

Corporate and Other

	Years Ended December 31,		
	2005	2004 (In thousands)	2003
Operating revenues	\$ 16,379	\$ 17,152	\$ 17,220
Operating expenses	14,839	24,427	15,745
Operating income (loss)	\$ 1,540	\$ (7,275)	\$ 1,475

The amounts in the above table include intercompany transactions.

Operating Revenues. The Company's businesses that are part of Corporate and Other, reported operating revenues of \$16.4 million for 2005 and \$17.2 million for both 2004 and 2003. The \$0.8 million decrease for 2005 when compared to 2004 was due primarily to a decrease in IT service revenues. IT revenues have decreased because the Company generally has not been renewing contracts with non-affiliated customers due to ongoing efforts to focus the IT operations primarily on the Company's IT needs. This includes in 2006, the expected implementation of a new Customer Information System and related system changes and upgrades.

Operating Income. Corporate and Other reported operating income of \$1.5 million for 2005, compared to an operating loss of \$7.3 million for 2004 and operating income of \$1.5 million for 2003. The 2005 results improved when compared to the 2004 results due in large part to \$8.4 million in costs associated with the termination of the sale of the Company's APC subsidiary included in the 2004 results. Also contributing to the improved results for 2005 were decreases in depreciation, IT and other miscellaneous expenses. The primary cause of the decrease in 2004, when compared to 2003, was the \$8.4 million in costs associated with the termination of the sale of the Company's APC subsidiary. The remainder of the decrease for 2004, when compared to 2003, was due primarily to goodwill and fixed asset impairment charges of \$0.4 million at the Company's IT operations and an increase in corporate consulting and professional fees, partially offset by a \$0.3 million decrease in depreciation.

Other Income and Deductions

	Years Ended December 31,		
	2005	2004 (In thousands)	2003
Interest expense	\$ (43,058)	\$ (44,293)	\$ (39,685)
Debt exchange and extinguishment costs	(1,456)	—	(24,030)
Other income	2,768	2,497	2,154
Total other income (deductions)	\$ (41,746)	\$ (41,796)	\$ (61,561)

Interest Expense. Interest expense decreased by \$1.2 million in 2005, when compared to 2004, and increased by \$4.6 million in 2004, when compared to 2003. The 2005 decrease was primarily due to lower levels of long-term debt as a result of the redemption of \$29.9 million of the Company's senior notes in the second quarter of 2004 and the redemption of \$10.3 million and \$30.9 million of the Company's 10.25% Subordinated Notes in April 2005 and September 2005, respectively.

Contributing to the 2004 increase was the adoption during 2003 of SFAS 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity," and FASB Interpretation No. 46, "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51" ("FIN 46"). Dividends on Trust Preferred Securities issued by the Company's capital trusts and interest expense on the Company's debt held by the capital trusts incurred after July 1, 2003, has been reflected in interest expense as a result of adopting these accounting standards. These changes account for \$1.0 million of the increase in interest expense during 2004. For further information on SFAS 150 and other new accounting standards that affect the Trust Preferred Securities, refer to Note 4 of the Notes to the Consolidated Financial Statements in Item 8 of this Form 10-K. The remainder of the increase in interest expense for 2004 when compared to 2003 was

primarily due to higher levels of long-term debt, an increase in financing fees related to the Company's short-term bank credit facility and an increase in amortization of debt issuance costs due to the issuance of additional long-term debt in 2003, partially offset by lower levels of short-term bank borrowings. A larger portion of the Company's outstanding debt during all of 2004 and half of 2003 was long-term debt, which had a higher rate of interest than the Company's short-term debt.

Refer to Note 4 of the Notes to the Consolidated Financial Statements in Item 8 of this Form 10-K for information regarding the issuance and retirement of debt and Trust Preferred Securities during the past three years.

Debt Exchange and Extinguishment Costs. During 2005, in association with the Company redemption, at par, of certain of its long-term debt, the Company incurred a \$1.5 million non-cash debt extinguishment charge in its Consolidated Statements of Operations. The \$1.5 million charge represented the write-off of the unamortized debt issuance costs related to the debt. For 2003, the Company's Consolidated Statements of Operations reflect \$24 million of debt exchange and extinguishment costs. In May 2003, the Company completed a refinancing of certain of its long-term debt through the issuance of new senior unsecured notes and the exchange and repurchase of existing notes. In connection with the repurchase of existing notes, the Company paid approximately \$24 million for make-whole premiums or similar items. For further information regarding the 2005 redemption and the 2003 refinancing, refer to Note 4 of the Notes to the Consolidated Financial Statements in Item 8 of this Form 10-K.

Other Income. The \$0.3 million increase in other income for 2005, when compared to 2004, was primarily due to higher interest income (including allowance for funds used during construction ("AFUDC")), partially offset by a decrease in equity earnings from the Company's investment in ERGSS. The \$0.3 million increase in other income for 2004, when compared to 2003, was primarily due to higher equity earnings from the Company's investment in ERGSS and an increase in AFUDC.

Income Taxes

The change in income taxes, when comparing one year to another, is due primarily to changes in income before income taxes and minority interest. However, in 2004, the Company made a change in estimate of its prior years state income taxes, which resulted in an additional income tax benefit of approximately \$2.2 million. Refer to Note 3 of the Notes to the Consolidated Financial Statements in Item 8 of this Form 10-K for information on current and deferred income tax expense, deferred tax assets and liabilities, and recent net operating losses for tax purposes.

Minority Interest — Dividends on Company-Obligated Mandatorily Redeemable Trust Preferred Securities of Subsidiaries Holding Solely Debt Securities of Semco Energy, Inc., Net of Income Tax Benefit

As discussed in the "Interest Expense" section, dividends on trust preferred securities incurred after July 1, 2003, were reflected in interest expense rather than in minority interest. This change accounts for the decrease in dividends on trust preferred securities in 2004, when compared to 2003. In addition, the retirement of approximately \$101 million of trust preferred securities in August 2003 also contributed to the decrease in dividends on trust preferred securities. For further information on the retirement of the trust preferred securities, see Note 4 of the Notes to the Consolidated Financial Statements in Item 8 of this Form 10-K.

Discontinued Operations

Substantially all the operating assets of the Company's construction services business were sold in September 2004. The Company has accounted for this business as a discontinued operation and, accordingly, the operating results and the loss on the disposal of this business are segregated and reported as discontinued operations in the Consolidated Statements of Operations. During 2005, the Company recorded additional income related to its discontinued construction services business as a result of a settlement of litigation. For additional information, including a component breakdown of operating results reflected in discontinued operations, refer to Note 14 of the Notes to the Consolidated Financial Statements in Item 8 of this Form 10-K.

Dividends and Repurchase Premium on Convertible Preference Stock

The Company issued CPS in the first and second quarters of 2004. These securities and the paid-in-kind, non-cash dividends on them are described in Note 4 of the Notes to the Consolidated Financial Statements. These securities were redeemed in March 2005. Dividend expense for the CPS amounted to \$0.9 million and \$3.2 million for the years ending December 31, 2005, and 2004, respectively. The Company's Consolidated Statements of Operations for 2005 also included an \$8.2 million premium associated with the repurchase of the CPS in March 2005.

Dividends on Convertible Cumulative Preferred Stock

The Company issued the Preferred Stock in the first quarter of 2005. The Preferred Stock and the cash dividends on the Preferred Stock are described in Note 4 of the Notes to the Consolidated Financial Statements. Dividend expense for the Preferred Stock amounted to \$3.0 million for the year ended December 31, 2005.

Liquidity and Capital Resources

Cash Flows Used For Investing. The Company's Gas Distribution Business is capital intensive and a substantial amount of cash is spent annually on investments in property, plant and equipment. The following table identifies capital investments for the past three years:

	Years Ended December 31,		
	2005	2004	2003
		(In thousands)	
Capital investments			
Property additions — gas distribution	\$ 38,739	\$ 37,924	\$ 28,323
Property additions — corporate and other	1,417	988	1,843
Business acquisition, net of cash acquired	3,076	—	—
	<u>\$ 43,232</u>	<u>\$ 38,912</u>	<u>\$ 30,166</u>

Property additions for the Gas Distribution Business increased \$0.8 million during 2005, when compared to 2004. Property additions for the Gas Distribution Business increased \$9.6 million during 2004, when compared to 2003. The primary reason for the increase in property additions in 2005 and 2004, when compared to 2003, was a higher amount of spending on computer systems and other special projects.

Property additions for Corporate and Other increased \$0.4 million during 2005, when compared to 2004. The increase was primarily due to leasehold improvement costs incurred for the Company's leased office facilities. Property additions for Corporate and Other decreased \$0.9 million during 2004, when compared to 2003. The primary reason for the decrease was the sale of the Company's construction services business.

In addition, the Company acquired substantially all of the assets and certain liabilities of Peninsular Gas on June 1, 2005. The Company paid approximately \$2.8 million, net of cash acquired, for this acquisition in the second quarter of 2005 and an additional \$0.3 million in the third quarter of 2005. For further information, refer to Note 14 of the Notes to the Consolidated Financial Statements in Item 8 of this Form 10-K.

In 2006, the Company plans to spend approximately \$42 million on property additions. The Company may also, as part of the execution of its strategic plan, make acquisitions of, or investments in, other businesses.

Cash Flows Provided by Operations. The Company's net cash provided by (used for) operating activities totaled \$28.8 million in 2005, \$40.2 million in 2004 and \$(12.5) million in 2003. The change in operating cash flows is influenced by changes in the level and cost of gas in underground storage, changes in accounts receivable and accounts payable and other working capital changes. The changes in these accounts are largely the result of the timing of cash receipts and payments. The change in cash provided by operating activities is also impacted by changes in the operating results of the Company's businesses.

The Company's largest use of cash is for the purchase of natural gas for its customers. Generally, gas is injected into storage during the months of April through October and withdrawn for sale from November through March. In prior years, the Company also used significant amounts of short-term borrowings to finance natural gas purchases for storage during the non-heating season. However, in 2003, the Company reduced its dependence on short-term borrowings for its seasonal storage gas purchases by utilizing part of the proceeds from the issuance of additional long-term debt to pay down its short-term credit facility. An increase in the price of natural gas during the last half of 2005 required the Company to again utilize significant amounts of short-term borrowings for its natural gas purchases.

The Company's credit ratings were lowered over the past few years by both Moody's Investors Service and Standard & Poor's. As a result of these events and other circumstances, the interstate pipelines the Company utilizes require prepayment for their services. In addition, certain of the Company's gas suppliers may require the Company to prepay or provide letters of credit for gas purchases over and above the levels of credit they may have extended the Company. These prepayment requirements shortened the Company's accounts payable cycle during 2003. The improvement in cash flows from operating activities in 2004 was due primarily to the easing of these credit restrictions put in place during 2003 by certain of the gas suppliers utilized by the Company. This lengthened the Company's accounts payable cycle in 2004 when compared to 2003. The other primary factor contributing to the increase in operating cash flows in 2004 was a smaller increase in the price of gas during 2004 when compared to 2003.

The decrease in cash flows from operating activities during 2005 was due primarily to a substantial increase in the market price of natural gas purchased in the last half of 2005. As a result, the cost of the Company's gas in underground storage at December 31, 2005, was approximately \$29 million higher than it was at December 31, 2004. The higher cost of gas was also reflected in customer rates, which caused a significant increase in accounts receivable from December 31, 2004, to December 31, 2005. The impact of higher gas prices on operating cash flow was partially offset by more favorable credit terms the Company obtained from various gas suppliers during 2005. For additional information concerning the recent increases in natural gas prices, refer to the discussion in Management's Discussion and Analysis, under the caption "The Impact of Higher Natural Gas Prices".

Cash Flows Provided by Financing. The Company's net cash provided by (used for) financing activities totaled \$15.8 million, \$(28.5) million and \$40.9 million in 2005, 2004 and 2003, respectively.

	Years Ended December 31,		
	2005	2004	2003
		(In thousands)	
Cash provided by (used for) financing activities			
Issuance of common stock and common stock warrants, net of expenses	\$ 29,918	\$ 2,500	\$ 3,329
Issuance of convertible cumulative preferred stock, net of expenses	66,302	—	—
Issuance of convertible preference stock, net of expenses	—	45,590	—
Repurchase of convertible preference stock and common stock warrants	(60,000)	—	—
Issuance (repayment) of notes payable and payment of related expenses	38,983	(43,074)	(39,800)
Issuance of long-term debt, net of redemptions	(56,364)	(30,132)	109,622
Debt exchange and extinguishment costs	—	—	(24,030)
Payment of dividends on convertible cumulative preferred stock	(2,333)	—	—
Payment of dividends on common stock	—	(4,221)	(8,235)
Change in book overdrafts included in current liabilities	(690)	883	—
	<u>\$ 15,816</u>	<u>\$ (28,454)</u>	<u>\$ 40,886</u>

During 2004, the Company issued, through a private placement to K-1, \$50 million of CPS and Warrants to purchase 905,565 shares of the Company's Common Stock. The net proceeds (proceeds less issuance costs) from the issuance amounted to approximately \$46.3 million and were used to pay down short-term debt and invest temporarily in cash equivalents. In June 2004, a portion of the proceeds invested temporarily in cash equivalents was used to redeem all \$29.9 million of its outstanding 8% Senior Notes Due 2010 at par. The Company paid stock dividends on the CPS of 1,766 additional shares of CPS during 2004. For further information, refer to Note 4 of the Notes to the Consolidated Financial Statements.

During the first quarter of 2005, the Company repurchased all of the CPS (52,543 shares) and Warrants (905,565 Warrants) held by K-1. The aggregate purchase price for the CPS and Warrants was \$60 million. During the first quarter of 2005, the Company also completed the sale of 350,000 shares of Preferred Stock. The gross proceeds from this offering were approximately \$70 million, of which \$60 million was used to fund the repurchase of CPS and Warrants from K-1. The remaining proceeds were used to redeem \$10.3 million principal amount of the Company's 10.25% Subordinated Notes held by SEMCO Capital Trust I. The Trust, in turn, used the proceeds to redeem 400,000 Trust Preferred Securities and 12,371 common securities on April 29, 2005.

During the third quarter of 2005, the Company completed an offering of 4,945,000 shares of Common Stock. The proceeds from this offering were used to redeem the remaining \$30.9 million of the 10.25% Subordinated Notes held by the Trust. The Trust, in turn, used the proceeds from the redemption of the 10.25% Subordinated Notes to redeem the remaining 1.2 million Trust Preferred Securities and 37,114 common securities on September 14, 2005.

For further information regarding these transactions, refer to Note 4 of the Notes to the Consolidated Financial Statements in Item 8 of this Form 10-K.

In December of 2003, the Company issued an aggregate of \$50 million of senior unsecured notes with a premium of \$2.1 million. The proceeds from this issuance were used to repay indebtedness under the Company's then-existing bank credit facility.

In May of 2003, the Company completed an offering of an aggregate of \$300 million of senior unsecured notes. The Company used approximately \$92.3 million of the new notes in an exchange for other outstanding debt of the Company. For further information regarding the use of the remaining proceeds from the \$300 million offering, which included the retirement of other debt of the Company and payment of debt extinguishment costs, see Note 4 of the Notes to the Consolidated Financial Statements in Item 8 of this Form 10-K.

In June 2004, the Company suspended the quarterly cash dividend on the Company's Common Stock, with the objective of supplementing free cash flow. In addition, the decision reflects the Company's desire to retain cash in order to strengthen its balance sheet, enhance financial flexibility and to be better positioned to grow the Company's Gas Distribution Business in the future. Cash dividends paid per share for common shareholders were \$0.15, and \$0.40 in 2004, and 2003, respectively.

Non-Cash Financing Activities. For information regarding non-cash financing activities, refer to the caption "Statements of Cash Flows" in Note 1 of the Notes to the Consolidated Financial Statements in Item 8 of this Form 10-K.

Pension Plans and Other Post Retirement Benefits. The Company has defined-benefit pension plans ("Pension Plans") that cover approximately 99% of the Company's employees. During 2005, the Company contributed \$5.7 million to the Pension Plans. The Company anticipates that the annual contribution to the Pension Plans in 2006 will be approximately \$5.4 million. The funding of such contributions will come from amounts collected in Gas Distribution Business rates or through short-term borrowings.

The Company provides certain medical and prescription drug benefits to approximately 300 eligible retired employees and their surviving spouses under postretirement benefit plans ("Postretirement Plans"). During 2005, the Company paid approximately \$1.7 million to cover the costs of the Postretirement Plans out of its corporate assets. The Company anticipates that the annual payments to cover the costs of the

Postretirement Plans in 2006 will be approximately \$1.7 million and will be paid out of corporate assets or its funded postretirement benefit plans.

Future Financing. In general, the Company funds its capital expenditure program and dividend payments with operating cash flows and the utilization of its Bank Credit Agreement. When appropriate, the Company will refinance its short-term debt with long-term debt, Common Stock issuances or other long-term financing instruments. The Company is currently evaluating the refinancing potential for one of its debt obligations. Approximately \$59.6 million of 8% senior notes that are due June 30, 2016 ("8% Senior Notes") will become callable at par on June 30, 2006. The Company is considering the merits of the redemption at par of the 8% Senior Notes on or after the first call date as well as the issuance of a similar amount and similar term debt instrument. Any previously incurred debt issuance costs that have not been amortized up to the date of redemption would be expensed at the time of the redemption. At December 31, 2005, the unamortized debt issuance costs related to the 8% Senior Notes amounted to \$1.1 million.

The Company's capital structure at December 31, 2005, consisted of approximately 66.7% total debt (including current maturities and notes payable), 8.5% preferred stock and 24.8% common equity. The Company continues to assess its overall liquidity and capital structure, with a view to migrating over time to a capital structure which is consistent with that of an investment grade company. One of the Company's primary goals is to increase equity as a percentage of total capital while reducing the Company's overall debt to total capital ratio. Although there are no current specific plans to issue equity or reduce long-term debt in 2006, the Company will continue to look for and, as appropriate, take advantage of market opportunities to do so as they arise.

On June 14, 2005, a universal shelf registration statement on Form S-3 ("June 2005 Registration Statement") filed by the Company with the SEC became effective. The Company registered an aggregate of \$150 million of various securities under the June 2005 Registration Statement. Subsequent to the effectiveness of the June 2005 Registration Statement, the Company completed a Common Stock offering of \$31.3 million, leaving \$118.7 million of securities available for possible future issuances of Common Stock, preferred stock, trust preferred securities and long-term debt. At the present time, the Company does not meet the requirements under its indentures to issue additional senior notes but the Company is permitted to refinance maturing debt. Long-term debt of the Company scheduled to mature during the next five years includes \$150 million of 7.125% notes due in 2008, \$5 million of 6.40% notes due in 2008 and \$30 million of 6.49% notes due in 2009.

In September 2005, the Company entered into the Bank Credit Agreement for \$120 million, which expires on September 15, 2008. The Bank Credit Agreement amends and restates the Company's previous short-term bank credit facility, which consisted of a \$60 million multi-year revolving facility and a \$40.8 million 364-day facility, both of which were due to expire on September 23, 2005. Interest under the terms of the Bank Credit Agreement is at variable rates, which are based on LIBOR or prime lending rates, plus applicable margins. At December 31, 2005, the Company was utilizing \$95.7 million of the borrowing capacity available under the Bank Credit Agreement, leaving approximately \$24.3 million of the borrowing capacity unused. The \$95.7 million of capacity being used consisted of \$16.8 million of outstanding letters of credit and \$78.9 million of outstanding borrowings. Refer to Note 5 of the Notes to the Consolidated Financial Statements in Part II, Item 8 of this Form 10-K for additional information regarding the Bank Credit Agreement, including a description of the covenants contained therein.

The Company's Gas Distribution Business is seasonal in nature. During the winter heating season, higher volumes of gas are sold, resulting in peak profitability during the fourth and first quarters of the year. The Company's cash flow and its corresponding use of its Bank Credit Agreement typically also follow a seasonal pattern. The Company uses funds available under the Bank Credit Agreement to finance, on a short-term basis, the variability and seasonality of its operating cash flow and working capital requirements. Typically, as the Company collects cash from winter heating sales in the latter part of the first quarter and the second quarter, it will pay down the borrowings under the Bank Credit Agreement. During the summer months, it will reduce its short-term borrowings under the Bank Credit Agreement, and possibly build up sufficient cash to enable it to enter into short-term investments. As gas is purchased throughout the summer and injected into

storage in preparation for the winter heating season and the Company completes its annual construction and capital expenditure program, the Company expects to incur borrowings under the Bank Credit Agreement. Such borrowings typically begin to occur prior to the end of the third quarter and intensify, such that the maximum short-term borrowings occur around the end of the year. This borrowing pattern is affected by numerous items including the credit terms under which the Company purchases natural gas for sale to customers and its GCR factors in various jurisdictions. As winter sales occur and gas sales revenues are billed and collected, the Company again begins to reduce its short-term borrowings in the first quarter. Refer to the discussion in Management's Discussion and Analysis, under the caption "The Impact of Higher Natural Gas Prices," for information regarding additional working capital requirements that have resulted from recent increases in the price of natural gas.

Business Development Initiatives. From time to time, in pursuing its growth strategy, the Company considers, among other things, acquisitions of or investments in local distribution, pipeline, and gas storage businesses and assets. These acquisitions and investments are typically considered pursuant to confidentiality agreements, which, among other things, allow the exchange of data subject to non-disclosure requirements (usually barring the disclosure or misuse of such data and requiring that the fact of discussions of a possible acquisition or investment be kept secret). The Company generally will not make any public announcement of such activities until definitive agreements with respect thereto have been signed.

Ratio of Earnings to Fixed Charges and Ratio of Earnings to Combined Fixed Charges and Preferred Stock Dividends. The Company's ratio of earnings to fixed charges, as defined under Item 503 of SEC regulation S-K, was 1.40 for 2005, 1.06 for 2004 and less than a one-to-one coverage for 2003. The amount of earnings that would be required to attain a ratio of one-to-one for 2003 was approximately \$8.0 million. The Company's ratio of earnings to combined fixed charges and preferred stock dividends, as defined under Item 503 of SEC regulation S-K was less than a one-to-one coverage for 2005, 2004 and 2003. The amount of earnings that would be required to attain a ratio of one-to-one for 2005, 2004 and 2003 was approximately \$0.9 million, \$3.4 million and \$8.0 million, respectively.

Off-Balance Sheet Arrangements. The Company does not have any off-balance sheet financing arrangements as defined in Item 303(a)(4) of Regulation S-K.

Guarantees. The Company has letters of credit that are required to be disclosed under the provisions of Financial Accounting Standards Board Interpretation No. 45, "Guarantors Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others." For information on these letters of credit, refer to Note 13 of the Notes to the Consolidated Financial Statements in Item 8 of this Form 10-K.

Contractual Obligations and Commercial Commitments. Summarized below are the contractual obligations and commercial commitments of the Company as of December 31, 2005:

Contractual Obligations	Payments Due by Period						2011 and Beyond
	Total	2006	2007	2008	2009	2010	
			(In millions)				
Long-term debt obligations	\$ 454.6	\$ —	\$ —	\$ 155.0	\$ 30.0	\$ —	\$ 269.6
Unconditional gas purchase and gas transportation obligations	228.9	168.7	26.6	19.4	11.6	2.6	—
Operating lease obligations	15.2	1.9	1.8	1.9	1.9	1.9	5.8
Total contractual obligations	\$ 698.7	\$ 170.6	\$ 28.4	\$ 176.3	\$ 43.5	\$ 4.5	\$ 275.4

Commercial Commitments	Amount of Commitment Expiration per Period						2011 and Beyond
	Total	2006	2007	2008	2009	2010	
Bank credit facility	\$ 120.0	\$ —	\$ —	\$ 120.0	\$ —	\$ —	\$ —

Other Commitments and Contingencies. For information about other commitments and contingencies, refer to Note 13 of the Notes to the Consolidated Financial Statements in Item 8 of this Form 10-K.

Market Risk Information

The Company's primary market risk arises from fluctuations in natural gas and propane prices and interest rates. The Company's exposure to commodity price risk arises from changes in natural gas and propane prices throughout the United States and in eastern Canada, where the Company conducts sales and purchase transactions. The Company does not currently use financial derivative instruments (such as swaps, collars or futures) to manage its exposure to commodity price risk. A significant portion of the natural gas requirements of the Company's Michigan gas distribution operations are covered under third-party supply arrangements and the GCR mechanism through which commodity costs are paid by customers. ENSTAR's natural gas requirements are primarily covered by a number of RCA-approved long-term supply arrangements and the GCR mechanism through which commodity costs are paid by customers. For further information on how these agreements and mechanisms reduce the Company's exposure to commodity price risk, see the caption "Cost of Gas, Gas Charges Recoverable from Customers, and Amounts Payable to Customers" in Note 1 of the Notes to the Consolidated Financial Statements in Item 8 of this Form 10-K.

The Company is also subject to interest rate risk in connection with the issuance of variable and fixed-rate debt. In order to maintain its desired mix of fixed-rate and variable-rate debt, the Company may use interest rate swap agreements and exchange fixed and variable-rate interest payment obligations over the life of the agreements, without exchange of the underlying principal amounts. See Note 7 of the Notes to the Consolidated Financial Statements in Item 8 of this Form 10-K for additional information on interest rate swap agreements and how the Company accounts for its risk management activities.

For information regarding the fair value of the Company's financial instruments, refer to Note 6 of the Notes to the Consolidated Financial Statements in Item 8 of this Form 10-K. The following table provides information about the Company's financial instruments that are sensitive to interest rate changes as of December 31, 2005:

As of December 31, 2005	Principal Payments by Expected Maturity Date and Interest Rate Detail						Total
	2006	2007	2008	2009	2010	2011 and Beyond	
	(In millions, except percentages)						
Long-term debt							
Fixed rate	\$ —	\$ —	\$ 155.0	\$ 30.0	\$ —	\$ 269.6	\$ 454.6
Average interest rate	—	—	7.10%	6.49%	—	7.78%	7.46%
Bank Credit facility							
Variable rate(a)	\$ 120.0	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 120.0
Average interest rate(b)	5.62%	—	—	—	—	—	5.62%

- (a) Amounts represent total credit available to the Company at December 31, 2005 rather than the actual amount outstanding at December 31, 2005.
- (b) The average interest rate reported for the variable rate bank credit facility is the average rate during the year ended December 31, 2005.

Impact of Inflation

The cost of gas purchased by the Gas Distribution Business for sale to customers is recovered from customers through GCR pricing mechanisms. The GCR pricing mechanisms allow for the adjustment of rates charged to customers to reflect, in the absence of cost disallowances, increases and decreases in the cost of gas purchased by the Company. See the caption "Cost of Gas, Gas Charges Recoverable from Customers, and Amounts Payable to Customers" in Note 1 of the Notes to the Consolidated Financial Statements in Item 8 of this Form 10-K for more information on these mechanisms. Increases and decreases in customer rates

under the GCR pricing mechanisms generally occur annually but can occur more frequently in certain circumstances and occur monthly in the service area regulated by the CCBC. The price of natural gas increased substantially during the last half of 2005. For information regarding the impact of higher natural gas prices on the Company, refer to the risk factors in Item 1A and the caption “The Impact of Higher Natural Gas Prices” in Item 7 of this Form 10-K.

Increases in other operating costs are recovered in MPSC-, CCBC- and RCA-approved rates, typically as a result of a base rate filing made by the Company. Recovering cost increases through this process may adversely affect the results of operations due to the time lag involved securing necessary rate approvals and the decisions made on the merits of the Company’s requests. The Company attempts to minimize the impact of inflation by controlling costs, increasing productivity and filing base rate cases on a timely basis.

Critical Accounting Policies

The Company has prepared its Consolidated Financial Statements in conformity with accounting principles generally accepted in the U.S. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from those estimates. In the event estimates or assumptions prove to be different from actual results, adjustments are made in subsequent periods to reflect more current information. The following is a summary of the Company’s most critical accounting policies, which are defined as those policies under which judgments or uncertainties could affect the application of those policies and materially different amounts could be reported under different conditions or using different assumptions. For a complete discussion of the Company’s significant accounting policies, refer to Note 1 of the Notes to the Consolidated Financial Statements in Item 8 of this Form 10-K.

Rate Regulation. The Gas Distribution Business is subject to regulation. The regulatory matters associated with gas distribution customers located in the City of Battle Creek, Michigan, and surrounding communities are subject to the jurisdiction of the CCBC. The MPSC has jurisdiction over the regulatory matters related to the Company’s remaining Michigan customers. Regulatory matters for gas distribution customers in Alaska and APC are subject to the jurisdiction of the RCA. These regulatory bodies have jurisdiction over, among other things, rates, accounting procedures, and standards of service.

The Gas Distribution Business has accounting policies, which conform to SFAS 71, “Accounting for the Effect of Certain Types of Regulation” and which are in accordance with the accounting requirements and ratemaking practices of the MPSC, CCBC and RCA. The application of these accounting policies allows the Company to defer expenses and income as regulatory assets and liabilities in the Consolidated Statements of Financial Position when it is probable that those expenses and income will be allowed in the rate-setting process in a period different from the period in which they would have been reflected in the Consolidated Statements of Operations by an unregulated business. These deferred regulatory assets and liabilities are then included in the Consolidated Statements of Operations in the periods in which the same amounts are reflected in rates. Management’s assessment of the probability of recovery or pass-through of regulatory assets and liabilities requires judgment and interpretation of laws and regulatory commission orders. If, for any reason, the Company ceases to meet the criteria for application of regulatory accounting treatment for all or part of its operations, the regulatory assets and liabilities related to those portions ceasing to meet such criteria would be eliminated from the Consolidated Statements of Financial Position and included in the Consolidated Statements of Operations for the period in which the discontinuance of regulatory accounting treatment occurs. Such amounts would be classified as extraordinary items.

Goodwill. The Company evaluates its goodwill for impairment in accordance with SFAS 142, “Goodwill and Other Intangible Assets.” SFAS 142 requires that the Company perform impairment tests on its goodwill balance annually or at any time when events occur that could impact the value of the Company’s business segments. The Company’s determination of whether an impairment has occurred is based on an estimate of discounted cash flows attributable to the Company’s reporting units that have goodwill, as compared to the carrying value of those reporting units’ net assets. The Company must make long-term

forecasts of future revenues, expenses and capital expenditures related to the reporting unit in order to make the estimate of discounted cash flows. These forecasts require assumptions about future demand, future market conditions, regulatory developments and other factors. Significant and unanticipated changes to these assumptions could require a provision for impairment in a future period. If an impairment test of goodwill shows that the carrying amount of the goodwill is in excess of the fair value, a corresponding impairment loss would be recorded in the Consolidated Statements of Operations.

The 2005 annual impairment tests were performed for the Company's business segments and indicated that there was no impairment of goodwill for any of its business segments. The 2004 annual impairment tests were performed for the Company's business segments and indicated that there was an impairment of goodwill at the Company's IT services business. The 2003 annual impairment tests were performed for the Company's business segments and indicated that there was an impairment of goodwill for the construction services business. For further information on these impairments, see Note 1 of the Notes to the Consolidated Financial Statements in Item 8 of this Form 10-K.

Pensions and Other Postretirement Benefits. The Company accounts for pension costs and other postretirement benefit costs in accordance with the SFAS 87, "Employers' Accounting for Pensions" and SFAS 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions," respectively. These statements require liabilities to be recorded in the Consolidated Statements of Financial Position at the present value of these future obligations to employees net of any plan assets. The calculation of these liabilities and associated expenses require the expertise of actuaries and are subject to many assumptions, including life expectancies, present value discount rates, expected long-term rate of return on plan assets, rate of compensation increase and anticipated health care costs. The discount rate used by the Company is determined by reference to the CitiGroup pension discount curve, other long-term corporate bond measures and the expected cash flows of the plans. The duration of the securities underlying those indexes reasonably matches the expected timing of anticipated future benefit payments. The expected long-term rate of return on plan assets is established based on the Company's expectations of asset returns for the investment mix in its plans (with some reliance on historical asset returns for the plans). The expected returns of various asset categories are blended to derive an appropriate long-term assumption.

Any change in these assumptions can significantly change the liability and associated expenses recognized in any given year. For example, a one percentage point increase in anticipated health care costs each year would increase the accumulated retiree medical obligation as of December 31, 2005, by \$5.7 million and the aggregate of the service and interest cost components of net periodic retiree medical costs for 2005, by \$0.4 million. For further sensitivity analyses, refer to Note 8 of the Notes to the Consolidated Financial Statements in Item 8 of this Form 10-K.

New Accounting Standards

In December 2004, the FASB issued SFAS 123-R (Revised 2004) — "Share-Based Payment." In March 2005, the FASB issued Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations. In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections" Refer to the "New Accounting Standards" section of Note 1 of the Notes to the Consolidated Financial Statements in Item 8 of this Form 10-K for information on these new accounting standards.

Item 7A. *Quantitative and Qualitative Disclosures About Market Risk*

For the information required pursuant to this item, refer to the section titled “Market Risk Information” in Item 7 of this Form 10-K.

Item 8. *Financial Statements and Supplementary Data*

This item includes the following information in the order shown:

Report of Independent Registered Public Accounting Firm

Consolidated Statements of Operations

Consolidated Statements of Financial Position

Consolidated Statements of Cash Flows

Consolidated Statements of Capitalization

Consolidated Statements of Changes in Common Shareholders’ Equity

Consolidated Statements of Comprehensive Income

Notes to the Consolidated Financial Statements

Financial Statement Schedule II — Consolidated Valuation and Qualifying Accounts

All other financial statement schedules are omitted because they are not applicable or the required information is shown in the Consolidated Financial Statements or Notes thereto.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of
SEMCO Energy, Inc.:

We have completed integrated audits of SEMCO Energy, Inc.'s 2005 and 2004 consolidated financial statements and of its internal control over financial reporting as of December 31, 2005, and an audit of its 2003 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated Financial Statements and Financial Statement Schedule

In our opinion, the consolidated statements of financial position and capitalization and the related consolidated statements of operations, changes in common shareholders' equity, comprehensive income and cash flows present fairly, in all material respects, the financial position of SEMCO Energy, Inc. and its subsidiaries at December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in Item 15(a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Internal Control over Financial Reporting

Also, in our opinion, management's assessment, included in Management's Report on Internal Control Over Financial Reporting appearing under Item 9A, that the Company maintained effective internal control over financial reporting as of December 31, 2005 based on *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control — Integrated Framework* issued by the COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that,

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in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP

Detroit, Michigan

March 8, 2006

CONSOLIDATED STATEMENTS OF OPERATIONS

	Years Ended December 31,		
	2005	2004	2003
	(In thousands, except per share amounts)		
Operating Revenues			
Gas sales	\$ 569,136	\$ 463,356	\$ 427,936
Gas transportation	29,142	29,071	27,737
Other	16,824	15,909	17,282
	<u>615,102</u>	<u>508,336</u>	<u>472,955</u>
Operating expenses			
Cost of gas sold	443,860	346,241	308,919
Operations and Maintenance	71,913	67,333	65,152
Depreciation and amortization	28,224	27,578	27,448
Property and other taxes	11,601	13,149	10,739
Expenses related to terminated sale of subsidiary	—	8,398	—
Goodwill impairment charge	—	152	—
	<u>555,598</u>	<u>462,851</u>	<u>412,258</u>
Operating income	<u>59,504</u>	<u>45,485</u>	<u>60,697</u>
Other income (deductions)			
Interest expense	(43,058)	(44,293)	(39,685)
Debt exchange and extinguishment costs	(1,456)	—	(24,030)
Other	2,768	2,497	2,154
	<u>(41,746)</u>	<u>(41,796)</u>	<u>(61,561)</u>
Income (loss) before income taxes and minority interest	17,758	3,689	(864)
Income tax (expense) benefit	(6,021)	467	80
Minority interest — dividends on company-obligated mandatorily redeemable trust preferred securities of subsidiaries holding solely debt securities of SEMCO Energy, Inc., net of income tax benefit of \$0, \$0 and \$2,316	—	—	(4,300)
Income (loss) from continuing operations	11,737	4,156	(5,084)
Discontinued operations			
Income (loss) from construction services operations, net of income tax (expense) benefit of \$(312), \$1,782 and \$7,362	538	(4,641)	(24,871)
Loss on divestiture of construction services operations, net of income tax benefit of \$0, \$1,722 and \$0	—	(4,698)	—
Net income (loss)	12,275	(5,183)	(29,955)
Dividends on convertible cumulative preferred stock	2,994	—	—
Dividends and repurchase premium on convertible preference stock	9,112	3,203	—
Net income (loss) available to common shareholders	<u>\$ 169</u>	<u>\$ (8,386)</u>	<u>\$ (29,955)</u>
Earnings per share — basic			
Income (loss) from continuing operations	\$ (0.01)	\$ 0.03	\$ (0.23)
Net income (loss) available to common shareholders	\$ 0.01	\$ (0.30)	\$ (1.34)
Earnings per share — diluted			
Income (loss) from continuing operations	\$ (0.01)	\$ 0.03	\$ (0.23)
Net income (loss) available to common shareholders	\$ 0.01	\$ (0.30)	\$ (1.34)
Dividends declared per share	\$ —	\$ 0.08	\$ 0.35
Average common shares outstanding — basic	30,408	28,263	22,297
Average common shares outstanding — diluted	30,408	28,296	22,297

The accompanying notes to the consolidated financial statements are an integral part of these statements.

CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

	December 31,	
	2005	2004
	(In thousands, except for number of shares and par value)	
Current Assets		
Cash and cash equivalents	\$ 4,124	\$ 2,118
Restricted cash	1,590	1,588
Receivables, less allowances of \$1,758 and \$2,247	64,584	36,327
Accrued revenue	71,615	54,285
Gas in underground storage, at average cost	93,065	63,980
Prepaid expenses	15,307	21,450
Deferred income taxes	5,345	341
Materials and supplies, at average cost	4,970	4,876
Regulatory asset — gas charges recoverable from customers	971	137
Other	1,114	1,266
	<u>262,685</u>	<u>186,368</u>
Property Plant and Equipment		
Gas distribution	735,052	697,079
Corporate and other	39,879	39,607
	<u>774,931</u>	<u>736,686</u>
Less accumulated depreciation	<u>197,543</u>	<u>177,012</u>
	<u>577,388</u>	<u>559,674</u>
Deferred Charges and Other Assets		
Goodwill	143,374	143,283
Regulatory assets	12,602	12,062
Unamortized debt expense	10,057	13,313
Other	10,449	11,498
	<u>176,482</u>	<u>180,156</u>
Total Assets	<u>\$ 1,016,555</u>	<u>\$ 926,198</u>
Current Liabilities		
Current maturities of long-term debt	\$ —	\$ 15,092
Notes payable	78,900	39,300
Accounts payable	64,557	29,254
Customer advance payments	22,043	19,818
Regulatory liability — amounts payable to customers	12,281	5,624
Pension and other postretirement costs	7,100	4,300
Accrued interest	4,616	4,508
Other	8,806	9,187
	<u>198,303</u>	<u>127,083</u>
Deferred Credits and Other Liabilities		
Regulatory liabilities	59,214	57,442
Deferred income taxes	30,715	20,758
Customer advances for construction	17,263	15,887
Pension and other postretirement costs	3,490	5,571
Other	5,385	1,631
	<u>116,067</u>	<u>101,289</u>
Commitments and Contingencies (See Note 13)		
Capitalization		
Long-term debt	441,659	483,335
Convertible cumulative preferred stock, \$1 par value, 500,000 shares authorized; 350,000 and 0 shares outstanding	66,526	—
Series B convertible preference stock, \$1 par value, 70,000 shares authorized; 0 and 51,766 shares outstanding	—	48,405
Common shareholders' equity	194,000	166,086
	<u>702,185</u>	<u>697,826</u>
Total Liabilities and Capitalization	<u>\$ 1,016,555</u>	<u>\$ 926,198</u>

The accompanying notes to the consolidated financial statements are an integral part of these statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years Ended December 31,		
	2005	2004 (In thousands)	2003
Cash flow provided by (used for) operating activities			
Net income (loss)	\$ 12,275	\$ (5,183)	\$ (29,955)
Adjustments to reconcile net income (loss) to net cash provided by (used for) operating activities:			
Depreciation and amortization	28,224	27,578	27,448
Depreciation and amortization in discontinued operations	—	443	7,832
Amortization of debt costs and debt basis adjustments included in interest expense	3,507	3,630	2,369
Accumulated deferred income taxes and amortization of investment tax credits	4,955	(3,658)	(10,848)
Non-cash impairment charges	—	152	20,474
Non-cash share-based compensation	756	187	56
Loss on divestiture of discontinued construction services business	—	6,420	—
Debt exchange and extinguishment costs	1,456	—	24,030
Changes in operating assets and liabilities and other, excluding the impact of business acquisitions and divestitures:			
Receivables, net	(27,764)	5,956	208
Accrued revenue	(17,054)	(10,514)	(4,456)
Prepaid expenses	6,143	1,320	679
Materials, supplies and gas in underground storage	(29,113)	(5,337)	(24,225)
Regulatory asset — gas charges recoverable from customers	(832)	6,124	(4,061)
Accounts payable	35,303	10,480	(15,282)
Customer advances and amounts payable to customers	10,257	3,643	4,561
Other	713	(1,016)	(11,375)
Net cash provided by (used for) operating activities	28,826	40,225	(12,545)
Cash flows provided by (used for) investing activities			
Property additions — gas distribution	(38,739)	(37,924)	(28,323)
Property additions — corporate and other	(1,417)	(988)	(1,843)
Business acquisition, net of cash acquired	(3,076)	—	—
Proceeds from divestiture of discontinued construction services business, net of related expenses	—	21,290	—
Proceeds from other property sales, net of retirement costs	(642)	(1,164)	1,683
Proceeds from early retirement of a note receivable	—	7,838	—
Proceeds from redemption of investment in unconsolidated subsidiary	1,240	—	—
Changes in restricted cash	(2)	(1,388)	1,012
Net cash used for investing activities	(42,636)	(12,336)	(27,471)
Cash flows provided by (used for) financing activities			
Issuance of common stock and common stock warrants, net of expenses	29,918	2,500	3,329
Issuance of convertible cumulative preferred stock, net of expenses	66,302	—	—
Issuance of convertible preference stock, net of expenses	—	45,590	—
Repurchase of convertible preference stock and common stock warrants	(60,000)	—	—
Issuance (repayment) of notes payable and payment of related expenses	38,983	(43,074)	(39,800)
Issuance of long-term debt, net of expenses	—	(167)	247,931
Repayment of long-term debt	(56,364)	(29,965)	(138,309)
Debt exchange and extinguishment costs	—	—	(24,030)
Payment of dividends on convertible cumulative preferred stock	(2,333)	—	—
Payment of dividends on common stock	—	(4,221)	(8,235)
Change in book overdrafts included in current liabilities	(690)	883	—
Net cash provided by (used for) financing activities	15,816	(28,454)	40,886
Cash and cash equivalents			
Net increase (decrease)	2,006	(565)	870
Beginning of period	2,118	2,683	1,813
End of period	\$ 4,124	\$ 2,118	\$ 2,683

The accompanying notes to the consolidated financial statements are an integral part of these statements.

CONSOLIDATED STATEMENTS OF CAPITALIZATION

	December 31,	
	2005	2004
	(In thousands, except for number of shares and par value)	
Long-term debt		
6.50% senior notes due 2005	\$ —	\$ 15,000
3.77% senior notes due 2005	—	92
6.40% senior notes due 2008	5,000	5,000
7.125% senior notes due 2008	148,268	149,455
6.49% senior notes due 2009	30,000	30,000
7.03% senior notes due 2013	10,000	10,000
7.75% senior notes due 2013	188,795	188,012
8.00% senior notes due 2016	59,596	59,631
10.25% subordinated notes due 2040	—	41,237
	<u>\$ 441,659</u>	<u>\$ 498,427</u>
Less: Current maturities of long-term debt	—	15,092
	<u>\$ 441,659</u>	<u>\$ 483,335</u>
Convertible cumulative preferred stock		
\$1 par value, 500,000 shares authorized; 350,000 and 0 shares outstanding	<u>\$ 66,526</u>	<u>\$ —</u>
Series B convertible preference stock		
\$1 par value, 70,000 shares authorized; 0 and 51,766 shares outstanding	<u>\$ —</u>	<u>\$ 48,405</u>
Common shareholders' equity		
Common stock, par value \$1 per share — 100,000,000 shares authorized; 33,704,025 and 28,396,538 shares outstanding	\$ 33,704	\$ 28,397
Capital surplus	241,944	217,073
Unearned compensation associated with restricted stock	(795)	—
Accumulated comprehensive income (loss)	(9,073)	(7,435)
Retained earnings (deficit)	<u>(71,780)</u>	<u>(71,949)</u>
	<u>\$ 194,000</u>	<u>\$ 166,086</u>
Total capitalization	<u>\$ 702,185</u>	<u>\$ 697,826</u>

The accompanying notes to the consolidated financial statements are an integral part of these statements.

CONSOLIDATED STATEMENTS OF CHANGES IN COMMON SHAREHOLDERS' EQUITY

	Years Ended December 31,		
	2005	2004 (In thousands)	2003
Shares of common stock			
Beginning of year	28,397	28,059	18,682
Issuance of common stock pursuant to a public offering	4,945	—	—
Issuance of common stock pursuant to stock purchase contracts associated with the FELINE PRIDES securities	—	—	8,737
Issuance of common stock pursuant to share-based compensation arrangements	14	9	12
Issuance of restricted common stock	169	—	—
Issuance of common stock for the DRIP and other	179	329	628
End of year	<u>33,704</u>	<u>28,397</u>	<u>28,059</u>
Common stock			
Beginning of year	\$ 28,397	\$ 28,059	\$ 18,682
Issuance of common stock pursuant to a public offering	4,945	—	—
Issuance of common stock pursuant to stock purchase contracts associated with the FELINE PRIDES securities	—	—	8,737
Issuance of common stock pursuant to share-based compensation arrangements	14	9	12
Issuance of restricted common stock	169	—	—
Issuance of common stock for the DRIP and other	179	329	628
End of year	<u>\$ 33,704</u>	<u>\$ 28,397</u>	<u>\$ 28,059</u>
Capital surplus			
Beginning of year	\$ 217,073	\$ 214,779	\$ 120,089
Issuance of common stock pursuant to a public offering, net of expenses	24,730	—	—
Issuance of common stock pursuant to stock purchase contracts associated with the FELINE PRIDES securities, net of expenses	—	—	92,181
Issuance of common stock pursuant to share-based compensation arrangements	70	47	44
Issuance of restricted common stock	815	—	—
Issuance of common stock for the DRIP and other	867	1,375	2,465
Issuance of common stock warrants	—	741	—
Repurchase of common stock warrants	(2,094)	—	—
Non-cash share-based compensation	483	131	—
End of year	<u>\$ 241,944</u>	<u>\$ 217,073</u>	<u>\$ 214,779</u>
Unearned Compensation associated with restricted common stock			
Beginning of year	\$ —	\$ —	\$ —
Issuance of restricted common stock	(984)	—	—
Amortization of unearned compensation expense associated with restricted common stock	189	—	—
End of year	<u>\$ (795)</u>	<u>\$ —</u>	<u>\$ —</u>
Accumulated comprehensive income (loss)			
Beginning of year	\$ (7,435)	\$ (6,972)	\$ (7,597)
Minimum pension liability adjustment, net of income tax benefit (expense) of \$1,008, \$420 and \$(200)	(1,872)	(781)	372
Valuation adjustment for marketable securities, net of income tax expense of \$31, \$30 and \$0	58	57	—
Unrealized derivative gain (loss) on interest rate hedge from an investment in an affiliate	176	261	253
End of year	<u>\$ (9,073)</u>	<u>\$ (7,435)</u>	<u>\$ (6,972)</u>
Retained earnings (deficit)			
Beginning of year	\$ (71,949)	\$ (61,448)	\$ (21,152)
Net income (loss) available to common shareholders	169	(8,386)	(29,955)
Cash dividends declared on common stock — \$0.00, \$0.08 and \$0.35 per share	—	(2,115)	(10,341)
End of year	<u>\$ (71,780)</u>	<u>\$ (71,949)</u>	<u>\$ (61,448)</u>

The accompanying notes to the consolidated financial statements are an integral part of these statements.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	Years Ended December 31,		
	2005	2004	2003
		(In thousands)	
Net income (loss)	\$ 12,275	\$ (5,183)	\$ (29,955)
Minimum pension liability adjustment, net of income tax benefit (expense) of \$1,008, \$420 and \$(200)	(1,872)	(781)	372
Valuation adjustment for marketable securities, net of income tax expense of \$31, \$30 and \$0	58	57	—
Unrealized derivative gain (loss) on interest rate hedge from an investment in an affiliate	176	261	253
Total comprehensive income (loss)	<u>\$ 10,637</u>	<u>\$ (5,646)</u>	<u>\$ (29,330)</u>

The accompanying notes to the consolidated financial statements are an integral part of these statements.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Company Description and Significant Accounting Policies

Company Description. SEMCO Energy, Inc., is a New York Stock Exchange-listed regulated public utility headquartered in Port Huron, Michigan. References to the “Company” mean SEMCO Energy, Inc., SEMCO Energy, Inc. and its subsidiaries, individual subsidiaries or divisions of SEMCO Energy, Inc. or the segments discussed below as appropriate in the context of the disclosure.

The Company reports one reportable business segment: Gas Distribution. The Company’s Gas Distribution business segment distributes and transports natural gas to approximately 286,000 customers in Michigan and approximately 123,000 customers in Alaska. These operations are known together as the “Gas Distribution Business.” The Gas Distribution Business is subject to regulation, which is discussed in the “Rate Regulation” section below. This business segment accounted for approximately 99% of the Company’s 2005 consolidated operating revenues.

The Company’s other business segments that do not meet the quantitative thresholds required to be reportable business segments (“non-separately reportable business segments”) are combined and included with the Company’s corporate division in a category the Company refers to as “Corporate and Other.” The Company’s non-separately reportable business segments primarily include operations and investments in information technology (“IT”) services, propane distribution, intrastate natural gas pipelines, and a natural gas storage facility. The IT services operation is headquartered in Michigan and provides IT services with a focus on mid-range computers, particularly the IBM I-Series (or AS-400) platform. The Company has reorganized its IT operations to focus them primarily on the Company’s IT needs, resulting in declining revenues from non-affiliated customers. The Company expects to continue to provide IT services to certain non-affiliated customers where it believes it can do so profitably. The Company’s propane distribution operation typically sells more than 4 million gallons of propane annually to retail customers in Michigan’s upper peninsula and northeast Wisconsin. The Company’s pipeline and storage operations operate natural gas transmission and storage facilities in Michigan.

Discontinued Operations. During the first quarter of 2004, the Company began accounting for its construction services business as a discontinued operation and reclassified prior periods accordingly. In September 2004, the Company sold the assets of its construction services business to InfraSource Services, Inc. for approximately \$21.3 million. For additional information, refer to Note 14.

Basis of Presentation. The financial statements of the Company were prepared in conformity with accounting principles generally accepted in the United States. In connection with the preparation of the financial statements, management was required to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates.

Principles of Consolidation. The consolidated financial statements include the accounts of SEMCO Energy, Inc. and its wholly-owned subsidiaries. Investments in unconsolidated companies where the Company has significant influence, but does not control the entity, are reported using the equity method of accounting.

Rate Regulation. The Gas Distribution Business is subject to regulation. The Michigan Public Service Commission (“MPSC”) has jurisdiction over the regulatory matters related to the Company’s Michigan customers, except for customers in the City of Battle Creek, Michigan, and nearby communities. The City Commission of Battle Creek (“CCBC”) has jurisdiction over the regulatory matters related to the Company’s customers in the City of Battle Creek, Michigan and nearby communities. The Regulatory Commission of Alaska (“RCA”) has jurisdiction over the regulatory matters related to the Company’s Alaska customers. These regulatory bodies have jurisdiction over, among other things, rates, accounting procedures, and standards of service. The approximate number of the Company’s customers located in service areas regulated by each of the three regulatory bodies is as follows: MPSC — 249,000; CCBC — 37,000; and RCA — 123,000.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 1. Company Description and Significant Accounting Policies (continued)

The Gas Distribution Business is subject to Statement of Financial Accounting Standards (“SFAS”) 71. Refer to Note 2 for additional information regarding SFAS 71.

Cash and Cash Equivalents. Cash and cash equivalents include cash on hand, money market funds, and commercial paper with original maturities of three months or less.

Restricted Cash. At December 31, 2005, and 2004, the Company had \$1.6 million of restricted cash. Restricted cash includes the portion of a supplemental retirement trust account expected to be distributed within one year, and deposits to an escrow account to comply with credit requirements of two of the Company’s gas suppliers.

Accounts Receivable. Trade accounts receivable are recorded at the billed amount and do not bear interest. The allowance for doubtful accounts is the Company’s best estimate of the amount of probable credit losses in existing accounts receivable. Allowance for doubtful accounts is based primarily on the aging of receivables, while also taking into consideration historical write-off experience and regional economic data. The Company reviews allowance for doubtful accounts monthly. Account balances are charged off against the allowance when the Company determines it is probable that certain individual receivables will not be recovered. Uncollectible accounts, or bad debt expense, was \$2.4 million, \$3.1 million and \$3.6 million for the years 2005, 2004 and 2003, respectively.

Accrued Revenue. Accrued revenue represents revenue earned in the current period but not billed to the customer until a future date, usually within one month.

Gas in Underground Storage. The gas inventory of the Gas Distribution Business at December 31, 2005, and 2004 was reported at average cost. In general, commodity costs and variable transportation costs are capitalized as gas in underground storage. Fixed costs, primarily pipeline demand charges and storage charges, are expensed as incurred through the cost of gas.

Property, Plant, Equipment and Depreciation. The Company’s property, plant and equipment are recorded at cost. The Company provides for depreciation on a straight-line basis over the estimated useful lives of the related property. The lives over which the Company’s significant classes of regulated and non-regulated depreciable property are depreciated are as follows (in years):

<u>Regulated Property, Plant & Equipment (Gas Distribution Business)</u>		<u>Non-Regulated Property, Plant & Equipment (Corporate and Other)</u>	
Land	—	Intrastate gas pipelines	25
Underground gas storage property	25 — 39	Propane storage tanks	30
Gas transmission property	30 — 41	Computer & related equipment	5
Gas distribution property	19 — 58	Software	3
General property	5 — 34		

The ratio of depreciation to the average balance of regulated property was approximately 3.8%, 3.8% and 4.0% for the years 2005, 2004 and 2003, respectively. The ratio of depreciation to the average balance of non-regulated property approximated 3.5%, 4.2% and 4.9% for the years 2005, 2004 and 2003, respectively.

Depreciation rates on the Company’s regulated property are set by the regulatory commissions that have jurisdiction over the property. The depreciation rates are intended to expense, over the expected life of the property, both the original cost of the property and the expected costs to remove or retire the property at the end of its useful life. The portion of depreciation expense related to expensing the original cost of the property is charged to accumulated depreciation while the portion related to expensing the expected costs to remove or retire the regulated property, less expected salvage proceeds, is charged to a regulatory liability. This regulatory liability is known in the utility industry as negative salvage value. When the regulated property is ultimately retired, or otherwise disposed of in the ordinary course of business, the original cost of the property

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 1. Company Description and Significant Accounting Policies (continued)

is charged to accumulated depreciation, and the actual removal costs, less salvage proceeds are charged to the regulatory liability. With respect to the retirement or disposal of non-regulated assets, the resulting gains or losses are recognized in income.

During 2004, under the provisions of SFAS 144, "Accounting for Impairment or Disposal of Long-Lived Assets," the Company recorded a \$0.2 million charge in the fourth quarter of 2004 for the impairment of long-lived assets. The impairment charge was a result of the Company's decision to exit the residential portion of its Internet Service Provider ("ISP") operation that was part of its IT business. The \$0.2 million before-tax charge for impairment of long-lived assets is reflected in the Company's Consolidated Statements of Operations in operations and maintenance expenses.

During 2003, under the provisions of SFAS 144, the Company recorded a \$2.8 million charge in the third quarter of 2003 for the impairment of long-lived assets. The \$2.8 million before-tax charge is included in the Company's Consolidated Statements of Operations, as part of the loss from the discontinued construction services business.

Goodwill and Goodwill Impairment. Goodwill represents the excess of purchase price and related costs over the value assigned to the net identifiable assets of businesses acquired. The Company accounts for goodwill under the provisions of SFAS 141, "Business Combinations", and SFAS 142, "Goodwill and Other Intangible Assets." SFAS 141 addresses financial accounting and reporting for all business combinations and requires that all business combinations entered into subsequent to June 2001 be recorded under the purchase method. This statement also addresses financial accounting and reporting for goodwill and other intangible assets acquired in a business combination at acquisition. SFAS 142 addresses financial accounting and reporting for intangible assets acquired individually or with a group of other assets at acquisition. This statement also addresses financial accounting and reporting for goodwill and other intangible assets subsequent to their acquisition.

On June 1, 2005, the Company acquired substantially all of the assets and certain liabilities of Peninsular Gas Company ("Peninsular Gas"). Approximately \$0.1 million of the purchase price was allocated to goodwill. Refer to Note 14 for further information regarding this transaction.

The Company is required to perform impairment tests on its goodwill annually or at any time when events occur which could impact the value of the Company's business segments. If an impairment test of goodwill shows that the carrying amount of the goodwill is in excess of the fair value, a corresponding impairment loss would be recorded in the Consolidated Statements of Operations.

The 2005 annual impairment tests were performed for the Company's business segments and indicated that there was no impairment of goodwill.

During 2004, it was determined that all of the goodwill associated with the Company's IT services business was impaired. The impairment charge was a result of the Company's decision to exit the residential portion of its ISP operation. All of the goodwill for the Company's IT services business was related to the residential ISP operation. The \$0.2 million before-tax charge for impairment of goodwill is reflected in the Company's Consolidated Statements of Operations in operating expenses. The 2004 annual goodwill impairment test was also performed for each of the Company's other business segments during the third and fourth quarters of 2004 and indicated that there was no impairment of goodwill.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 1. Company Description and Significant Accounting Policies (continued)

During 2003, it was determined that all of the goodwill associated with the Company's construction services business (\$17.6 million) was impaired. The \$17.6 million before-tax charge for impairment of goodwill is reflected in the Company's Consolidated Statements of Operations, as part of the loss from the discontinued construction services operations. The 2003 annual goodwill impairment test was also performed for each of the Company's other business units during the third and fourth quarters of 2003 and indicated that there was no impairment of goodwill. The following table summarizes changes in the carrying amount of goodwill for the past two years:

	Gas Distribution Segment	Corporate and Other (In thousands)	Total Company
Balance as of December 31, 2003	\$ 140,227	\$ 3,208	\$ 143,435
Impairment charge	—	(152)	(152)
Balance as of December 31, 2004	\$ 140,227	\$ 3,056	\$ 143,283
Goodwill acquired in a business acquisition on June 1, 2005	91	—	91
Impairment charge	—	—	—
Balance as of December 31, 2005	<u>\$ 140,318</u>	<u>\$ 3,056</u>	<u>\$ 143,374</u>

Unamortized Debt Expense. The Company defers expenses incurred in connection with the issuance of debt and amortizes these deferred expenses over the terms of the debt. If the underlying debt is retired or refinanced, any unamortized expenses are charged to expense in the Company's Consolidated Statements of Operations, except in situations where the debt was specifically allocated to the Company's Gas Distribution Business. In instances when debt allocated specifically to the Gas Distribution Business is refinanced, any unamortized expenses are deferred as a regulatory asset and amortized over the term of the new debt.

Customer Advance Payments. The Company receives advance payments from customers who sign up for the Company's budget payment program. This program is designed so customers can pay their estimated annual gas charges in equal monthly payments. As a result, customers make advance payments during the non-heating season when consumption is generally low, and then utilize these advance payments to pay for a portion of their gas bills during the heating season, when consumption is generally high. Customer advance payments also include deposits the Company receives from customers to cover customer credit risk.

Revenue Recognition. The Gas Distribution Business bills monthly on a cycle basis and follows the utility industry practice of recognizing accrued revenue for services rendered to its customers but not billed at month end. Gas sales revenue is comprised of three components: (i) monthly customer service fees; (ii) volumetric distribution charges; and (iii) volumetric gas commodity charges. Monthly customer service fees represent fixed fees charged to customers. Distribution charges are charged to customers based on the volume of gas consumed by customers. Gas commodity charges represent the cost of gas consumed by customers. As discussed in more detail in the Cost of Gas section below, the Company generally does not earn any income on the gas commodity charge portion of customer rates.

The Company's other businesses recognize revenues in the period that services are rendered or products are delivered to customers.

Cost of Gas, Gas Charges Recoverable from Customers, and Amounts Payable to Customers. The Company's gas distribution area regulated by the MPSC operated with an MPSC-approved gas cost recovery ("GCR") pricing mechanism during 2003, 2004 and 2005. The Alaska-based gas distribution operation ("ENSTAR") has an RCA-approved gas cost adjustment ("GCA") pricing mechanism, which is similar to the GCR pricing mechanism. Both of these pricing mechanisms (hereinafter referred to as "GCR" pricing mechanisms) are designed so that, in the absence of any cost disallowances, the Company's cost of gas

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 1. Company Description and Significant Accounting Policies (continued)

purchased is passed-through to the Company's customers and, therefore, the Company does not recognize any income on the gas commodity charge portion of customer rates.

The GCR pricing mechanisms allow for the adjustment of rates charged to customers for increases and decreases in the cost of gas purchased by the Company for sale to customers. However, in the Company's gas distribution area regulated by the MPSC, the GCR pricing mechanism is subject to a MPSC review of the Company's GCR gas purchase plans and actual gas purchases. A GCR gas purchase plan is filed annually with the MPSC by December 31 of each year for the upcoming April 1 to March 31 GCR period. A reconciliation case is filed by June 30 of each year to reconcile actual gas purchases during the previous April 1 to March 31 GCR period to the GCR gas purchase plan for the period. Both the GCR gas purchase plan and the reconciliation case may involve MPSC reviews of Company actions and decisions and potential cost disallowances. When costs are disallowed, such costs are expensed in the cost of gas but are not recovered in rates.

The annual GCR period in Alaska runs from January 1 to December 31. The GCR rate established by the RCA reflects the pricing mechanisms in certain long-term gas supply contracts approved by the RCA and recovers the cost of natural gas purchased by the Company under those contracts.

Under the GCR pricing mechanisms, the gas commodity charge portion of customers' gas rates (which is also referred to as the "GCR rate") in Alaska and the Company's Michigan service area regulated by the MPSC is generally adjusted annually to reflect the estimated cost of gas purchased for the upcoming 12-month GCR period. Any difference between actual allowed cost of gas purchased and the estimate for a particular GCR period is deferred as either a gas charge over- or under-recovery and included in customer GCR rates during the next GCR period. A gas charge over-recovery occurs when the estimated cost of gas exceeds the actual cost of gas purchased and is reflected in Amounts Payable to Customers in the current liabilities section of the Company's Consolidated Statements of Financial Position. A gas charge under-recovery occurs when the actual cost of gas purchased exceeds the estimated cost of gas and is reflected in Gas Charges Recoverable from Customers in the current assets section of the Company's Consolidated Statements of Financial Position. The GCR rate may be adjusted more frequently than annually if it is determined that there are significant variances from the estimates used in the annual determination. At December 31, 2005, the Company had \$12.3 million recorded in current liabilities for Amounts Payable to Customers and \$1.0 million recorded in current assets for Gas Charges Recoverable from Customers, under the GCR pricing mechanisms.

The Company's gas service area regulated by the CCBC had been operating under a fixed gas charge program during 2003, 2004 and the first three months of 2005. Under that program the Company suspended its GCR pricing mechanism and utilized a fixed gas charge in the rates for customers located in its service area regulated by the CCBC ("CCBC-regulated customers"). The Company was able to offer this GCR suspension and fixed rate mainly as a result of a gas supply agreement covering CCBC-regulated customers. Under the terms of the agreement, the gas supplier provided a significant portion of the Company's natural gas requirements, and managed the Company's natural gas supply and the supply aspects of transportation and storage operations for the Company's gas distribution area regulated by the CCBC, at a cost that was, in most instances, below the fixed price charged to CCBC-regulated customers. As a result, during 2003, 2004 and the first quarter of 2005, the Company retained any gas costs savings that resulted when the cost of purchased natural gas was below the fixed price charged to CCBC-regulated customers.

However, beginning April 1, 2005, the Company once again began to use a GCR pricing mechanism in the service area regulated by the CCBC and therefore, no longer retains any gas cost savings. The GCR pricing mechanism calls for the GCR rate to be revised monthly, to track and recover changes in the cost of natural gas purchased by the Company for use by CCBC-regulated customers.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 1. Company Description and Significant Accounting Policies (continued)

Self-Insurance. The Company is self-insured for health care costs up to \$75,000 per subscriber annually. Insurance coverage is carried for risks in excess of this amount. The Company recognized self-insured health care expense of approximately \$2.4 million, \$4.0 million, and \$4.1 million for the years ended December 31, 2005, 2004 and 2003, respectively. Estimated claims incurred but not reported were \$0.6 million and \$0.8 million as of December 31, 2005, and 2004, respectively, and are included in other accrued liabilities in the Consolidated Statement of Financial Position.

Income Taxes. The Company files a consolidated federal income tax return and income taxes are allocated among the Company's subsidiaries and divisions based on their separate taxable income. Investment tax credits ("ITC") utilized in prior years for income tax purposes are deferred for financial accounting purposes and are amortized through credits to the income tax provision over the lives of the related property. For additional information, refer to Note 3.

Share-Based Compensation. The Company accounts for share-based compensation arrangements in accordance with SFAS 123, "Accounting for Stock-Based Compensation," as amended by SFAS 148, "Accounting for Stock-Based Compensation — Transition and Disclosure." In accordance with SFAS 123, the Company has chosen to account for certain of its share-based compensation arrangements under Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") for purposes of determining net income but must present the pro forma disclosures required by SFAS 123. As a result, the Company's net income (loss) as reported in its Consolidated Statements of Operations reflects compensation expense for certain of its share-based compensation arrangements calculated using the intrinsic value method provided for under the provisions and related interpretations of APB 25 rather than the fair value method provided for under SFAS 123. If all of the Company's share-based compensation expense had been determined in a manner consistent with the provisions of SFAS 123, the Company's net income (loss) available to common shareholders and related earnings (loss) per share would have been reduced to the pro forma amounts set forth in the table below. Refer to Note 9 for further information about the Company's share-based compensation arrangements. For information on a new accounting standard for share-based compensation which was adopted by the Company on January 1, 2006, refer to the "New Accounting Standards" section within this note.

	Years Ended December 31,		
	2005	2004	2003
	(In thousands, except per share amounts)		
Net income (loss) available to common shareholders			
As reported	\$ 169	\$ (8,386)	\$ (29,955)
Add back total share-based compensation expense included in reported net income, net of related tax effects	492	122	36
Deduct total share-based compensation expense determined under fair value based method for all awards, net of related tax effects	755	330	380
Pro forma	<u>\$ (94)</u>	<u>\$ (8,594)</u>	<u>\$ (30,299)</u>
Earnings (loss) per share — basic			
As reported	\$ 0.01	\$ (0.30)	\$ (1.34)
Pro forma	\$ —	\$ (0.30)	\$ (1.36)
Earnings (loss) per share — diluted			
As reported	\$ 0.01	\$ (0.30)	\$ (1.34)
Pro forma	\$ —	\$ (0.30)	\$ (1.36)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 1. Company Description and Significant Accounting Policies (continued)

New Accounting Standards. In December 2004, the Financial Accounting Standards Board (“FASB”) issued SFAS 123-R (Revised 2004) — “Share-Based Payment.” This standard supercedes APB No. 25 and requires recognition of expense in the financial statements of the cost of share-based payment transactions, including stock option awards, based on the fair value of the award at the grant date. This statement also amends SFAS 95, “Statement of Cash Flows,” to require that excess tax benefits related to the excess of the share-based compensation deductible for tax purposes over the compensation recognized for financial reporting purposes be classified as cash inflows from financing activities rather than as a reduction of taxes paid in operating activities. The provisions of this standard are effective for public companies for annual periods beginning after June 15, 2005, and thus are not reflected in the accompanying consolidated financial statements. The Company adopted this statement on January 1, 2006, using the modified prospective method described in SFAS 123-R. The Company believes that the pro forma amounts set forth above provide a reasonable estimate of the impact of this standard on the Company’s Consolidated Financial Statements.

In March 2005, the FASB issued Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations. This Interpretation clarifies the term “conditional asset retirement obligation” as used in SFAS No. 143. The term refers to a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity. The obligation to perform the asset retirement activity is unconditional even though uncertainty exists about the timing and/or method of settlement. Accordingly, an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. The fair value of a liability for the conditional asset retirement obligation should be recognized when incurred. This Interpretation also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. As a result of the adoption of this Interpretation by the Company in the fourth quarter of 2005, certain asset retirement obligations were identified, and they are estimated to cost the Company approximately \$24.1 million at the date of removal. The present value of this obligation at December 31, 2005, was \$2.3 million, which was recorded in the fourth quarter of 2005.

In May 2005, the FASB issued SFAS No. 154, “Accounting Changes and Error Corrections” (“SFAS No. 154”). This statement establishes new standards on accounting for changes in accounting principles. Pursuant to SFAS No. 154, all such changes must be accounted for by retrospective application to the financial statements of prior periods unless it is impracticable to do so. SFAS No. 154 completely replaces APB Opinion No. 20 and SFAS No. 3, though it carries forward the guidance in those pronouncements with respect to accounting for changes in estimates, changes in the reporting entity and the correction of errors. This statement is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company does not believe the adoption of this standard will have a material impact on its financial position and results of operations.

Statements of Cash Flows. For purposes of the Consolidated Statements of Cash Flows, the Company considers all highly liquid investments purchased with original maturities of three months or less to be cash and cash equivalents.

Dividends associated with the Company’s Convertible Preference Stock (“CPS”) were \$0.9 million and \$3.2 million in 2005 and 2004, respectively. These dividends were paid in additional shares of CPS, or what is commonly referred to as stock dividends or payment-in-kind dividends. The issuance of stock dividends is a non-cash financing activity and therefore is not reflected in the Consolidated Statements of Cash Flows. Refer to Note 4 for further information regarding the issuance of stock dividends on the CPS and the subsequent repurchase of the CPS in March 2005.

In August 2003, the Company issued approximately 8.74 million shares of Common Stock for \$101 million through the mandatory purchase obligation under the terms of stock purchase contracts, which were a component of the Company’s FELINE PRIDES securities. The Company also retired approximately

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 1. Company Description and Significant Accounting Policies (continued)

\$101 million of 9% trust preferred securities, which were also a component of the FELINE PRIDES securities. These transactions were non-cash financing activities and therefore both the issuance of the \$101 million of Common Stock and the retirement of the \$101 million of 9% trust preferred securities are not reflected in the Consolidated Statements of Cash Flows. Refer to Note 4 for further information.

In May 2003, the Company completed an offering of an aggregate of \$300 million of senior unsecured notes. The Company used approximately \$92.3 million of the new notes in an exchange for other outstanding debt of the Company. The debt exchange was a non-cash financing activity and therefore is not reflected in the Consolidated Statements of Cash Flows. Refer to Note 4 for further information regarding the debt exchange.

Supplemental cash flow information for the years ended December 31, 2005, 2004, and 2003, is summarized in the following table.

	Years Ended December 31,		
	2005	2004	2003
	(In thousands)		
Cash paid during the year for:			
Interest and dividends on trust preferred securities	\$ 39,443	\$ 41,216	\$ 49,173
Income taxes, net of (refunds)	\$ (1,840)	\$ 3,500	\$ (3,000)

Note 2. Regulatory Matters

MPSC. In December 2004, the Company filed a base rate increase request totaling \$11.65 million with the MPSC. Among other things, the Company proposed an increase in customer service fees and a weather normalization rider, for the purpose of mitigating the impact of weather on customer bills and the Company's financial results. On March 29, 2005, the MPSC approved a settlement with the Company, which, at the time of settlement, was expected to produce an additional \$7.1 million in annual revenue from customers in the Company's MPSC-regulated service area. Increases in the fixed customer charge for several commercial and industrial customer classes and the increase in fees for certain services mitigate some of the effect of weather on the Company's revenues. The settlement did not include the Company's proposed increase in residential customer service fees or weather normalization rider. The rate adjustments authorized by this settlement became effective on March 30, 2005.

The Company filed its application for MPSC approval of its GCR plan and rate on December 29, 2004, and the MPSC approved a settlement of that case on September 20, 2005. The approved base GCR rate was \$7.9055 per Mcf, plus a NYMEX-based contingency adjustment that brought the rate to \$9.6165 per Mcf. The \$9.6165 rate was effective with the October 2005 billing month.

As a result of substantial increases in gas prices in the United States, on October 4, 2005, the Company filed a petition with the MPSC, to reopen the settlement and re-set its GCR rate for the 12-month period ending March 31, 2006. On October 6, 2005, the MPSC issued an order reopening the Company's GCR proceeding and setting an expedited timetable for the proceeding. On October 28, 2005, the MPSC approved a settlement under which the Company increased its GCR rate to \$11.2684 per Mcf from \$9.6165 per Mcf, effective for usage in the November 2005 billing month and through the end of the March 2006 billing month. The settlement provided that the Company may not seek further GCR rate increases for the remainder of this GCR year which ends in March 2006.

On October 26, 2005, the MPSC approved another settlement under which the former customers of Peninsular Gas will pay an increased GCR rate (\$12.09 per Mcf) beginning in the November 2005 billing month through the March 2006 billing month. The Company now serves these customers after having purchased the assets of Peninsular Gas in June 2005. This increase affects approximately 4,000 customers.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 2. Regulatory Matters (continued)

The Company seeks to end its GCR period ending on March 31 of each year, with no significant under-recovery or over-recovery. In February 2006, because natural gas prices had fallen from earlier levels and to attempt to end the GCR period with no significant under- or over-recovery of gas costs, the Company reduced its GCR factor to \$9.7600/ Mcf for customers in its MPSC regulated service area, including the former customers of Peninsular Gas.

In an attempt to provide supplemental assistance to customers who are unable to pay their bills on time or in full and to price lost and unaccounted for ("LAUF") natural gas volumes at current market prices in customer rates, the Company has proposed to the MPSC (i) the establishment of an assistance program to help eligible low income customers pay their gas bills, and (ii) a change in how the Company accounts for its expenses for LAUF gas and uncollectible customer accounts ("uncollectibles"). The proposed assistance program would allow the Company to charge-off one half of the commodity charge portion of an eligible customer's account up to \$550 in certain circumstances. The Company also proposed, to ensure more timely cost recovery, that the commodity portion of LAUF gas and uncollectibles be collected via the GCR rate. To offset these recoveries through the GCR rate, the Company also proposed to reduce its volumetric distribution charges by removing the amount of the rate case allowance for LAUF gas and the gas commodity portion of all uncollectibles from base rates. The Company would instead record LAUF gas costs and the gas commodity portion of uncollectibles, including the charge-offs under the assistance program, to cost of gas sold. Additionally, as a contribution, the Company proposed to credit up to \$150,000 annually to offset the charge-offs made to uncollectibles pursuant to the proposed assistance program. On February 13, 2006, the Company filed to withdraw these proposals, with the intention of resubmitting some or all of the proposals, in the same form or with modifications, in one or more future proceedings.

On October 14, 2004, the MPSC initiated a generic proceeding involving all Michigan electric and gas utilities to review SFAS 143 "Accounting for Asset Retirement Obligations," Federal Energy Regulatory Commission Order No. 631, "Accounting, Financial Reporting, and Rate Filing Requirements for Asset Retirement Obligations," and related accounting and ratemaking issues. As directed by the MPSC, on March 15, 2005, the Company filed responses, in the form of testimony, to various questions raised by the MPSC regarding the Company's accounting practices for property retirements, including the cost of removal. Among other things, this proceeding involves an examination of possible changes in accounting for property retirements, for rate-making purposes. On December 5, 2005, the Administrative Law Judge issued a Proposal for Decision recommending that the proceedings be dismissed on procedural grounds. The matter awaits a decision by the MPSC.

CCBC. In November 2004, the Company filed a base increase request totaling \$5.07 million with the CCBC. In February 2005, the CCBC approved a settlement, which, at the time of settlement, was expected to produce an additional \$3.55 million in annual revenue, to be effective with the first customer billing cycle of April 2005, with additional annual revenue increases of \$150,000 to be put into effect beginning in April of 2006, and 2007, respectively, subject to certain conditions, including the Company's making annual contributions to assist low income customers in paying their bills for service. With certain exceptions, the Company has agreed not to request a further base rate increase to be effective before April 1, 2008. These revenue increases are to be recovered, in part, through increased customer service fees.

The GCR rate for the approximately 37,000 customers in the service territory regulated by the CCBC is revised monthly, to track and recover changes in the cost of natural gas purchased by the Company for use by CCBC-regulated customers. The Company seeks to end its GCR period (which ends on March 31 of each year) with no significant gas charge under-recovery or over-recovery.

The Company and the CCBC announced on October 5, 2005, that they will ask the MPSC to assume jurisdiction over this service area. In 2006, the Company and the CCBC plan to file a joint application with the MPSC asking for approval of this jurisdictional change. The Company had previously agreed to support such a request as part of a base rate increase settlement with the CCBC. The Company does not believe that

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 2. Regulatory Matters (continued)

this proposed change will have a material impact on its natural gas rates, results of operations or financial position.

RCA. On June 20, 2005, the RCA issued an order requiring ENSTAR to file a revenue requirement and cost of service study (including rate design data) with the RCA by June 6, 2008 (using a test year ended December 31, 2007). In addition, ENSTAR is required to file a depreciation study of utility plant (as of December 31, 2006) by June 1, 2007. These filings also will include the Company's Alaska Pipeline Company ("APC") subsidiary.

Regulatory Assets and Liabilities. The Gas Distribution Business is subject to the provisions of SFAS 71. The provisions of SFAS 71 allow the Company to defer expenses and income as regulatory assets and liabilities in the Consolidated Statements of Financial Position when it is probable that those expenses and income will be allowed in the rate setting process in a period different from the period in which they would have been reflected in the Consolidated Statements of Operations by an unregulated entity. These deferred regulatory assets and liabilities are then included in the Consolidated Statements of Operations in the periods in which the same amounts are reflected in rates. Management's assessment of the probability of recovery or pass-through of regulatory assets and liabilities requires judgment and interpretation of laws and regulatory commission orders. If, for any reason, the Company ceases to meet the criteria for application of regulatory accounting treatment for all or part of its operations, the regulatory assets and liabilities related to those portions ceasing to meet such criteria would be eliminated from the Consolidated Statements of Financial Position and included in the Consolidated Statements of Operations for the period in which the discontinuance of regulatory accounting treatment occurs. Such amounts would be classified as extraordinary items. Criteria that give rise to the discontinuance of SFAS 71 include (i) increasing competition that restricts the ability of the Gas Distribution Business to charge prices to recover specific costs, and (ii) a significant change in the manner in which rates are set by regulatory agencies from cost-based regulation to another form of regulation. The Company's review of these criteria currently supports the continuing application of SFAS 71.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 2. Regulatory Matters (continued)

The following table summarizes the regulatory assets and liabilities recorded in the Consolidated Statements of Financial Position, as well as the remaining period, as of December 31, 2005, over which the Company expects to realize or settle the assets or liabilities.

	December 31,		
	2005	2004	Remaining Period
	(In thousands, except number of years)		
Regulatory assets			
Current			
Gas charges recoverable from customers	\$ 971	\$ 137	1 year
Noncurrent			
Deferred retiree medical costs	\$ 6,294	\$ 7,193	7 years
Deferred loss on retirement of debt	1,827	2,133	5 — 11 years
Deferred asset retirement obligation	1,820	—	15 — 35 years
Other	2,661	2,736	1 — 10 years
	<u>\$ 12,602</u>	<u>\$ 12,062</u>	
Regulatory liabilities			
Current			
Amounts payable to customers (gas cost overrecovery)	\$ 12,281	\$ 5,624	1 year
Noncurrent			
Negative salvage value	\$ 56,627	\$ 54,094	15 — 40 years
Tax benefits amortizable to customers	2,235	2,731	8 years
Unamortized investment tax credits	352	617	1 year
	<u>\$ 59,214</u>	<u>\$ 57,442</u>	

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 3. Income Taxes

SFAS 109. The Company accounts for income taxes in accordance with SFAS 109, “Accounting For Income Taxes.” SFAS 109 requires an annual measurement of deferred tax assets and deferred tax liabilities based upon the estimated future tax effects of temporary differences and carry-forwards.

	Years Ended December 31,		
	2005	2004	2003
	(In thousands)		
Federal income tax expense (benefit):			
Current	\$ —	\$ (83)	\$ 460
Deferred to future periods	5,751	(1,546)	(11,172)
Amortization of deferred investment tax credits (“ITC”)	(265)	(265)	(296)
State income tax expense (benefit):			
Current	248	34	926
Deferred to future periods	599	(2,111)	324
Total income tax expense (benefit)	\$ 6,333	\$ (3,971)	\$ (9,758)
Less amounts included in:			
Minority interest — dividends on trust preferred securities	—	—	(2,316)
Discontinued operations	312	(3,504)	(7,362)
Income tax expense (benefit), excluding amounts shown separately	\$ 6,021	\$ (467)	\$ (80)

Reconciliation of Statutory Rate to Effective Rate. The table below provides a reconciliation of the difference between the Company’s provision for income taxes and income taxes computed at the statutory rate.

	Years Ended December 31,		
	2005	2004	2003
	(In thousands)		
Net Income (loss)	\$ 12,275	\$ (5,183)	\$ (29,955)
Add back income tax expense (benefit)	6,333	(3,971)	(9,758)
Pre-tax income (loss)	\$ 18,608	\$ (9,154)	\$ (39,713)
Computed federal income tax expense (benefit)	\$ 6,513	\$ (3,204)	\$ (13,899)
Amortization of deferred ITC	(265)	(265)	(296)
State income tax expense, net of federal taxes	550	880	812
Change in estimate of prior years’ state income taxes, net of federal taxes	—	(2,230)	—
Goodwill impairment charge not deductible for tax purposes	—	—	4,095
Other	(465)	848	(470)
Total income tax expense (benefit)	\$ 6,333	\$ (3,971)	\$ (9,758)

Deferred Income Taxes. Deferred income taxes arise from temporary differences between the tax basis of assets and liabilities and their reported amounts in the Company’s financial statements. At December 31, 2005, and 2004, there was a valuation allowance of \$0.4 million and \$0.6 million, respectively, recorded against deferred tax assets. The Company also has an estimated net operating loss (“NOL”) carryforward for federal tax purposes of \$96 million at December 31, 2005, of which an estimated \$4 million expires in 2021, \$22 million expires in 2022, \$53 million expires in 2023 and \$17 million expires in 2024. The Company’s

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 3. Income Taxes (continued)

ability to utilize its NOLs is limited by the Internal Revenue Code. However, the Company currently expects that it will achieve enough taxable income in future years to utilize its NOLs prior to their expiration.

The table below shows the principal components of the Company's deferred tax assets (liabilities).

	December 31,	
	2005	2004
	(In thousands)	
Property, plant and equipment	\$ (57,702)	\$ (56,207)
Retiree medical benefit liability	(200)	303
Retiree medical benefit regulatory assets	(2,203)	(2,518)
Deferred ITC	151	339
Unamortized debt expense	(499)	(613)
Property taxes	(1,757)	(2,629)
Goodwill	(11,178)	(8,722)
Other comprehensive income — minimum pension liability	4,932	3,924
Other comprehensive income — valuation adjustment	(61)	(30)
Gas in underground storage	1,312	(514)
Gas charge over-recovery	3,870	1,879
Net operating loss carryforward	33,503	38,851
AMT credit carryforward	2,276	2,276
Valuation allowance for deferred tax assets	(361)	(580)
Other	2,547	3,824
Total deferred taxes	\$ (25,370)	\$ (20,417)
Gross deferred tax liabilities	\$ (108,837)	\$ (99,670)
Gross deferred tax assets	83,828	79,833
Valuation allowance for deferred tax assets	(361)	(580)
Total deferred taxes	\$ (25,370)	\$ (20,417)

Note 4. Capitalization

Common Shareholders' Equity. On August 15, 2005, the Company completed an offering of 4,945,000 shares of Common Stock, at a public offering price of \$6.32 per share. The aggregate gross proceeds of the offering were \$31.3 million, with net proceeds of approximately \$30.0 million after deducting underwriting discounts and commissions. The proceeds from the completion of this offering were used to redeem all of the Company's outstanding 10.25% Series A Subordinated Debentures due 2040 ("10.25% Subordinated Notes") held by the Company's unconsolidated capital trust subsidiary, SEMCO Capital Trust I (the "Trust"), as discussed below.

During 2005, the Company issued 176,583 shares of restricted Common Stock to members of the Company's Board of Directors ("Board") as part of the compensation for their services. The restrictions on 7,833 of those shares were waived due to the immediate retirement eligibility of the two individuals who were granted those shares. The restricted shares of Common Stock vest over periods of up to three years and the value of the restricted Common Stock at the time of issuance (\$1.0 million) was added to the Company's common shareholders equity. There is an offsetting account, which is also recorded in common shareholders' equity, that represents the unearned compensation associated with the restricted Common Stock and, as of December 31, 2005, amounted to \$0.8 million.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 4. Capitalization (continued)

During 2005, 2004, and 2003, the Company issued approximately 40,000, 192,000 and 478,000 shares, respectively of its Common Stock to the Company's Direct Stock Purchase and Dividend Reinvestment Plan ("DRIP") to meet the dividend reinvestment and stock purchase requirements of its participants.

The Company issued approximately 144,000, 145,000 and 162,000 shares of Company Common Stock to certain of the Company's employee benefit and director deferred compensation plans in 2005, 2004, and 2003, respectively. Of these issuances, approximately 6,000, 9,000, and 12,000 are related to director deferred compensation. Refer to Note 9 for further information on directors' stock-based compensation.

On June 24, 2004, the Company suspended the quarterly cash dividend on the Company's Common Stock, with the objective of supplementing free cash flow. This decision also reflects the Company's desire to retain cash in order to strengthen the Company's balance sheet, enhance financial flexibility and to be better positioned to grow the Company's Gas Distribution Business in the future.

As discussed below under "Convertible Preference Stock and Stock Warrants," in March 2004, warrants to purchase 905,565 shares of Common Stock ("Warrants") were issued in conjunction with the issuance of CPS. The net proceeds associated with the Warrants, approximately \$0.7 million, were included in capital surplus in the common shareholders' equity section of the Consolidated Statements of Financial Position at December 31, 2004. In March 2005, the Company paid \$2.1 million to repurchase these Warrants. The \$2.1 million paid to repurchase the Warrants is reflected in common shareholders' equity as a decrease in capital surplus at December 31, 2005.

In August 2003, the Company issued approximately 8.74 million shares of Common Stock for \$101 million through the mandatory stock purchase obligation specified under the terms of the stock purchase contracts, which were a component of the FELINE PRIDES securities. As discussed below under "Other Matters Regarding Trust Preferred Securities," the Company also retired approximately \$101 million of 9% trust preferred securities in conjunction with this issuance of Common Stock. The issuance of the 8.74 million shares of Common Stock and the retirement of the 9% trust preferred securities were non-cash financing activities and, therefore, neither are reflected in the Company's Consolidated Statements of Cash Flows.

Convertible Preference Stock and Stock Warrants. During 2004, the Company issued through a private placement, \$50 million of CPS and Warrants to K-1 GHM, LLLP, an affiliate of a private equity firm, k1 Ventures Limited ("K-1"). The private placement included 50,000 shares of CPS and Warrants to purchase 905,565 shares of the Company's Common Stock. The net proceeds from this issuance were approximately \$46.3 million. The portion of the net proceeds associated with the Warrants, approximately \$0.7 million, was included in the common shareholders' equity section of the Consolidated Statements of Financial Position as an increase in capital surplus.

In connection with K-1's purchase of the CPS and Warrants, action by the RCA was needed on the issue of whether a change of control occurred as a result of that investment in the Company. When it became apparent that it would be difficult to obtain the desired rulings, the Company and K-1 began negotiations for the repurchase of the CPS and Warrants. For further information concerning the regulatory approvals sought in connection with K-1's investment in the Company, refer to the "Other Contingencies" section of Note 13.

On March 8, 2005, the Company reached an agreement with K-1 to repurchase all of the outstanding CPS shares (52,543) and Warrants held by K-1. On March 15, 2005, the Company completed this repurchase. The aggregate repurchase price under the agreement was \$60 million. Approximately \$57.9 million of the repurchase price related to the CPS and the remainder, approximately \$2.1 million, related to the Warrants. The repurchase price for the CPS included a premium over the book value of the CPS of approximately \$8.2 million. The \$8.2 million repurchase premium payment is reflected in the Company's Consolidated Statements of Operations for the year ended December 31, 2005. The \$2.1 million paid to repurchase the Warrants is included in capital surplus in the common shareholder's equity section of the

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 4. Capitalization (continued)

Consolidated Statements of Financial Position. During 2005 and 2004, the Company paid stock dividends on the CPS of 777 and 1,766 additional shares of CPS, respectively.

5% Series B Convertible Cumulative Preferred Stock. On March 15, 2005, concurrent with and in order to fund the repurchase of CPS and Warrants from K-1, the Company completed the offering of 5% Series B Convertible Cumulative Preferred Stock (“Preferred Stock”) to qualified institutional buyers pursuant to Rule 144A under the Securities Act of 1933 (the “Act”) and to persons in offshore transactions in reliance on Regulation S under the Act. In connection with the offering, the Company sold 325,000 shares of Preferred Stock. The gross proceeds from this offering were approximately \$65.0 million.

The Company also granted the initial purchasers a 30-day option to purchase up to an additional 25,000 shares of Preferred Stock in connection with the offering. On March 22, 2005, the sale of an additional 25,000 shares of Preferred Stock was completed pursuant to the exercise of the option by the initial purchasers. The gross proceeds from the sale of the additional shares were approximately \$5.0 million.

Of the proceeds from this combined offering, \$60 million was used to fund the repurchase of CPS and Warrants from K-1. The remaining proceeds were used to redeem \$10.3 million of the Company’s 10.25% Subordinated Notes, held by the Trust, on April 29, 2005. The Trust, in turn, used the proceeds to redeem 400,000 shares of its 10.25% Cumulative Trust Preferred Securities and 12,371 shares of its common securities.

Holders of shares of the Preferred Stock are entitled to receive cumulative annual cash dividends of \$10 per share, payable quarterly in cash on each February 15, May 15, August 15 and November 15. Dividends are paid in arrears on the basis of a 360-day year consisting of twelve 30-day months. Dividends on the Preferred Stock accumulated from the date of issuance and compound quarterly. On May 15, 2005, the Company paid dividends on its Preferred Stock totaling approximately \$0.6 million, or \$1.66667 per share, and on both August 15, 2005, and November 15, 2005, the Company paid dividends totaling approximately \$0.9 million, or \$2.50 per share.

The Preferred Stock is convertible at the holder’s option at any time at an initial conversion rate of 26.1428 shares of the Company’s Common Stock per \$200 liquidation preference of shares, which represents an initial conversion price of approximately \$7.65 per share of Common Stock. The Company may redeem the Preferred Stock for cash after February 20, 2010, at an initial redemption price equal to 100% of the liquidation preference, plus accumulated and unpaid dividends to the date of redemption. The Preferred Stock is mandatorily redeemable for cash on February 20, 2015, at a redemption price equal to 100% of the liquidation preference, plus accumulated and unpaid dividends to the date of redemption.

If certain specified “fundamental changes” involving the Company occur prior to February 20, 2010, the Company may be required to pay a make-whole premium on the Preferred Stock converted in connection with the fundamental change. The make-whole premium will be payable in shares of the Company’s Common Stock or the consideration into which the Common Stock has been converted or exchanged in connection with the fundamental change. The amount of the make-whole premium, if any, will be based on the Common Stock price and the effective date of the fundamental change. A “fundamental change” involving the Company will be deemed to have occurred if (i) certain transactions occur as a result of which there is a change of control of the Company, or (ii) the Company’s Common Stock ceases to be listed on a national securities exchange or quoted on The Nasdaq National Market or another established automated over-the-counter trading market in the United States.

Registration Statements. On April 11, 2005, the Company filed a universal shelf registration statement on Form S-3 with the SEC to register an aggregate of \$150 million of various securities, which was declared effective by the SEC on June 14, 2005. Subsequent to the effectiveness of this registration statement, the Company completed a Common Stock offering of \$31.3 million under the shelf registration statement, leaving \$118.7 million of securities available for possible future issuances under this registration statement. In

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 4. Capitalization (continued)

addition, and as discussed in more detail below, on May 26, 2005, the Company filed a resale shelf registration statement with the SEC, in compliance with its obligations under a registration rights agreement entered into at the time of the issuance of the Preferred Stock. This resale registration statement relates to the resale of shares of the Preferred Stock and to shares of Common Stock issuable upon conversion of the Preferred Stock and was declared effective by the SEC on August 12, 2005.

Company Obligated Mandatorily Redeemable Trust Preferred Securities. The Company had Company-obligated mandatorily redeemable trust preferred securities that were issued by its capital trust subsidiaries ("Trust Preferred Securities"). These trusts were established for the sole purpose of issuing Trust Preferred Securities to the public and lending the gross proceeds, including the proceeds from the Company's common equity investment, to the Company. The sole assets of the capital trusts were debt securities of the Company with terms similar to the terms of the related Trust Preferred Securities. The Trust Preferred Securities had characteristics of both debt and equity and for periods prior to July 1, 2003, they were reported in the Consolidated Statements of Financial Position as a separate line item between long-term debt and common shareholders' equity. For periods after July 1, 2003, and before December 31, 2003, the Trust Preferred Securities were reflected in the long-term debt section of the Consolidated Statements of Financial Position in compliance with the provisions of SFAS 150. Prior to July 1, 2003, the dividends on these Trust Preferred Securities were reflected in the Consolidated Statements of Operations as "minority interest — dividends on Trust Preferred Securities." In accordance with the provisions of SFAS 150, the dividends incurred on these securities during the period from July 1, 2003, through December 31, 2003, are reflected in "interest expense." The adoption of SFAS 150 did not have a material impact on the Company's net income (loss) available to common shareholders.

On April 29, 2005, the Company used a portion of the proceeds it received from the issuance of its Preferred Stock to redeem \$10.3 million of the 10.25% Subordinated Notes held by the Trust. Concurrently, the Trust used the proceeds it received from the redemption of the 10.25% Subordinated Notes to redeem 400,000 Trust Preferred Securities at a redemption price of \$25.00 per security, for a total principal payment of \$10.0 million. The Trust also used a portion of the proceeds to redeem \$0.3 million of the Company's common equity investment in the Trust, representing 12,371 common securities of the Trust.

On September 14, 2005, the Company used the proceeds it received from the sale of 4,945,000 shares of its Common Stock to redeem the remaining \$30.9 million of the 10.25% Subordinated Notes held by the Trust. Concurrently, the Trust used the proceeds it received from the redemption of the 10.25% Subordinated Notes to redeem the remaining 1.2 million Trust Preferred Securities at a redemption price of \$25.00 per security, for a total principal payment of \$30.0 million. The Trust also used a portion of the proceeds to redeem the remaining \$0.9 million of the Company's common equity investment in the Trust, representing 37,114 common securities of the Trust.

As a result of redemptions during 2005, at December 31, 2005, the Company had no common equity investment in the trusts, the trusts had no outstanding Trust Preferred Securities, and the Company had no outstanding debt due to the trusts. At December 31, 2004, the Company had a \$1.2 million common equity investment in these trusts, which was reflected in deferred charges and other assets in the Consolidated Statements of Financial Position and \$41.3 million of debt securities due to the trusts, of which \$41.2 million was reflected in long-term debt and \$0.1 million was reflected in current maturities of long-term debt, in the Consolidated Statements of Financial Position. The trusts had \$40.1 million of Trust Preferred Securities outstanding at December 31, 2004.

Other Matters Regarding Trust Preferred Securities. During a portion of 2003, the Company had 10.1 million shares of FELINE PRIDES securities outstanding. Each FELINE PRIDES security consisted of a stock purchase contract and a 9% trust preferred security of SEMCO Capital Trust II with a stated face value per security of \$10. Under the terms of each stock purchase contract, the FELINE PRIDES security holder was obligated to purchase from the Company, and the Company was obligated to sell to the FELINE

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 4. Capitalization (continued)

PRIDES security holder, between 0.7794 and 0.8651 shares of Company Common Stock in August 2003. The actual number of shares of Common Stock to be sold depended on the average market value of a share of Company Common Stock during a 20-day period ending in August 2003.

The FELINE PRIDES security holders were able to settle their obligation to purchase Company Common Stock by paying cash or by having their 9% trust preferred securities remarketed in August 2003. Approximately all of the FELINE PRIDES security holders elected to have their trust preferred securities remarketed to raise the cash needed to fulfill their obligations under the terms of the stock purchase contracts. The remarketing was not successful and the Company took possession of those trust preferred securities and retired them in order to satisfy the FELINE PRIDES security holders' obligations to purchase 8.74 million shares of the Company's Common Stock. The distribution rate on the 9% trust preferred securities was also reset in August 2003 to 3.77%.

Long-Term Debt. In November 2005, the Company's \$15.0 million of outstanding 6.5% Senior Notes matured and were redeemed at par. The Company utilized its Bank Credit Agreement to finance this redemption. For further information on the Bank Credit Agreement, refer to Note 5 of the Notes to the Consolidated Financial Statements.

On April 29, 2005, the Company redeemed \$10.3 million of the 10.25% Subordinated Notes held by the Trust. On September 14, 2005, the Company redeemed the remaining \$30.9 million of the 10.25% Subordinated Notes held by the Trust. The redemptions were funded from proceeds received from the sale of Preferred Stock and Common Stock in 2005, as previously discussed in this Note under the caption "Company Obligated Mandatorily Redeemable Trust Preferred Securities."

In June 2004, the Company redeemed all \$29.9 million of its outstanding 8% Senior Notes due 2010 at par. The Company utilized a portion of the net proceeds received from the issuance of CPS, as previously discussed, to redeem these notes.

In January 2004, the Company entered into an interest rate swap agreement with a financial institution in order to hedge \$50 million of its \$150 million 7.125% senior unsecured notes due 2008. The swap agreement, which covers these notes through maturity, effectively converts the fixed interest rate on these notes to a floating interest rate and is being accounted for as a fair value hedge. On a semi-annual basis, the Company pays the counterparty a floating interest rate based on LIBOR plus a spread of 375 basis points and receives payments based on a fixed interest rate of 7.125%. Refer to Note 7 for additional information.

In December 2003, the Company completed an offering of an aggregate of \$50 million of 7.75% senior unsecured notes due 2013 ("7.75% 2013 Notes"). The notes are of the same class as notes issued by the Company in May 2003, as discussed below. The \$50 million in notes were issued at a premium of \$2.1 million. The issuance was done concurrently with an amendment of the Company's then-existing bank credit facility and the proceeds from this issuance were used to repay indebtedness under that bank credit facility.

In May 2003, the Company completed an offering of an aggregate of \$300 million of senior unsecured notes. The offering consisted of \$150 million of 7.125% senior unsecured notes due 2008 ("7.125% 2008 Notes") and \$150 million of 7.75% 2013 Notes. Interest on these notes is payable semiannually. The Company used approximately \$92.3 million of the 7.75% 2013 Notes in an exchange for \$77 million of its outstanding 8.95% Remarketable or Redeemable Securities ("ROARS"). After the exchange was completed, the Company cancelled the \$77 million of ROARS. The Company accounted for the debt exchange under the provisions of Emerging Issues Task Force Opinion No. 96-19 ("EITF 96-19"). In accordance with EITF 96-19, the Company used the book value of the ROARS (\$77 million) as the initial book value for the \$92.3 million of 7.75% 2013 Notes issued in the exchange. The difference between the face amount and the initial book value of the 7.75% 2013 Notes will be amortized as interest expense, using the effective interest method, over the life of the notes. As a result, the book value of the 7.75% 2013 Notes will increase by the amount of amortization expense recognized over the life of the notes. The exchange of the \$92.3 million of

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 4. Capitalization (continued)

7.75% 2013 Notes for the \$77 million of ROARS was a non-cash financing activity. As a result, it is not reflected in the Company's Consolidated Statements of Cash Flows.

The Company used a portion of the proceeds from the issuance of the \$300 million of notes in 2003 to repurchase its \$55 million of outstanding 8.00% Senior Notes due 2004, \$30 million of outstanding 7.2% Senior Notes due 2007, \$25 million of outstanding 8.32% Senior Notes due 2024 and the remaining \$28 million of ROARS plus accrued interest. Approximately \$24 million of the proceeds was used to pay make-whole premiums or similar items in connection with the repurchase of the \$138 million in notes and securities. The make-whole premiums or similar items were incurred, in most instances, in order to repurchase these obligations prior to their maturity. The Company expensed the \$24 million at the time of the refinancing. The remainder of the proceeds was used to pay expenses associated with the issuance of the new notes (approximately \$10.1 million), to pay down short-term debt and for working capital and general corporate purposes.

At December 31, 2005, there were no annual sinking fund requirements for the Company's existing debt over the next five years. The Company has \$185 million of long-term debt maturing over the next five years as follows (in millions):

2006	\$	—
2007	\$	—
2008	\$	155
2009	\$	30
2010	\$	—

Note 5. Short-Term Borrowings

In September 2005, the Company entered into an amended and restated three-year unsecured revolving bank credit facility for \$120 million, which expires on September 15, 2008 (the "Bank Credit Agreement"). The Bank Credit Agreement amends and restates the Company's previous short-term bank credit facility, which consisted of a \$60 million multi-year revolving facility and a \$40.8 million 364-day facility, both of which were due to expire on September 23, 2005. Interest under the terms of the Bank Credit Agreement is at variable rates, which are based on LIBOR or prime lending rates, plus applicable margins. LIBOR-based borrowings are permitted for periods ranging from two weeks to one, two, three or six months. At December 31, 2005, the Company was utilizing \$95.7 million of the borrowing capacity available under the Bank Credit Agreement, leaving approximately \$24.3 million of the borrowing capacity unused. The \$95.7 million of capacity being used consisted of \$16.8 million of outstanding letters of credit and \$78.9 million of outstanding borrowings.

	Years Ended December 31,		
	2005	2004	2003
		(In thousands)	
Notes payable balance at year end	\$ 78,900	\$ 39,300	\$ 82,034
Unused lines of credit at year end	\$ 24,277	\$ 61,914	\$ 38,275
Average interest rate at year end	6.1%	4.9%	3.4%
Highest borrowings at any month-end	\$ 89,300	\$ 65,203	\$ 124,468
Average borrowings	\$ 15,795	\$ 14,477	\$ 92,138
Weighted average interest rate	5.6%	3.6%	3.0%

Covenants in the Company's Bank Credit Agreement require maintenance at the end of each calendar quarter of a minimum consolidated net worth of \$225.0 million, adjusted annually by 50% of consolidated net income, if positive, plus 100% of the proceeds of each new capital offering conducted by the Company or any

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 5. Short-Term Borrowings (continued)

of its subsidiaries on or after June 30, 2005, net of issuance costs, less the aggregate principal amount of any junior capital which is retired, prepaid or redeemed in connection with a new capital offering (at December 31, 2005, the required minimum net worth was \$225.0 million). In addition, the Bank Credit Agreement requires the Company to maintain, at the end of each fiscal quarter, a minimum interest coverage ratio of not less than 1.25 to 1 through September, 30, 2007, and not less than 1.30 to 1 thereafter, and a maximum leverage ratio of not more than 65%. As of December 31, 2005, the Company was in compliance with these Bank Credit Agreement covenants. The Company's failure to comply with any of its financial covenants may result in an event of default which, if not cured or waived, could result in the acceleration of the debt under the Bank Credit Agreement or the indentures governing its outstanding debt issuances that contain cross-acceleration or cross-default provisions. In such a case, there can be no assurance that the Company would be able to refinance or otherwise repay such indebtedness, which could result in a material adverse effect on its business, results of operation, liquidity and financial condition.

Note 6. Financial Instruments

The following methods and assumptions were used to estimate the fair value of each significant class of financial instruments:

Cash, Cash Equivalents, Accounts Receivables, Payables and Notes Payable. The carrying amount approximates fair value because of the short maturity of those instruments.

Long-Term Debt. The fair values of the Company's long-term debt are estimated based on quoted market prices for the same or similar issues. The table below shows the estimated fair values of the Company's long-term debt as of December 31, 2005, and 2004.

	December 31,	
	2005	2004
	(In thousands)	
Long-term debt, including current maturities		
Carrying amount	\$ 441,659	\$ 498,427
Fair value	471,967	548,060

Note 7. Risk Management Activities and Derivative Transactions

The Company's business activities expose it to a variety of risks, including commodity price risk and interest rate risk. The Company's management identifies risks associated with the Company's business and determines which risks it wants to manage with financial instruments and which type of instruments it should use to manage those risks.

The Company records all derivative instruments it enters into under the provisions of SFAS 133, "Accounting for Derivative Instruments and Hedging Activities," and SFAS 137, SFAS 138 and SFAS 149, which were amendments to SFAS 133 (hereinafter collectively referred to as "SFAS 133"). SFAS 133 requires that every derivative instrument (including certain derivative instruments embedded in other contracts) be recorded in the statement of financial position, as either an asset or liability, measured at its fair value. SFAS 133 also requires that changes in the derivative's fair value be recognized currently in earnings unless specific hedge accounting criteria are met. Special accounting for qualifying hedges allows a derivative's gains and losses to offset related results on the hedged item in the statement of operations, and requires that a company must formally document, designate, and assess the effectiveness of transactions that receive hedge accounting. For derivatives designated as cash flow hedges, changes in fair value are recorded in comprehensive income for the portion of the change in value of the derivative that is an effective hedge.

An affiliate in which the Company has a 50% ownership interest (Eaton Rapids Gas Storage System or "ERGSS") uses a floating-to-fixed interest rate swap agreement to hedge the variable interest rate payments