MGE Energy's and MGE's long-term debt is based on quoted market prices for similar financial instruments at September 30, 2012, and December 31, 2011. Since the long-term debt is not traded in an active market, it is classified as Level 2 (see discussion regarding the fair value level hierarchy below in section b). The estimated fair market value, of MGE Energy's and MGE's financial instruments are as follows:

<i>(In thousands)</i>	September 30, 2012		December 31, 2011	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
MGE Energy				
<i>Assets:</i>				
Cash and cash equivalents	\$ 59,203	\$ 59,203	\$ 41,169	\$ 41,169
<i>Liabilities:</i>				
Long-term debt*	362,473	436,747	364,473	432,515
MGE				
<i>Assets:</i>				
Cash and cash equivalents	29,536	29,536	13,898	13,898
<i>Liabilities:</i>				
Long-term debt*	362,473	436,747	364,473	432,515

**Includes long-term debt due within
one year.*

b.

Recurring Fair Value Measurements.

Fair value is defined as the price that would be received to sell an asset or would be paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants at the measurement date. The standard clarifies that fair value should be based on the assumptions market participants would use when pricing the asset or liability including assumptions about risk. The standard also

establishes a three level fair value hierarchy based upon the observability of the assumptions used and requires the use of observable market data when available. The levels are:

Level 1 - Pricing inputs are quoted prices within active markets for identical assets or liabilities.

Level 2 - Pricing inputs are quoted prices within active markets for similar assets or liabilities; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations that are correlated with or otherwise verifiable by observable market data.

Level 3 - Pricing inputs are unobservable and reflect management's best estimate of what market participants would use in pricing the asset or liability.

The following table presents the balances of assets and liabilities measured at fair value on a recurring basis for MGE Energy and MGE.

<i>(In thousands)</i>	Fair Value as of September 30, 2012			
	Total	Level 1	Level 2	Level 3
MGE Energy				
Assets:				
Exchange-traded investments	\$ 409\$	409\$	-\$	-
Total Assets	\$ 409\$	409\$	-\$	-
Liabilities:				
Derivatives, net	\$ 75,257\$	(858)\$	-\$	76,115
Deferred compensation	1,922	-	1,922	-
Total Liabilities	\$ 77,179\$	(858)\$	1,922\$	76,115
MGE				
Assets:				
Exchange-traded investments	\$ 138\$	138\$	-\$	-
Total Assets	\$ 138\$	138\$	-\$	-
Liabilities:				
Derivatives, net	\$ 75,257\$	(858)\$	-\$	76,115
Deferred compensation	1,922	-	1,922	-
Total Liabilities	\$ 77,179\$	(858)\$	1,922\$	76,115

No transfers were made in or out of Level 1 or Level 2 for the nine months ended September 30, 2012.

<i>(In thousands)</i>	Fair Value as of December 31, 2011			
	Total	Level 1	Level 2	Level 3
MGE Energy				
Assets:				
Exchange-traded investments	\$ 350\$	350\$	-\$	-
Total Assets	\$ 350\$	350\$	-\$	-
Liabilities:				
Derivatives, net ^(a)	\$ 42,356\$	1,695\$	-\$	40,661
Deferred compensation ^(b)	1,725	-	1,725	-
Total Liabilities	\$ 44,081\$	1,695\$	1,725\$	40,661
MGE				
Assets:				
Exchange-traded investments	\$ 188\$	188\$	-\$	-
Total Assets	\$ 188\$	188\$	-\$	-
Liabilities:				
Derivatives, net ^(a)	\$ 42,356\$	1,695\$	-\$	40,661
Deferred compensation ^(b)	1,725	-	1,725	-
Total Liabilities	\$ 44,081\$	1,695\$	1,725\$	40,661

(a) These amounts are shown gross and exclude \$3.0 million of collateral that was posted against derivative positions with counterparties.

(b) The deferred compensation liability at December 31, 2011, was transferred from Level 1 to Level 2.

Investments include exchange-traded investment securities valued using quoted prices on active exchanges and are therefore classified as Level 1.

Derivatives include exchange-traded derivative contracts, over-the-counter party transactions, a ten-year purchased power agreement, and FTRs. Most exchange-traded derivative contracts are valued based on unadjusted quoted prices in active markets and are therefore classified as Level 1. A small number of exchange-traded derivative contracts are valued using quoted market pricing in markets with insufficient volumes and are therefore classified as Level 3. Transactions done with an over-the-counter party are on inactive markets and are therefore classified as Level 3. These transactions are valued based on quoted prices with markets with similar exchange traded transactions. FTRs are priced based upon monthly auction results for identical or similar instruments in a closed market with limited data available and are therefore classified as Level 3.

The ten-year purchased power agreement (see Footnote 9) was valued using an internally-developed pricing model and therefore is classified as Level 3. The model projects future market energy prices and compares those prices to the projected power costs to be incurred under the contract. Inputs to the model require significant management judgment and estimation. Future energy prices are based on a forward power pricing curve using exchange-traded contracts in the electric futures market, where such exchange-traded contracts exist, and upon calculations based on forward gas prices, where such exchange-traded contracts do not exist. A basis adjustment is applied to the market energy price to reflect the price differential between the market price delivery point and the counterparty delivery point. The historical relationship between the delivery points is reviewed and a discount (below 100%) or premium (above 100%) is derived. This comparison is done for both peak times when demand is high and off peak times when demand is low. If the basis adjustment is lowered, the fair value measurement will decrease and if the basis adjustment is increased, the fair value measurement will increase.

The projected power costs anticipated to be incurred under the purchased power agreement are determined using many factors, including historical generating costs, future prices, and expected fuel mix of the counterparty. An increase in the projected fuel costs would result in a decrease in the fair value measurement of the purchased power agreement. A significant input that MGE estimates is the counterparty's fuel mix in determining the projected power cost. MGE also considers the assumptions that market participants would use in valuing the asset or liability. This consideration includes assumptions about market risk such as liquidity, volatility and contract duration. The fair value model uses a discount rate that incorporates discounting, credit, and model risks.

This model is prepared by members of the Energy Supply group. It is reviewed on a quarterly basis by management in Energy Supply and Finance to review the assumptions, inputs and fair value measurements.

The following table presents the significant unobservable inputs used in the pricing model.

Significant Unobservable Inputs	Model Input
Basis adjustment	
On peak	96.8 %
Off peak	94.8 %
Counterparty fuel mix:	
Internal generation	49 % - 65 %
Purchased power	51 % - 35 %

The deferred compensation plan allows participants to defer certain cash compensation into a notional investment account. These amounts are included within other deferred liabilities in the balance sheets of MGE Energy and MGE. The notional investments earn interest based upon the semiannual rate of U.S. Treasury Bills having a 26 week maturity increased by 1% compounded monthly with a minimum annual rate of 7%, compounded monthly. The notional investments are based upon observable market data, however, since the deferred compensation obligations themselves are not exchanged in an active market, they are classified as Level 2.

The following table summarizes the changes in Level 3 assets and liabilities measured at fair value on a recurring basis for both MGE Energy and MGE.

<i>(In thousands)</i>	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Beginning balance,	\$ (79,580)	\$ (22,983)	\$ (40,661)	\$ (19,216)
Realized and unrealized gains (losses):				
Included in regulatory liabilities (assets)	3,465	(2,927)	(35,455)	(6,694)
Included in other comprehensive income	-	-	-	-
Included in earnings	(3,422)	182	(6,659)	815
Included in current assets	-	(7)	(77)	(66)
Purchases	5,864	178	7,764	342
Sales	45	-	77	-
Issuances	-	-	-	-
Settlements	(2,487)	(353)	(1,104)	(1,091)
Transfers in and/or out of Level 3	-	-	-	-
Balance as of September 30,	\$ (76,115)	\$ (25,910)	\$ (76,115)	\$ (25,910)
Total gains (losses) included in earnings attributed to the change in unrealized gains (losses) related to assets and liabilities held at September 30, ^(d)	\$ -	\$ -	\$ -	\$ -

The following table presents total realized and unrealized gains (losses) included in income for Level 3 assets and liabilities measured at fair value on a recurring basis for both MGE Energy and MGE (*d*).

<i>(In thousands)</i>	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Purchased Power Expense	\$ (3,422)	\$ 182	\$ (6,659)	\$ 815
Cost of Gas Sold Expense	-	-	-	-
Regulated Gas Revenues	-	-	-	-
Total	\$ (3,422)	\$ 182	\$ (6,659)	\$ 815

(d) MGE's exchange-traded derivative contracts, over-the-counter party transactions, ten-year purchased power agreement, and FTRs are subject to regulatory deferral. These derivatives are therefore marked to fair value and are offset with a corresponding regulatory asset or liability.

New Accounting Pronouncements - MGE Energy and MGE.

a.

Fair Value Measurements and Disclosures.

In May 2011, the FASB issued authoritative guidance within the Codification's Fair Value Measurements and Disclosures topic that provides guidance on additional disclosures about fair value measurements, specifically related to Level 3 assets and liabilities. This authoritative guidance became effective January 1, 2012. The authoritative guidance did not have any financial impact, but required additional disclosures. See Footnote 11 for additional information.

b.

Presentation of Comprehensive Income.

In June 2011, the FASB issued authoritative guidance within the Codification's Comprehensive Income topic that provides guidance on presentation of comprehensive income. Comprehensive income will be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. This authoritative guidance became effective January 1, 2012. The authoritative guidance had an effect on our financial statement presentation of comprehensive income. See the Statement of Comprehensive Income for additional information.

c.

Disclosures about Offsetting Assets and Liabilities.

In December 2011, the FASB issued authoritative guidance within the Codification's Balance Sheet topic that provides guidance on disclosures about offsetting assets and liabilities. The new disclosure requirements mandate that entities disclose both gross and net information for instruments and transactions eligible for offset in the balance sheet as well as instruments and transactions subject to a master netting arrangement. In addition, the standard requires disclosure of collateral received and posted in connections with a master netting arrangement. This authoritative guidance will become effective January 1, 2013. The authoritative guidance will not have a financial impact, but will require additional disclosures.

13.

Segment Information - MGE Energy and MGE.

MGE Energy operates in the following business segments: electric utility, gas utility, nonregulated energy, transmission investment, and all other. See MGE Energy's and MGE's 2011 Annual Report on Form 10-K for additional discussion of each of these segments.

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The following tables show segment information for MGE Energy's operations for the indicated periods:

<i>(In thousands)</i>			Non-	Transmission	All	Consolidation/	Consolidated
MGE Energy	Electric	Gas	Regulated Energy	Investment	Others	Elimination/ Entries	Total
<i>Three Months Ended September 30,</i>							
<i>2012</i>							
Operating revenues	\$ 118,914	\$ 16,587	\$ 2,337		-\$	-\$	137,838
Interdepartmental revenues	159	4,658	8,679		-	(13,496)	-
Total operating revenues	119,073	21,245	11,016		-	(13,496)	137,838
Depreciation and amortization	(6,530)	(1,399)	(1,777)		-	-	(9,706)
Other operating expenses	(78,823)	(22,675)	(36)		(206)	13,496	(88,244)
Operating income (loss)	33,720	(2,829)	9,203		(206)	-	39,888
Other income, net	342	97	-	2,280	137	-	2,856
Interest (expense) income, net	(2,535)	(715)	(1,631)		32	-	(4,849)
Income (loss) before taxes	31,527	(3,447)	7,572	2,280	(37)	-	37,895
Income tax (provision) benefit	(11,873)	1,565	(3,039)	(909)	3	-	(14,253)
Net income (loss)	\$ 19,654	\$(1,882)	\$ 4,533	\$ 1,371	\$(34)	-\$	23,642
<i>Three Months Ended September 30,</i>							
<i>2011</i>							
Operating revenues	\$ 114,963	\$ 17,249	\$ 1,360		-\$	-\$	133,572
Interdepartmental revenues	163	5,083	9,582		-	(14,828)	-
Total operating revenues	115,126	22,332	10,942		-	(14,828)	133,572
Depreciation and amortization	(7,144)	(1,377)	(1,775)		-	-	(10,296)
Other operating expenses	(78,118)	(23,422)	(44)		(186)	14,828	(86,942)
Operating income (loss)	29,864	(2,467)	9,123		(186)	-	36,334
Other income, net	35	12	-	2,167	127	-	2,341
Interest (expense) income, net	(2,747)	(775)	(1,660)		40	-	(5,142)
Income (loss) before taxes	27,152	(3,230)	7,463	2,167	(19)	-	33,533
Income tax (provision) benefit	(9,944)	1,350	(2,994)	(870)	(37)	-	(12,495)
Net income (loss)	\$ 17,208	\$(1,880)	\$ 4,469	\$ 1,297	\$(56)	-\$	21,038
<i>Nine Months Ended September 30,</i>							
<i>2012</i>							
Operating revenues	\$ 305,189	\$ 92,235	\$ 6,894		-\$	-\$	404,318
Interdepartmental revenues	387	10,721	26,032		-	(37,140)	-
Total operating revenues	305,576	102,956	32,926		-	(37,140)	404,318
Depreciation and amortization	(19,554)	(4,158)	(5,330)		-	-	(29,042)
Other operating expenses	(223,876)	(94,162)	(85)		(880)	37,140	(281,863)

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Operating income (loss)	62,146	4,636	27,511	-	(880)	-	93,413
Other income, net	602	170	-	6,764	439	-	7,975
Interest (expense) income, net	(7,727)	(2,179)	(4,915)	-	104	-	(14,717)
Income (loss) before taxes	55,021	2,627	22,596	6,764	(337)	-	86,671
Income tax (provision) benefit	(20,300)	(740)	(9,069)	(2,719)	117	-	(32,711)
Net income (loss)	\$ 34,721\$	1,887\$	13,527\$	4,045\$	(220)\$	-\$	53,960

Nine Months Ended September 30, 2011

Operating revenues	\$ 291,804\$	119,748\$	3,884\$	-\$	-\$	-\$	415,436
Interdepartmental revenues	391	8,247	28,559	-	-	(37,197)	-
Total operating revenues	292,195	127,995	32,443	-	-	(37,197)	415,436
Depreciation and amortization	(21,173)	(4,246)	(5,250)	-	-	-	(30,669)
Other operating expenses	(218,556)	(112,192)	(138)	-	(649)	37,197	(294,338)
Operating income (loss)	52,466	11,557	27,055	-	(649)	-	90,429
Other income, net	68	21	-	6,434	357	-	6,880
Interest (expense) income, net	(8,100)	(2,284)	(4,677)	-	14	-	(15,047)
Income (loss) before taxes	44,434	9,294	22,378	6,434	(278)	-	82,262
Income tax (provision) benefit	(15,666)	(3,532)	(8,981)	(2,592)	53	-	(30,718)
Net income (loss)	\$ 28,768\$	5,762\$	13,397\$	3,842\$	(225)\$	-\$	51,544

The following tables show segment information for MGE's operations for the indicated periods:

<i>(In thousands)</i>			Non-			Consolidation/		
MGE	Electric	Gas	Regulated Energy	Transmission Investment	Elimination Entries	Consolidated Total		
<i>Three Months Ended September 30, 2012</i>								
Operating revenues	\$ 118,914	\$ 16,587	2,337	-	-	137,838		
Interdepartmental revenues	159	4,658	8,679	-	(13,496)	-		
Total operating revenues	119,073	21,245	11,016	-	(13,496)	137,838		
Depreciation and amortization	(6,530)	(1,399)	(1,777)	-	-	(9,706)		
Other operating expenses*	(90,946)	(21,180)	(3,075)	-	13,496	(101,705)		
Operating income (loss)*	21,597	(1,334)	6,164	-	-	26,427		
Other income, net*	592	167	-	1,371	-	2,130		
Interest expense, net	(2,535)	(715)	(1,631)	-	-	(4,881)		
Net income (loss)	19,654	(1,882)	4,533	1,371	-	23,676		
Less: Net income attributable to noncontrolling interest, net of tax	-	-	-	-	(6,153)	(6,153)		
Net income (loss) attributable to MGE	\$ 19,654	(1,882)	4,533	1,371	(6,153)	17,523		
<i>Three Months Ended September 30, 2011</i>								
Operating revenues	\$ 114,963	\$ 17,249	1,360	-	-	133,572		
Interdepartmental revenues	163	5,083	9,582	-	(14,828)	-		
Total operating revenues	115,126	22,332	10,942	-	(14,828)	133,572		
Depreciation and amortization	(7,144)	(1,377)	(1,775)	-	-	(10,296)		
Other operating expenses*	(88,013)	(22,057)	(3,039)	-	14,828	(98,281)		
Operating income (loss)*	19,969	(1,102)	6,128	-	-	24,995		
Other (deductions) income, net*	(14)	(4)	-	1,297	-	1,279		
Interest expense, net	(2,747)	(775)	(1,660)	-	-	(5,182)		
Net income (loss)	17,208	(1,881)	4,468	1,297	-	21,092		
Less: net income attributable to noncontrolling interest, net of tax	-	-	-	-	(6,010)	(6,010)		
Net income (loss) attributable to MGE	\$ 17,208	(1,881)	4,468	1,297	(6,010)	15,082		
<i>Nine Months Ended September 30, 2012</i>								
Operating revenues	\$ 305,189	\$ 92,235	6,894	-	-	404,318		
Interdepartmental revenues	387	10,721	26,032	-	(37,140)	-		
Total operating revenues	305,576	102,956	32,926	-	(37,140)	404,318		
Depreciation and amortization	(19,554)	(4,158)	(5,330)	-	-	(29,042)		
Other operating expenses*	(244,303)	(94,938)	(9,154)	-	37,140	(311,255)		
Operating income*	41,719	3,860	18,442	-	-	64,021		
Other income, net*	729	206	-	4,045	-	4,980		
Interest expense, net	(7,727)	(2,179)	(4,915)	-	-	(14,821)		

Net income	34,721	1,887	13,527	4,045	-	54,180
Less: Net income attributable to noncontrolling interest, net of tax	-	-	-	-	(18,305)	(18,305)
Net income attributable to MGE	\$ 34,721\$	1,887\$	13,527\$	4,045\$	(18,305)\$	35,875

Nine Months Ended September 30, 2011

Operating revenues	\$ 291,804\$	119,748\$	3,884\$	-\$	-\$	415,436
Interdepartmental revenues	391	8,247	28,559	-	(37,197)	-
Total operating revenues	292,195	127,995	32,443	-	(37,197)	415,436
Depreciation and amortization	(21,173)	(4,246)	(5,250)	-	-	(30,669)
Other operating expenses*	(234,145)	(115,701)	(9,119)	-	37,197	(321,768)
Operating income*	36,877	8,048	18,074	-	-	62,999
Other (deductions) income, net*	(8)	(2)	-	3,842	-	3,832
Interest expense, net	(8,100)	(2,284)	(4,677)	-	-	(15,061)
Net income	28,769	5,762	13,397	3,842	-	51,770
Less: net income attributable to noncontrolling interest, net of tax	-	-	-	-	(17,935)	(17,935)
Net income attributable to MGE	\$ 28,769\$	5,762\$	13,397\$	3,842\$	(17,935)\$	33,835

*Amounts are shown net of the related tax expense, consistent with the presentation on the consolidated MGE Income Statement.

The following table shows segment information for MGE Energy's and MGE's assets and capital expenditures:

<i>(In thousands)</i> MGE Energy	Utility		Assets not		Consolidated		Consolidation/ Elimination		Total
	Electric	Gas	Allocated	Nonregulated Energy	Transmission Investment	All Others	Entries		
<i>Assets:</i>									
September 30, 2012	\$ 875,477	\$ 265,332	\$ 34,926	\$ 291,409	\$ 60,236	\$ 403,261	(365,985)	\$ 1,564,656	
December 31, 2011	794,738	285,702	32,882	299,421	57,006	401,862	(412,729)	1,458,882	
<i>Capital Expenditures:</i>									
Nine Months Ended September 30, 2012	\$ 55,518	\$ 9,749	-	\$ 642	-\$	-\$	-\$	65,909	
Year ended Dec. 31, 2011	47,206	15,830	-	2,140	-	-	-	65,176	

<i>(In thousands)</i> MGE	Utility		Assets not		Consolidated		Elimination		Total
	Electric	Gas	Allocated	Nonregulated Energy	Transmission Investment	Entries			
<i>Assets:</i>									
September 30, 2012	\$ 875,477	\$ 265,332	\$ 34,919	\$ 291,359	\$ 60,236	10,740	\$ 1,538,063		
December 31, 2011	794,738	285,702	32,882	299,171	57,006	(35,706)	1,433,793		
<i>Capital Expenditures:</i>									
Nine Months Ended September 30, 2012	\$ 55,518	\$ 9,749	-	\$ 642	-\$	-\$	65,909		
Year ended Dec. 31, 2011	47,206	15,830	-	2,140	-	-	65,176		

14.

Subsequent Events - MGE Energy and MGE.

ATC Capital Contribution.

On October 31, 2012, MGE Transco made a voluntary \$0.4 million capital contribution to ATC.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

General

MGE Energy is an investor-owned public utility holding company operating through subsidiaries in five business segments:

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Regulated electric utility operations, conducted through MGE,

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Regulated gas utility operations, conducted through MGE,

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Nonregulated energy operations, conducted through MGE Power and its subsidiaries,

.

Transmission investments, representing our equity investment in ATC, and

.

All other, which includes corporate operations and services.

Our principal subsidiary is MGE, which generates and distributes electric energy, distributes natural gas, and represents a majority portion of our assets, liabilities, revenues, and expenses. MGE generates and distributes electricity to approximately 139,000 customers in Dane County, Wisconsin, including the city of Madison, and purchases and distributes natural gas to approximately 144,000 customers in the Wisconsin counties of Columbia, Crawford, Dane, Iowa, Juneau, Monroe, and Vernon.

Our nonregulated energy operations own interests in electric generating capacity that is leased to MGE. The ownership/leasing structure was adopted under applicable state regulatory guidelines for MGE's participation in these generation facilities, consisting principally of a stable return on the equity investment in the new generation facilities over the term of the related leases. The nonregulated energy operations include an undivided 8.33% ownership interest in two 615 MW coal-fired generating units in Oak Creek, Wisconsin and a partial ownership of a cogeneration project on the UW-Madison campus. A third party operates the units in Oak Creek, and MGE operates the cogeneration project. Due to the nature of MGE's participation in these facilities, the results of our nonregulated operations are also consolidated into MGE's consolidated financial position and results of operations under applicable accounting

standards.

Overview

Our primary focus today and for the foreseeable future is our core utility customers at MGE as well as creating long-term value for shareholders. MGE continues to face the challenge of providing its customers with reliable power at competitive prices. MGE meets this challenge by investing in more efficient generation projects, including renewable energy sources. In the future, MGE will continue to focus on growing earnings while controlling operating and fuel costs. MGE will continue to maintain safe and efficient operations in addition to providing customer value. We believe it is critical to maintain a strong credit standing consistent with financial strength in MGE as well as the parent company in order to accomplish these goals.

We earn our revenue and generate cash from operations by providing electric and natural gas utility services, including electric power generation and electric power and gas distribution. The earnings and cash flows from the utility business are sensitive to various external factors, including:

.

Weather, and its impact on customer sales of electricity and gas,

.

Economic conditions, including current business activity and employment and their impact on customer demand,

.

Regulation and regulatory issues, and their impact on the timing and recovery of costs,

.

Energy commodity prices,

.

Equity price risk pertaining to pension related assets,

.

Credit market conditions, including interest rates and our debt credit rating,

.

Environmental laws and regulations, including adopted and pending environmental rule changes,

Construction risk in connection with the Columbia environmental project,

and other factors listed in "Item 1A. Risk Factors" in our 2011 Annual Report on Form 10-K and in this Report.

For the three months ended September 30, 2012, MGE Energy's earnings were \$23.6 million or \$1.02 per share compared to \$21.0 million or \$0.91 per share for the same period in the prior year. MGE's earnings for the three months ended September 30, 2012, were \$17.5 million compared to \$15.1 million for the same period in the prior year.

For the nine months ended September 30, 2012, MGE Energy's earnings were \$54.0 million or \$2.33 per share compared to \$51.5 million or \$2.23 per share for the same period in the prior year. MGE's earnings for the nine months ended September 30, 2012, were \$35.9 million compared to \$33.8 million for the same period in the prior year.

MGE Energy's income was derived from our business segments as follows:

<i>(In thousands)</i>	Three Months		Nine Months	
	Ended		Ended	
Business Segment:	September 30,	September 30,	September 30,	September 30,
	2012	2011	2012	2011
Electric Utility	\$ 19,654	\$ 17,208	\$ 34,721	\$ 28,768
Gas Utility	(1,882)	(1,880)	1,887	5,762
Nonregulated				
Energy	4,533	4,469	13,527	13,397
Transmission				
Investment	1,371	1,297	4,045	3,842
All Other	(34)	(56)	(220)	(225)
Net Income	\$ 23,642	\$ 21,038	\$ 53,960	\$ 51,544

Our net income during the three months ended September 30, 2012, primarily reflects the effects of the following factor:

.

A 3.8% increase in retail electric revenues, driven by increased residential customer demand primarily as a result of warmer-than-normal weather. Cooling degree days (a measure for determining the impact of weather during the cooling season) increased by 19% compared to the prior period.

Our net income during the nine months ended September 30, 2012, primarily reflects the effects of the following factors:

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A 4.9% increase in retail electric revenues reflecting, in part, increased customer demand as a result of warmer-than-normal weather. Cooling degree days (a measure for determining the impact of weather during the cooling season) increased by 32% compared to the prior period.

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An 11.8% decrease in gas sales reflecting lower customer demand due to a milder winter. Heating degree days (a measure for determining the impact of weather during the heating season) decreased by 25% compared to the prior period.

During the first nine months of 2012, the following events occurred:

Columbia Environmental Project: In early 2011, the PSCW authorized the construction of air emission reduction systems and associated equipment on Columbia Units 1 and 2. MGE's estimated share of the capital expenditures required to complete this project will be approximately \$140 million. MGE expects to incur capital expenditures as follows: \$18 million for the remainder of 2012, \$68 million in 2013, and \$12 million in 2014. As of September 30, 2012, MGE has accumulated \$42.3 million (excluding carrying costs) related to its share of the project, which is reflected in the Construction Work in Progress balance on MGE Energy's and MGE's consolidated balance sheets. Of this amount, MGE has accumulated \$38.0 million in 2012. MGE has recognized \$0.7 million (after tax) in AFUDC equity related to this project for the nine months ended September 30, 2012.

Rate Filing: On March 23, 2012, MGE filed an application with the PSCW requesting a 5.8% increase to electric rates and a 2.6% increase to gas rates. The proposed electric increase will cover costs for new environmental equipment at Columbia, final construction costs for the Elm Road Units (including the prudence of construction costs incurred above a previously approved cap), transmission reliability enhancements, and purchased power costs. MGE has requested that these rates become effective January 1, 2013. See Footnote 21 in the 2011 Annual Report Form 10-K for additional information on the construction costs for the Elm Road Units.

ATC: MGE Transco contributed \$1.8 million for voluntary capital contributions to ATC for the nine months ended September 30, 2012.

Smart Grid Investment Grant: MGE was approved in 2010 by the U.S. Department of Energy (DOE) under the federal stimulus program for a \$5.5 million grant for smart grid projects. The DOE grant requires MGE to match the grant funding, bringing the total cost of the projects to more than \$11 million. The projects involve the installation of technologies to boost efficiency, enhance service and improve reliability for customers. The stimulus grant is being used to fund the following projects: advanced metering infrastructure, plug-in hybrid electric vehicles support, and distribution management. As of September 30, 2012, MGE has spent \$7.9 million related to these projects. Of this amount, \$1.9 million was incurred during the nine months ended September 30, 2012. MGE also has outstanding agreements to purchase \$0.6 million in smart grid related products for the remainder of 2012 and \$1.3 million in 2013.

In the near term, several items may affect us, including:

Environmental Initiatives: There are proposed legislation, rules and initiatives involving matters related to air emissions, water effluent, hazardous materials and greenhouse gases, all of which affect generation plant capital expenditures and operating costs as well as future operational planning. Such legislation and rulemaking could significantly affect the costs of owning and operating fossil-fueled generating plants, such as Columbia and Elm Road, from which we derive approximately 43% of our electric generating capacity. We would expect to seek and receive recovery of any such costs in rates; however, it is difficult to estimate the amount of such costs due to the uncertainty as to the timing and form of the legislation and rules, and the scope and time of the recovery of costs in rates. In addition, MGE is involved in claims surrounding the alleged failure, among other things, to obtain necessary air permits and implement necessary emission controls associated with past activities at Columbia. MGE and the other co-owners are defending against these claims. See Columbia discussion in Footnote 8.a. in Notes to Consolidated Financial Statements.

General economic conditions: Economic conditions both inside and outside our service area are expected to continue to affect the level of demand for our utility services and may affect the collection of our accounts receivable and the creditworthiness of counterparties with whom we do business. We have in place lines of credit aggregating \$115 million for MGE Energy (including MGE) and \$75 million for MGE to address our liquidity needs.

The following discussion is based on the business segments as discussed in Footnote 13.

Three Months Ended September 30, 2012 and 2011

Electric Utility Operations - MGE Energy and MGE

Electric sales and revenues

The following table compares MGE's electric revenues and electric kWh sales by customer class for each of the periods indicated:

	Revenues			Sales (kWh)		
	Three Months Ended			Three Months Ended		
	September 30,			September 30,		
<i>(in thousands, except cooling degree days)</i>	2012	2011	% Change	2012	2011	% Change
Residential	\$ 42,652	\$ 39,176	8.9 %	264,217	251,426	5.1 %

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Commercial	60,317	59,131	2.0 %	507,696	516,744	(1.8)%
Industrial	5,468	5,588	(2.1)%	65,994	71,591	(7.8)%
Other-retail/municipal	11,356	11,497	(1.2)%	118,548	132,721	(10.7)%
Total retail	119,793	115,392	3.8 %	956,455	972,482	(1.6)%
Sales to the market	390	606	(35.6)%	2,802	4,376	(36.0)%
Adjustments to revenues	(1,269)	(1,035)	(22.6)%	-	-	- %
Total	\$ 118,914	\$ 114,963	3.4 %	959,257	976,858	(1.8)%
Cooling degree days (normal 452)				729	612	19.1 %

Electric operating revenues increased \$4.0 million or 3.4% for the three months ended September 30, 2012, due to the following:

<i>(In millions)</i>	
Rate changes	\$ 6.3
Volume	(1.9)
Sales to the market	(0.2)
Adjustments to revenues	(0.2)
Total	\$ 4.0

Rate changes. Rates charged to retail customers for the three months ended September 30, 2012, were 5.6% or \$6.3 million higher than those charged during the same period in the prior year.

In December 2011, the PSCW authorized MGE to increase 2012 rates for retail electric customers by 4.3% or \$15.7 million. The increase in retail electric rates is driven by MGE's electric fuel and purchased power costs, increased transmission costs, an update to the Elm Road Units' costs, and an increase for energy efficiency programs.

Volume. During the three months ended September 30, 2012, there was a 1.6% decrease in total retail sales volumes compared to the same period in the prior year.

Sales to the market. Sales to the market represent wholesale sales made to third parties who are not ultimate users of the electricity. These sales may include spot market transactions on the markets operated by MISO and PJM. These sales may also include bilateral sales to other utilities or power marketers.

Adjustments to revenues. The adjustments to revenues amount includes the elimination of carrying costs for the Elm Road Units and WCCF that were collected in electric rates, which are recognized as nonregulated energy operating revenues in our Nonregulated Energy Operations segment.

Electric fuel and purchased power

The expense for fuel for electric generation decreased \$0.3 million or 1.6% during the three months ended September 30, 2012, compared to the same period in the prior year. Internal electric generation costs decreased \$1.3 million as a result of a 7.6% decrease in the per-Unit cost (largely due to lower natural gas prices), which was offset by an increase of \$1.0 million due to a 6.5% increase in volume.

Excluding the fuel rules adjustments discussed below, purchased power expense decreased \$0.4 million during the three months ended September 30, 2012, compared to the same period in the prior year. A 16.9% decrease in the volume of purchased power from third parties lowered expense by \$2.6 million, which was offset by a \$2.2 million or 17.2% increase in the per-Unit cost of purchased power.

The PSCW has adopted new fuel rules effective January 1, 2011, that require MGE to defer electric fuel-related costs that fall outside a 2% cost tolerance band around the amount used in the most recent rate proceeding. Any fuel rules adjustments are reflected in purchased power expense. During the third quarter of 2012, MGE's actual fuel costs fell below the lower end of this tolerance band which resulted in MGE deferring \$3.2 million in fuel-related cost savings to be returned to customers and increased purchased power costs. Any over/under recovery of the deferred costs is determined on an annual basis and adjusted in future billings to customers. In the third quarter of 2011, MGE reversed \$2.7 million of incremental fuel-related costs deferred as of June 30, 2011, and increased purchased power costs (it was determined no fuel cost recovery would come from customers under the fuel rules). For the third quarter of 2012 compared to the prior year, the impact of these fuel rules adjustments was to create a difference in purchased power expense of \$0.5 million. After combining the fuel rules adjustments with the actual savings discussed above,

purchased power expense increased \$0.1 million (\$0.5 million fuel rules difference less the \$0.4 million decrease discussed above) during the three months ended September 30, 2012, compared to the prior year.

Electric operating and maintenance expenses

Electric operating and maintenance expenses increased \$1.6 million during the three months ended September 30, 2012, compared to the same period in 2011. The following changes contributed to the net change:

<i>(In millions)</i>	
Increased administrative and general costs	\$ 1.5
Increased customer service costs	0.2
Other	(0.1)
Total	\$ 1.6

For the three months ended September 30, 2012, increased administrative and general costs are primarily due to increased pension costs and increased customer service costs are due to increased energy conservation costs.

Electric depreciation expense

Electric depreciation expense decreased \$0.6 million for the three months ended September 30, 2012, compared to the same period in the prior year. This decrease is related to the retirement of Blount assets at the end of 2011 due to the switch from operating with coal to natural gas.

Gas Utility Operations - MGE Energy and MGE*Gas deliveries and revenues*

The following table compares MGE's gas revenues and gas therms delivered by customer class during each of the periods indicated:

	Revenues			Therms Delivered		
	Three Months Ended September 30,			Three Months Ended September 30,		
			%			%
<i>(In thousands, except HDD and average rate per therm of retail customer)</i>	2012	2011	Change	2012	2011	Change
Residential	\$ 8,004	\$ 8,614	(7.1)%	5,658	5,939	(4.7)%
Commercial/Industrial	7,960	8,001	(0.5)%	17,175	13,008	32.0 %
Total retail	15,964	16,615	(3.9)%	22,833	18,947	20.5 %
Gas transportation	515	506	1.8 %	6,310	6,367	(0.9)%
Other revenues	108	128	(15.6)%	-	-	- %
Total	\$ 16,587	\$ 17,249	(3.8)%	29,143	25,314	15.1 %
Heating degree days (normal 182)				212	216	(1.9)%
Average Rate Per Therm of Retail Customer	\$ 0.699	\$ 0.877	(20.3)%			

Gas revenues decreased \$0.7 million or 3.8% for the three months ended September 30, 2012. These changes are related to the following factors:

<i>(In millions)</i>	
Gas costs/rates	\$ (4.1)
Gas deliveries	3.4
Total	\$ (0.7)

Gas costs/rates. The average retail rate per therm for the three months ended September 30, 2012, decreased 20.3% compared to the same period in 2011, reflecting lower natural gas commodity costs.

Retail gas deliveries. For the three months ended September 30, 2012, retail gas deliveries increased 20.5% compared to the same period in 2011.

Cost of gas sold

For the three months ended September 30, 2012, cost of gas sold decreased by \$0.8 million, compared to the same period in the prior year. The volume of gas purchased increased 22.8%, which resulted in \$1.8 million of increased expense. However, the cost per therm of natural gas decreased 9.6%, which resulted in \$2.6 million of decreased expense.

Gas operating and maintenance expenses

Gas operating and maintenance expenses increased by \$0.6 million for the three months ended September 30, 2012, compared to the same period in 2011. The following changes contributed to the net change:

<i>(In millions)</i>	
Increased administrative and general costs	\$ 0.5
Increased customer service costs	0.1
Increased distribution costs	0.1
Decreased customer accounts costs	(0.1)
Total	\$ 0.6

Nonregulated Energy Operations - MGE Energy and MGE

For both the three months ended September 30, 2012 and 2011, net income at the nonregulated energy operations segment was \$4.5 million. The nonregulated energy operations are conducted through MGE Energy's subsidiaries: MGE Power, MGE Power Elm Road and MGE Power West Campus. These subsidiaries have been formed to construct, own and lease electric generating capacity to assist MGE.

Transmission Investment Operations - MGE Energy and MGE*Transmission investment other income*

For the three months ended September 30, 2012, other income at the transmission investment segment was \$2.3 million compared to \$2.2 million for the same period in 2011. The transmission investment segment holds our interest in ATC, and its income reflects our equity in the earnings of ATC. See Footnote 3 for additional information concerning ATC and summarized financial information regarding ATC.

Consolidated Income Taxes - MGE Energy and MGE

MGE Energy's effective income tax rate for the three months ended September 30, 2012, is 37.6% compared to 37.3% for the same period in 2011, and MGE's effective income tax rate for the three months ended September 30, 2012, is 37.6% compared to 37.1% for the same period in 2011.

Noncontrolling Interest, Net of Tax - MGE

The noncontrolling interest, net of tax, reflects the accounting required for MGE Energy's interest in MGE Power Elm Road (the Elm Road Units) and MGE Power West Campus (WCCF). MGE Energy owns 100% of MGE Power Elm Road and MGE Power West Campus; however, due to the contractual agreements for these projects with MGE, the entities are considered VIEs and their results are consolidated with those of MGE, the primary beneficiary of the VIEs. Also included in noncontrolling interest, net of tax, is MGE Energy's interest in MGE Transco. The following table shows MGE Energy's noncontrolling interest, net of tax, reflected on MGE's consolidated statement of income:

	Three Months Ended	
	September 30,	
<i>(in millions)</i>	2012	2011
MGE Power Elm Road	\$ 3.7	\$ 3.7
MGE Power West Campus	\$ 1.9	\$ 1.9
MGE Transco	\$ 0.6	\$ 0.5

Nine Months Ended September 30, 2012 and 2011

Electric Utility Operations - MGE Energy and MGE*Electric sales and revenues*

The following table compares MGE's electric revenues and electric kWh sales by customer class for each of the periods indicated:

	Revenues			Sales (kWh)		
	Nine Months Ended September 30,			Nine Months Ended September 30,		
<i>(in thousands, except cooling degree days)</i>	2012	2011	% Change	2012	2011	% Change
Residential	\$ 102,481	\$ 97,225	5.4 %	646,238	638,925	1.1 %
Commercial	160,309	152,751	4.9 %	1,400,390	1,398,161	0.2 %
Industrial	15,130	14,993	0.9 %	191,363	201,815	(5.2)%
Other-retail/municipal	29,886	28,583	4.6 %	334,097	336,788	(0.8)%
Total retail	307,806	293,552	4.9 %	2,572,088	2,575,689	(0.1)%
Sales to the market	1,144	1,489	(23.2)%	25,760	32,634	(21.1)%
Adjustments to revenues	(3,761)	(3,237)	(16.2)%	-	-	- %
Total	\$ 305,189	\$ 291,804	4.6 %	2,597,848	2,608,323	(0.4)%
Cooling degree days (normal 622)				1,065	804	32.5 %

Electric operating revenues increased \$13.4 million or 4.6% for the nine months ended September 30, 2012, due to the following:

(In millions)

Rate changes	\$ 14.7
Volume	(0.4)
Sales to the market	(0.3)
Adjustments to revenues	(0.6)
Total	\$ 13.4

Rate changes. Rates charged to retail customers for the nine months ended September 30, 2012, were 5.0% or \$14.7 million higher than those charged during the same period in the prior year.

In December 2011, the PSCW authorized MGE to increase 2012 rates for retail electric customers by 4.3% or \$15.7 million. The increase in retail electric rates is driven by MGE's electric fuel and purchased power costs, increased transmission costs, an update to the Elm Road Units' costs, and an increase for energy efficiency programs.

Volume. During the nine months ended September 30, 2012, there was a 0.1% decrease in total retail sales volumes compared to the same period in the prior year.

Sales to the market. Sales to the market represent wholesale sales made to third parties who are not ultimate users of the electricity. These sales may include spot market transactions on the markets operated by MISO and PJM. These sales may also include bilateral sales to other utilities or power marketers.

Adjustments to revenues. The adjustments to revenues amount includes the elimination of carrying costs for Elm Road Units and the WCCF that were collected in electric rates, which are recognized as nonregulated energy operating revenues in our Nonregulated Energy Operations segment.

Electric fuel and purchased power

The expense for fuel for electric generation decreased \$2.6 million or 6.6% during the nine months ended September 30, 2012, compared to the same period in the prior year. Internal electric generation costs decreased \$2.8 million as a result of a 7.2% decrease in the per-unit cost (largely due to lower natural gas prices), and higher generation volumes of 0.7% or \$0.2 million.

Excluding the fuel rules adjustments discussed below, purchased power expense decreased \$0.9 million during the nine months ended September 30, 2012, compared to the same period in the prior year, due to a 1.7% decrease in the volume of power purchased from third parties.

The PSCW has adopted new fuel rules effective January 1, 2011, that require MGE to defer electric fuel-related costs that fall outside a 2% cost tolerance band around the amount used in the most recent rate proceeding. Any fuel rules adjustments are reflected in purchased power expense. During the nine months ended September 30, 2012, MGE's actual fuel costs fell below the lower end of this tolerance band, which resulted in MGE deferring \$5.9 million in fuel-related cost savings to be returned to customers and increased purchased power costs. Any over/under recovery of the deferred costs is determined on an annual basis and adjusted in future billings to customers. After combining the fuel rules adjustments with the actual savings discussed above, purchased power expense increased \$5.0 million (\$5.9 million fuel rules difference less the \$0.9 million decrease discussed above) during the nine months ended September 30, 2012, compared to the prior year.

Electric operating and maintenance expenses

Electric operating and maintenance expenses increased \$4.0 million during the nine months ended September 30, 2012, compared to the same period in 2011. The following changes contributed to the net change:

<i>(In millions)</i>	
Increased administrative and general costs	\$ 4.3
Increased customer services costs	0.8
Increased distribution costs	0.7
Increased transmission costs	0.4
Decreased production costs	(2.2)
Total	\$ 4.0

For the nine months ended September 30, 2012, increased administrative and general costs are primarily due to increased pension costs. Increased customer service costs are due to higher energy conservation spending. Increased distribution costs are due to increased overhead line expenses. Production costs decreased primarily due to decreased costs at Columbia and the Elm Road Units.

Electric depreciation expense

Electric depreciation expense decreased \$1.6 million for the nine months ended September 30, 2012, compared to the same period in the prior year. This decrease is related to the retirement of Blount assets at the end of 2011 due to the switch from operating with coal to natural gas.

Gas Utility Operations - MGE Energy and MGE***Gas deliveries and revenues***

The following table compares MGE's gas revenues and gas therms delivered by customer class during each of the periods indicated:

	Revenues			Therms Delivered		
	Nine Months Ended September 30,			Nine Months Ended September 30,		
<i>(In thousands, except HDD and average rate per therm of retail customer)</i>	2012	2011	% Change	2012	2011	% Change
Residential	\$ 51,620	\$ 67,180	(23.2)%	51,246	64,827	(20.9)%
Commercial/Industrial	38,521	50,183	(23.2)%	72,743	75,265	(3.4)%
Total retail	90,141	117,363	(23.2)%	123,989	140,092	(11.5)%
Gas transportation	1,744	1,909	(8.6)%	22,726	26,287	(13.5)%
Other revenues	350	476	(26.5)%	-	-	- %
Total	\$ 92,235	\$ 119,748	(23.0)%	146,715	166,379	(11.8)%
Heating degree days (normal 4,582)				3,581	4,805	(25.5)%
Average Rate Per Therm of Retail Customer	\$ 0.727	\$ 0.838	(13.2)%			

Gas revenues decreased \$27.5 million or 23.0% for the nine months ended September 30, 2012. These changes are related to the following factors:

<i>(In millions)</i>	
Gas costs/rates	\$ (13.7)
Gas deliveries	(13.5)
Transportation and other effects	(0.3)
Total	\$ (27.5)

Retail gas deliveries. For the nine months ended September 30, 2012, retail gas deliveries decreased 11.5% compared to the same period in 2011, as a result of milder weather during the winter months.

Gas costs/rates. The average retail rate per therm for the nine months ended September 30, 2012, decreased 13.2% compared to the same period in 2011, reflecting lower natural gas commodity costs.

Cost of gas sold

For the nine months ended September 30, 2012, cost of gas sold decreased by \$22.1 million, compared to the same period in the prior year. The volume of purchased gas decreased 12.0%, which resulted in \$8.6 million of decreased expense. In addition, the cost per therm of natural gas decreased 21.3%, which resulted in \$13.5 million of decreased expense.

Gas operating and maintenance expenses

Gas operating and maintenance expenses increased by \$2.2 million for the nine months ended September 30, 2012, compared to the same period a year ago. The following changes contributed to the net change:

<i>(In millions)</i>	
Increased administrative and general costs	\$ 1.2
Increased distribution costs	0.4
Increased customer service costs	0.4
Increased customer accounts costs	0.2
Total	\$ 2.2

For the nine months ended September 30, 2012, increased administrative general costs are primarily due to increased pension costs.

Nonregulated Energy Operations - MGE Energy and MGE

For the nine months ended September 30, 2012 and 2011, net income at the nonregulated energy operations segment was \$13.5 million and \$13.4 million, respectively. The nonregulated energy operations are conducted through MGE Energy's subsidiaries: MGE Power, MGE Power Elm Road and MGE Power West Campus. These subsidiaries have been formed to construct, own and lease electric generating capacity to assist MGE.

Transmission Investment Operations - MGE Energy and MGE

Transmission investment other income

For the nine months ended September 30, 2012 and 2011, other income at the transmission investment segment was \$6.8 million and \$6.4 million, respectively. The transmission investment segment holds our interest in ATC, and its income reflects our equity in the earnings of ATC. See Footnote 3 for additional information concerning ATC and summarized financial information regarding ATC.

Consolidated Income Taxes - MGE Energy and MGE

MGE Energy's effective income tax rate for the nine months ended September 30, 2012, is 37.7% compared to 37.3% for the same period in 2011, and MGE's effective income tax rate for the nine months ended September 30, 2012, is 37.7% compared to 37.3% for the same period in 2011.

Noncontrolling Interest, Net of Tax - MGE

The noncontrolling interest, net of tax, reflects the accounting required for MGE Energy's interest in MGE Power Elm Road (the Elm Road Units) and MGE Power West Campus (WCCF). MGE Energy owns 100% of MGE Power Elm Road and MGE Power West Campus; however, due to the contractual agreements for these projects with MGE, the entities are considered VIEs and their results are consolidated with those of MGE, the primary beneficiary of the VIEs. Also included in noncontrolling interest, net of tax, is MGE Energy's interest in MGE Transco. The following table shows MGE Energy's noncontrolling interest, net of tax, reflected on MGE's consolidated statement of income:

	Nine Months Ended September 30,	
<i>(in millions)</i>	2012	2011
MGE Power Elm Road	\$ 11.1	\$ 10.9
MGE Power West Campus	\$ 5.6	\$ 5.6
MGE Transco	\$ 1.6	\$ 1.4

Contractual Obligations and Commercial Commitments - MGE Energy and MGE

There were no material changes, other than from the normal course of business, to MGE Energy's and MGE's contractual obligations (representing cash obligations that are considered to be firm commitments) and commercial commitments (representing commitments triggered by future events) during the nine months ended September 30, 2012, except as noted below. Further discussion of the contractual obligations and commercial commitments is included in Footnote 8 of this Report and Footnote 18 and "Contractual Obligations and Commercial Commitments for MGE Energy and MGE" under "Management's Discussion and Analysis of Financial Condition and Results of Operations" in MGE Energy's and MGE's 2011 Annual Report on Form 10-K.

Purchase Power Agreement Contract Dispute - MGE Energy and MGE

MGE is seeking resolution to a contract dispute regarding its Purchase Power Agreement with Riverside Energy Center LLC, a Calpine subsidiary, for capacity and energy from the Riverside Energy Center located in Beloit, Wisconsin. MGE declared the PPA terminated. Any savings in capacity costs that ultimately result from the termination of the Riverside PPA will flow through to the Company's customers. MGE is currently deferring amounts equal to the capacity payments MGE would be making under the terms of the Riverside PPA if it were still in effect. This deferral will create a liability to MGE's customers for a future credit, assuming MGE's right to terminate the PPA is ultimately upheld. If MGE does not prevail in the dispute, the capacity payment deferred will be paid to Riverside Energy Center, LLC.

Purchase Contracts - MGE Energy and MGE

MGE Energy and MGE have entered into various commodity supply, transportation and storage contracts to meet their obligations to deliver electricity and natural gas to customers. As of September 30, 2012, the future commitments related to these purchase contracts were as follows:

<i>(In thousands)</i>	2012	2013	2014	2015	2016
Coal ^(a)	\$ 2,483	\$ 21,884	\$ 9,459	\$ 6,340	\$ 1,623
Natural gas supply ^(b)	12,872	13,192	-	-	-
Purchase Power ^(c)	39,266	51,455	49,372	47,523	48,491
	\$ 54,621	\$ 86,531	\$ 58,831	\$ 53,863	\$ 50,114

(a)

Total coal commitments for the Columbia and Elm Road Units, including transportation. Fuel procurement for MGE's jointly owned Columbia and Elm Road Units are handled by WPL and WEPCO, respectively, who are the operators of those facilities. If any minimum purchase obligations must be paid under these contracts, management believes these obligations would be considered costs of service and recoverable in rates.

(b)

These commitments include market-based pricing. Management expects to recover these costs in future customer rates.

(c)

MGE has several purchase power agreements to help meet future electric supply requirements. Management expects to recover these costs in future customer rates.

Smart Grid Investment Grant - MGE Energy and MGE

MGE was approved in 2010 by the U.S. Department of Energy (DOE) under the federal stimulus program for a \$5.5 million grant for smart grid projects. The DOE grant requires MGE to match the grant funding, bringing the total cost of the projects to more than \$11 million. The projects involve the installation of technologies to boost efficiency, enhance service and improve reliability for customers. The stimulus grant is being used to fund the following projects: advanced metering infrastructure, plug-in hybrid electric vehicles support, and distribution management. As of September 30, 2012, MGE has spent \$7.9 million related to these projects and has outstanding agreements to purchase \$0.6 million in smart grid related products for the remainder of 2012 and \$1.3 million in 2013.

Other Commitments - MGE Energy

On January 31, 2012, MGE Energy entered a subscription agreement to invest in a nonpublic venture capital fund. From time to time, this entity will require capital infusions from its investors. MGE Energy has committed to contribute \$2.0 million in capital for such infusions. The timing of these infusions is dependent on the needs of the investee and is therefore uncertain at this time.

Long-term Debt - MGE Energy and MGE

On April 2, 2012, MGE issued \$28 million in principal amount of its 4.38% senior notes, due April 1, 2042. The Notes were issued pursuant to a Note Purchase Agreement. The Notes are unsecured and are not issued under, or governed by, MGE's Indenture dated as of September 1, 1998, which governs MGE's Medium-Term Notes. MGE used the net proceeds from the sale of the Notes, together with other available corporate funds, to repay and retire on April 3, 2012, its obligations under a Loan Agreement dated as of April 1, 2002 with the City of Madison, Wisconsin, under which MGE received the net proceeds from the issuance of \$28 million aggregate principal amount of 5.875% Series 2002A, Industrial Development Revenue Bonds that were issued by the City of Madison for MGE's benefit. The 5.875% Series 2002A Bonds were redeemed and retired on April 3, 2012, at 100% of their principal amount plus accrued interest with the proceeds of that loan repayment. Any interest savings in 2012 will be deferred.

Remarketing of 4.875% Series 2002B, Industrial Development Revenue Bonds - MGE Energy and MGE

On April 2, 2012, \$19.3 million of 4.875% Series 2002B, Industrial Development Revenue Bonds were remarketed at an interest rate of 3.45%. The net proceeds of the 4.875% Series 2002B Bonds were originally loaned to MGE pursuant to a Loan Agreement dated as of April 1, 2002 with the City of Madison, which issued the Series 2002B Bonds in 2002. MGE is responsible for the payment of principal, premium, if any, and interest on the Bonds. The 4.875% Series 2002B Bonds were originally issued bearing an interest rate of 4.875% per annum for a period that ended April 1, 2012, at which point the Bonds were subject to mandatory tender by their holders and remarketing. The Series 2002B Bonds were remarketed and carry an interest rate of 3.45% per annum, which is payable semi-annually on April 1 and October 1, until their maturity on October 1, 2027. The Series 2002B Bonds are redeemable on or after April 1, 2017, at a redemption price equal to 100% of the principal amount of the Bonds to be redeemed, plus accrued interest to the redemption date.

Liquidity and Capital Resources**Cash Flows**

The following summarizes cash flows for MGE Energy and MGE during the nine months ended September 30, 2012 and 2011:

<i>(In thousands)</i>	MGE Energy		MGE	
	2012	2011	2012	2011
Cash provided by/(used for):				
Operating activities	\$ 115,886	\$ 106,525	\$ 113,569	\$ 105,041
Investing activities	(68,188)	(47,889)	(67,955)	(45,374)
Financing activities	(29,664)	(20,853)	(29,976)	(37,664)

Cash Provided by Operating Activities**MGE Energy**

MGE Energy's consolidated net cash provided by operating activities is derived mainly from the electric and gas operations of its principal subsidiary, MGE.

Cash provided by operating activities for the nine months ended September 30, 2012, was \$115.9 million, an increase of \$9.4 million when compared to the same period in the prior year primarily related to lower income taxes as a result of the bonus depreciation related to ERGS.

MGE Energy's net income increased \$2.4 million for the nine months ended September 30, 2012, when compared to the same period in the prior year.

The cash flows for the nine months ended September 30, 2012, reflect a \$37.8 million benefit of lower taxes payable, compared to the same period in the prior year, primarily due to bonus depreciation related to ERGS.

Working capital accounts resulted in \$22.4 million in cash used by operating activities for the nine months ended September 30, 2012, primarily due to increased prepaid taxes and decreased accounts payable, partially offset by decreased receivable margin and decreased unbilled revenues. Working capital accounts resulted in \$17.3 million in cash provided by operating activities for the nine months ended September 30, 2011, primarily due to decreased unbilled, decreased accounts receivable, and decreased prepaid taxes, partially offset by decreased accounts payable.

An increase in pension contribution resulted in an additional \$1.9 million in cash used by operating activities for the nine months ended September 30, 2012, when compared to the same period in the prior year. These contributions include amounts to comply with the minimum funding standards of the Employee Retirement Income Security Act (ERISA) and the Pension Protection Act of 2006, as well as additional discretionary contributions.

MGE

Cash provided by operating activities for the nine months ended September 30, 2012, was \$113.6 million, an increase of \$8.5 million when compared to the same period in the prior year primarily related to lower income taxes as a result of the bonus depreciation related to ERGS.

Net income increased \$2.4 million for the nine months ended September 30, 2012, when compared to the same period in the prior year.

The cash flows for the nine months ended September 30, 2012, reflect a \$37.8 million benefit of lower taxes payable, compared to the same period in the prior year, primarily due to bonus depreciation related to ERGS.

Working capital accounts resulted in \$24.5 million in cash used by operating activities for the nine months ended September 30, 2012, primarily due to increased prepaid taxes and decreased accounts payable, partially offset by decreased receivable margin and decreased unbilled revenues. Working capital accounts resulted in \$15.9 million in cash provided by operating activities for the nine months ended September 30, 2011, primarily due to decreased unbilled, decreased accounts receivable, and decreased prepaid taxes, partially offset by decreased accounts payable.

An increase in pension contribution resulted in an additional \$1.9 million in cash used by operating activities for the nine months ended September 30, 2012, when compared to the same period in the prior year. These contributions include amounts to comply with the minimum funding standards of ERISA and the Pension Protection Act of 2006, as well as additional discretionary contributions.

Cash Used for Investing Activities

MGE Energy

MGE Energy's cash used for investing activities increased \$20.3 million for the nine months ended September 30, 2012, when compared to the same period in the prior year.

Capital expenditures for the nine months ended September 30, 2012, were \$65.9 million. This amount represents an increase of \$21.1 million from the expenditures made in the same period in the prior year. This increase is due to increased expenditures on the Columbia environmental project of \$30.8 million.

Cash used for investing activities for the nine months ended September 30, 2011, also included land purchased for investing purposes of \$2.2 million.

MGE

MGE's cash used for investing activities increased \$22.6 million for the nine months ended September 30, 2012, when compared to the same period in the prior year.

Capital expenditures for the nine months ended September 30, 2012, were \$65.9 million. This amount represents an increase of \$21.1 million from the expenditures made in the same period in the prior year. This increase is due to increased expenditures on the Columbia environmental project of \$30.8 million.

Cash Used for Financing Activities

MGE Energy

Cash used for MGE Energy's financing activities was \$29.7 million for the nine months ended September 30, 2012, compared to \$20.9 million of cash used for the nine months ended September 30, 2011.

For the nine months ended September 30, 2012, dividends paid were \$26.8 million compared to \$26.2 million in the prior year. This increase was a result of a higher dividend per share (\$1.161 vs. \$1.133).

During the nine months ended September 30, 2012, MGE issued and retired \$28.0 million of long-term debt. During the nine months ended September 30, 2011, MGE Power Elm Road issued \$30.0 million of long-term debt.

For the nine months ended September 30, 2011, net short-term debt repayments were \$22.5 million reflecting the use of proceeds from the MGE Power Elm Road long-term debt issue.

MGE

During the nine months ended September 30, 2012, cash used for MGE's financing activities was \$30.0 million compared to \$37.7 million of cash used by MGE's financing activities in the prior year.

Dividends paid from MGE to MGE Energy were \$13.5 million for the nine months ended September 30, 2012, compared to \$19.9 million in the prior year.

During the nine months ended September 30, 2012, MGE issued and retired \$28.0 million of long-term debt. During the nine months ended September 30, 2011, MGE Power Elm Road issued \$30.0 million of long-term debt.

Distributions to parent from noncontrolling interest were \$15.5 million for the nine months ended September 30, 2012. As a result of the long-term debt financing by MGE Power Elm Road, distributions to parent from noncontrolling interest were \$43.0 million for the nine months ended September 30, 2011. The proceeds from the financing were used to repay MGE Energy, which had been using its short-term credit facilities to help finance the Elm Road Units.

In addition, for the nine months ended September 30, 2011, net short-term debt repayments were \$3.5 million.

Capitalization Ratios

MGE Energy's capitalization ratios were as follows:

	MGE Energy	
	September 30, 2012	December 31, 2011
Common shareholders' equity	61.5 %	60.2 %
Long-term debt*	38.5 %	39.8 %

**Includes the current portion of long-term debt.*

MGE Energy's and MGE's Capital Requirements

MGE Energy's and MGE's liquidity are primarily affected by their capital requirements. During the nine months ended September 30, 2012, capital expenditures for MGE Energy and MGE totaled \$65.9 million, which included \$65.3 million of capital expenditures for utility operations.

In early 2011, the PSCW authorized the construction of air emission reduction systems and associated equipment on Columbia Units 1 and 2. MGE's estimated share of the capital expenditures required to complete this project will be

approximately \$140 million. MGE expects to incur capital expenditures as follows: \$18 million for the remainder of 2012, \$68 million in 2013, and \$12 million in 2014. As of September 30, 2012, MGE had incurred \$35.1 million (excluding carrying costs) in construction expenditures at Columbia related to the project and had accrued \$7.2 million in incurred, but unpaid capital expenditures. MGE has recognized \$0.7 million (after tax) in AFUDC equity related to this project for the nine months ended September 30, 2012.

Credit Ratings

MGE Energy's and MGE's access to the capital markets, including, in the case of MGE, the commercial paper market, and their respective financing costs in those markets, may depend on the credit ratings of the entity that is accessing the capital markets.

None of MGE Energy's or MGE's borrowing is subject to default or prepayment as a result of a downgrading of credit ratings, although a downgrading of MGE's credit ratings could increase fees and interest charges under both MGE Energy's and MGE's credit agreements.

Pension Plan Funding Stabilization

On July 6, 2012, the Moving Ahead for Progress in the 21st Century Act (MAP-21) was signed and became law. The provisions in MAP-21 provide pension plan funding relief through interest rate stabilization and will increase Pension Benefit Guaranty Corporation premiums payable with respect to plans. MGE does not believe the law will have a significant impact on its pension funding policy.

Environmental Matters

The following discussion is limited to updates or developments in environmental matters that occurred during the nine months ended September 30, 2012. Further discussion of environmental matters is included in MGE Energy's and MGE's 2011 Annual Report on Form 10-K and Footnote 8.a. of Notes to Consolidated Financial Statements in this Report.

Global climate change

MGE is a producer of GHG emissions, primarily from the fossil fuel generating facilities it utilizes to meet customers' energy needs, as well as from its natural gas pipeline system and fleet vehicles. Climate change and the regulatory response to it could significantly affect our operations in a number of ways, including increased operating costs and capital expenditures, restrictions on energy supply options, permitting difficulties and more stringent emission limits. MGE management would expect to seek and receive rate recovery of such compliance costs, if and when required. MGE will continue to monitor proposed climate change legislation and regulation. MGE is currently complying with applicable greenhouse gas regulations and is actively monitoring current proposed and other potential greenhouse gas regulations from the EPA.

GHG New Source Performance Standards for Electric Generating Units (EGU GHG NSPS)

On March 27, 2012, the EPA proposed greenhouse gas (GHG) New Source Performance Standards (NSPS) for coal fired and natural gas combined cycle (NGCC) electric generation units (EGUs). The proposal applies to new EGUs only; the EPA has stated that it does not intend for these rules to apply to modified or existing units at this time. The proposed NSPS may be finalized within 2012 and is not anticipated to significantly affect MGE's existing generation units.

Vacation of EPA's Cross State Air Pollution Rule (CSAPR) and Reinstatement of the Clean Air Interstate Rule (CAIR)

EPA has so far promulgated three interstate air pollution rules [the NO_x SIP Call, the Clean Air Interstate Rule (CAIR) and the Cross-State Air Pollution Rule (CSAPR)] which were each designed to reduce nitrogen oxide (NO_x) and/or sulphur dioxide (SO₂) air emissions from electric generating units (EGUs) located in Wisconsin and other states. NO_x and SO₂ interact in the atmosphere to form ambient ozone and fine particulate matter pollution. As explained below, only the CAIR currently affects MGE's generation assets.

In 2000, the U.S. Court of Appeals for the D.C. Circuit held that Wisconsin had been illegally included in a portion of the NO_x SIP Call, but stayed the remaining legal challenges to the rule pending EPA's development of additional interstate transport rules. At this time, the requirements of the NO_x SIP Call and the costs of compliance remain uncertain.

In 2005, EPA promulgated the CAIR imposing additional controls on NO_x and SO₂ emissions from EGUs located in Wisconsin and other states. However, in December 2008, the U.S. Court of Appeals for the D.C. Circuit remanded the CAIR to the EPA with directions to revise or replace the rule. The Court's remand order directed that the CAIR remain in effect until the EPA promulgated a replacement rule. The Court's order did not include a deadline for the EPA to act.

In August 2011, the EPA responded to the remand of the CAIR by promulgating the CSAPR. However, in August, 2012, the U.S. Court of Appeals for the D.C. Circuit vacated CSAPR and instructed the EPA to continue administering the CAIR pending finalizing a valid replacement rule. The EPA has petitioned the U.S. Court of Appeals for the D.C. Circuit to reconsider its decision *en banc*. At this time, the CAIR remains currently effective.

Our evaluation of the CAIR demonstrates that MGE will be in compliance with the CAIR's Phase I requirements without capital expenditures or modifications to our operations. We have also evaluated our potential expenditures if the CAIR remains in place for the Phase II reductions. New SO₂ controls at Columbia are already underway and are planned to be completed by mid to late 2014 (see the discussion regarding the Columbia Environmental Project below). Once the new environmental control project is completed at Columbia, it is expected that the plant will emit below anticipated Phase II CAIR allocation levels. MGE expects that any costs incurred to meet Phase II of the CAIR will be fully recoverable through rates.

See Footnote 8.a for additional discussion regarding CSAPR and the CAIR.

Other Matters

PJM Resettlement

MGE is a member of PJM. PJM, an RTO, is a neutral and independent party that coordinates and directs the operation of the transmission grid within its area of coverage, administers a competitive wholesale electricity market and plans regional transmission expansion improvements to maintain grid reliability and relieve congestion. In 2009, PJM determined certain market participants, including MGE, were not eligible to receive transmission loss credits. In September 2009, MGE paid PJM \$1.2 million at that time as part of this resettlement.

In July 2011, FERC reversed the 2009 decision and determined PJM should refund certain amounts back to market participants, including MGE. In May 2012, FERC denied rehearing requests by financial marketers and ordered the resettlement. In July 2012, MGE received a \$1.2 million refund from PJM related to the resettlement, which was credited to purchased power.

There continues to be an open rehearing request at FERC and a petition at the U.S. Court of Appeals. There is potential that MGE would have to pay back the refund received from PJM.

Ratification of Union Agreements

MGE has employees who are covered by a collective bargaining agreement with Local Union 2304 of the International Brotherhood of Electric Workers and also has employees who are covered by a collective bargaining agreement with Local Union No. 39 of the Office and Professional Employees International Union. Both of these collective bargaining agreements expired on April 30, 2012. On May 31, 2012, both unions ratified their respective labor agreements, which will be in effect from May 1, 2012, until April 30, 2015.

New Accounting Principles

See Footnote 12 for discussion of new accounting pronouncements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

MGE Energy and MGE are potentially exposed to market risk associated with interest rates, commodity prices, and equity returns. MGE currently has no exposure to foreign currency risk. MGE manages some risk exposure through risk management policies and the use of derivative instruments. MGE's risk management policy prohibits speculative trading transactions.

Commodity Price Risk

MGE has commodity price risk exposure with respect to the price of natural gas, electricity, coal, emission credits, and oil. MGE employs established policies and procedures to reduce the market risks associated with changing commodity prices. MGE's commodity risks are somewhat mitigated by the current ratemaking process in place for recovering electric fuel cost, purchased energy costs, and the cost of natural gas. MGE's electric fuel costs are subject to fuel rules established by the PSCW.

MGE's electric operations burn natural gas in several of its peaking power plants and, in many cases, the cost of purchased power is tied to the cost of natural gas. MGE bears regulatory risk for the recovery of such fuel and purchased power costs when they are higher than the base rate established in its current rate structure.

The PSCW approved new fuel rules that became effective January 1, 2011. The new rules require the PSCW and Wisconsin utilities to defer electric fuel-related costs that fall outside a symmetrical cost tolerance band around the amount approved for a utility in its most recent rate proceeding. Any over/under recovery of the actual costs is determined on an annual basis and will be adjusted in future billings to electric retail customers. Under the electric fuel rules, MGE is required to defer the benefit of lower costs if the actual fuel rules costs fall outside the lower end of the range and would defer costs, less any excess revenues, if the actual fuel rules costs exceeded the upper end of the range. Excess revenues are defined as revenues in the year in question that provide MGE with a greater return on common equity than authorized by the PSCW in MGE's latest rate order. The range is defined by the PSCW and has been modified throughout the years based on market conditions and other relevant factors. Currently, MGE is subject to a plus or minus 2% range. MGE assumes the risks and benefits of variances that are within the cost tolerance band. For 2012, fuel and purchased power costs included in MGE's base fuel rates are \$100.7 million. See Footnote 10.b. for additional information.

MGE's gas segment is governed by the purchased gas adjustment clause (PGA). Under the PGA, MGE is able to pass through to customers the cost of gas.

MGE also reduces price risk caused by market fluctuations via physical contracts and financial derivative contracts, including futures, swaps, options, forwards, and other contractual commitments. The maximum length of time over

which cash flows related to energy commodities can be hedged under applicable PSCW approvals is four years.

MGE has financial gas and electric commodity contracts to hedge commodity price risk in the gas and electric segments. These contracts are primarily comprised of exchange-traded option and future contracts. MGE also holds FTRs, which are used to hedge the risk of increased transmission congestion charges. At September 30, 2012, the fair value of these instruments exceeded their cost basis by \$1.8 million. Under the PGA clause and electric fuel rules, MGE may include in the costs of fuel (natural gas or power) the costs and benefits of the aforementioned fuel price risk management tools. Because these costs/benefits are recoverable, the related unrealized loss/gain has been deferred on the balance sheet as a regulatory asset/liability.

MGE has also entered into a ten-year purchased power agreement that provides MGE with firm capacity and energy that began on June 1, 2012, and ends on May 31, 2022 (the "base term"). The agreement also allows MGE the option to extend the contract after the base term. The agreement is a derivative contract and is recognized at its fair value on the balance sheet. The fair value of the contract at September 30, 2012, reflects a loss position of \$77.1 million.

Interest Rate Risk

Both MGE Energy and MGE may have short term borrowings at varying interest rates. MGE issues commercial paper for its short-term borrowings, while MGE Energy draws from its current credit facility to meet its short-term borrowing needs. Borrowing levels vary from period to period depending upon capital investments and other factors. Future short-term interest expense and payments will reflect both future short-term interest rates and borrowing levels. MGE Energy and MGE manage interest rate risk by limiting their variable rate exposure and continually monitoring the effects of market changes on interest rates. MGE is not exposed to changes in interest rates on a substantial portion of its long-term debt until that debt matures and is refinanced at market rates.

Equity Price Risk - Pension-Related Assets

MGE currently funds its liabilities related to employee benefits through trust funds. These funds, which include investments in debt and equity securities, are managed by various investment managers. Changes in market value of these investments can have an impact on the future expenses related to these liabilities.

Credit Risk - Counterparty

Credit risk is the loss that may result from counterparty nonperformance. MGE is exposed to credit risk primarily through its merchant energy business. MGE uses credit policies to manage its credit risk, which include utilizing an established credit approval process, monitoring counterparty limits, employing credit mitigation measures such as collateral or prepayment arrangements, and using netting agreements.

Due to the possibility of extreme volatility in the prices of energy commodities and derivatives, the market value of contractual positions with individual counterparties could exceed established credit limits or collateral provided by those counterparties. If such a counterparty were then to fail to perform its obligations under its contract (for example, fail to deliver the electricity MGE originally contracted for), MGE could sustain a loss that could have a material impact on its financial results.

Additionally, if a counterparty were to default and MGE were to liquidate all contracts with that entity, MGE's credit loss would include the loss in value of mark-to-market contracts; the amount owed for settled transactions; and additional payments, if any, to settle unrealized losses on accrual contracts. As of September 30, 2012, no counterparties have defaulted.

MGE is obligated to provide service to all electric and gas customers within its respective franchised territories. MGE's franchised electric territory includes a 316 square-mile area in Dane County, Wisconsin, and MGE's franchised gas territory includes a service area covering 1,631 square miles in Wisconsin. Based on results for the year ended December 31, 2011, no one customer constituted more than 9% of total operating revenues for MGE Energy and MGE. Credit risk for electric and gas is managed by MGE's credit and collection policies, which are consistent with state regulatory requirements.

Cash, cash equivalents, and customer accounts receivable are the financial instruments that potentially subject MGE Energy and MGE to concentrations of credit risk. MGE Energy and MGE place their cash and cash equivalents with high credit-quality financial institutions. MGE has limited concentrations of credit risk from customer accounts receivable because of the large number of customers and relatively strong economy in its service territory.

Item 4. Controls and Procedures.

During the third quarter of 2012, each registrant's management, including the principal executive officer and principal financial officer, evaluated its disclosure controls and procedures related to the recording, processing, summarization, and reporting of information in its periodic reports that it files with the SEC. These disclosure controls and procedures have been designed to ensure that material information relating to that registrant, including its subsidiaries, is accumulated and made known to that registrant's management, including these officers, by other employees of that registrant and its subsidiaries as appropriate to allow timely decisions regarding required disclosure, and that this information is recorded, processed, summarized, evaluated, and reported, as applicable, within the time periods specified in the SEC's rules and forms. Due to the inherent limitations of control systems, not all misstatements may be detected. These inherent limitations include the realities that judgments in decision making can be faulty and breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. Also, the registrants do not control or manage certain of their unconsolidated entities and thus, their access and ability to apply their procedures to those entities is more limited than is the case for their consolidated subsidiaries.

As of September 30, 2012, each registrant's principal executive officer and principal financial officer concluded that its disclosure controls and procedures were effective. Each registrant intends to strive continually to improve its disclosure controls and procedures to enhance the quality of its financial reporting.

During the quarter ended September 30, 2012, there were no changes in either registrant's internal controls over financial reporting that materially affected, or are reasonably likely to affect materially, that registrant's internal control over financial reporting.

PART II. OTHER INFORMATION.

Item 1. Legal Proceedings.

MGE Energy and MGE

MGE Energy and its subsidiaries, including MGE, from time to time are involved in various legal proceedings that are handled and defended in the ordinary course of business.

See Footnote 8.a. and 8.d. for more information.

Item 1A. Risk Factors.

There were no material changes in the risk factors previously disclosed in Part I, Item 1A. of the 2011 Form 10-K, except as described below.

We face construction risk in connection with the completion of the Columbia environmental project.

The large-scale environmental project at the Columbia generating facility is subject to various risks that could cause costs to increase or delays in completion. These risks include shortages of, the inability to obtain, the cost of, and the consistency of, labor, materials and equipment; the inability of the general contractor or subcontractors to perform under their contracts; the inability to agree to terms of contracts or disputes in contract terms; work stoppages; adverse weather conditions; the inability to obtain necessary permits in a timely manner; changes in applicable laws or regulations; adverse interpretation or enforcement of permit conditions; governmental actions; legal action; and unforeseen engineering or technology issues. If the construction project is over budget, we may not be able to recover those excess costs. Inability to recover excess costs, or inability to complete the project in a timely manner, could adversely impact our financial condition and results of operations.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

Issuer Purchases of Equity Securities

Period	Total		Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs*	Maximum number (or Approximate Dollar Value) of Shares That May Yet Be Purchased Under the Plans or Programs*
	Number of Shares Purchased	Average Price Paid per Share		
July 1-31, 2012	31,350	\$ 48.19	-	-
August 1-31, 2012	23,315	49.50	-	-
September 1-30, 2012	70,648	52.37	-	-
Total	125,313	\$ 50.80	-	-

* Under the Stock Plan, common stock shares deliverable to plan participants may be either newly issued shares or shares purchased on the open market, as determined from time to time by MGE Energy. In June 2009, MGE Energy switched to using open market purchases to provide shares to meet obligations to participants in the Stock Plan. The shares are purchased on the open market through a securities broker-dealer and then are reissued under the Stock Plan as needed to meet share delivery requirements. The volume and timing of share repurchases in the open market depends upon the level of dividend reinvestment and optional share purchases being made from time to time by plan participants. As a result, there is no specified maximum number of shares to be repurchased and no specified termination date for the repurchases. All shares issued through the Stock Plan, whether newly issued or reissued following open market purchases, are issued and sold pursuant to a registration statement that was filed with the SEC and is currently effective.

Item 4. Mine Safety Disclosures.

Not applicable to MGE Energy and MGE.

Item 6. Exhibits.

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Statement regarding computation of ratio of earnings to fixed charges for Madison Gas and Electric Company.

Certifications Pursuant to Rule 13a-14(a) and 15d-14(a) of the Securities and Exchange Act of 1934 as to the Quarterly Report on Form 10-Q for the quarter ended September 30, 2012, filed by the following officers for the following companies:

31.1

Filed by Gary J. Wolter for MGE Energy, Inc.

31.2

Filed by Jeffrey C. Newman for MGE Energy, Inc.

31.3

Filed by Gary J. Wolter for Madison Gas and Electric Company

31.4

Filed by Jeffrey C. Newman for Madison Gas and Electric Company

Certifications Pursuant to Section 1350 of Chapter 63 of Title 18 United States Code (Sarbanes-Oxley Act of 2002) as to the Quarterly Report on Form 10-Q for the quarter ended September 30, 2012, filed by the following officers for the following companies:

32.1

Filed by Gary J. Wolter for MGE Energy, Inc.

32.2

Filed by Jeffrey C. Newman for MGE Energy, Inc.

32.3

Filed by Gary J. Wolter for Madison Gas and Electric Company

32.4

Filed by Jeffrey C. Newman for Madison Gas and Electric Company

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Interactive Data Files:

101.INS

XBRL Instance

101.SCH

XBRL Taxonomy Extension Schema

101.CAL

XBRL Taxonomy Extension Calculation

101.DEF

XBRL Taxonomy Extension Definition

101.LAB

XBRL Taxonomy Extension Labels

101.PRE

XBRL Taxonomy Extension Presentation

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Signatures - MGE Energy, Inc.

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

MGE ENERGY, INC.

Date: November 6, 2012 /s/ Gary J. Wolter
Gary J. Wolter

Chairman, President and Chief Executive Officer

(Duly Authorized Officer)

Date: November 6, 2012 /s/ Jeffrey C. Newman
Jeffrey C. Newman

Vice President, Chief Financial Officer, Secretary and Treasurer

(Chief Financial and Accounting Officer)

Signatures - Madison Gas and Electric Company

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

MADISON GAS AND ELECTRIC COMPANY

Date: November 6, 2012 /s/ Gary J. Wolter
Gary J. Wolter

Chairman, President and Chief Executive Officer

(Duly Authorized Officer)

Date: November 6, 2012 /s/ Jeffrey C. Newman
Jeffrey C. Newman

Vice President, Chief Financial Officer, Secretary and Treasurer

(Chief Financial and Accounting Officer)