

## *Second Quarter 2008 Compared with Second Quarter 2007*

### Revenue

Regulated natural gas utility segment revenue increased \$98.0 million, driven by the following:

- An approximate 28% increase in the per-unit cost of natural gas over all of the regulated natural gas utilities in the second quarter of 2008, compared to the second quarter of 2007. For all of Integrys Energy Group's regulated natural gas utilities, natural gas commodity costs are directly passed through to customers in rates.
- An annual rate increase for PGL of \$71.2 million, which was effective February 14, 2008. PGL will use the new rate structure to continue to enhance natural gas delivery safety, reliability, and customer service. The new rate structure also includes several tools that provide the company the opportunity to recover the fixed costs of operating its natural gas delivery system while also better aligning the energy efficiency interests of the company with those of consumers, regulators, and elected officials.
- A combined 4.5% increase in natural gas throughput volumes. In general, the increase in natural gas throughput volumes was driven by colder quarter-over-quarter weather conditions across all of the natural gas utilities.

### Margin

The regulated natural gas utility segment margin increased \$23.5 million, driven by:

- The 2008 rate increase for PGL (discussed above), which had an estimated \$18 million positive quarter-over-quarter impact on margin.
- An increase in natural gas throughput volumes, driven by colder weather conditions, which had an estimated \$3 million positive quarter-over-quarter impact on margin.

### Operating Income

Operating income increased \$9.1 million, a result of the \$23.5 million increase in the regulated natural gas utility margin, partially offset by a \$14.4 million increase in operating expenses.

The increase in operating expenses were primarily related to the following:

- A non-cash goodwill impairment loss of \$6.5 million after-tax recognized for NSG. See Note 7, "Goodwill and Other Intangible Assets," for more information.
- A quarter-over-quarter increase of \$3.1 million related to street restoration costs at PGL.
- A \$2.0 million increase in the amortization of costs to achieve synergies and costs related to the 2007/2008 rate case, which were initially deferred as regulatory assets. The increase in operating expenses related to these costs was offset in margin. As a result, there was no significant impact on earnings related to the amortization of these regulatory assets.

## *Six Months 2008 Compared with Six Months 2007*

### Revenue

Regulated natural gas utility segment revenue increased \$676.7 million, driven by:

- A combined increase in PGL and NSG natural gas utility revenue of \$575.0 million, from \$523.1 million of natural gas utility revenue and approximately 0.6 billion therms of natural gas throughput volumes recognized during the six months ended June 30, 2007, to \$1,098.1 million of natural gas utility revenue and approximately 1.4 billion therms of natural gas throughput volumes recognized during the six months ended June 30, 2008. The increase in revenue at both of these natural gas utilities was driven primarily by the fact that they were not acquired until February 21, 2007 in addition to higher period-over-period natural gas prices. PGL was also positively impacted by an annual rate increase of \$71.2 million, effective February 14, 2008. Both PGL and NSG also experienced colder than normal weather conditions prior to February 14, 2008, which had a positive impact on revenue.
- An increase in natural gas revenue of \$101.7 million at the remaining natural gas utilities (WPSC, MERC, and MGUC), driven by the following:
  - An approximate 14% increase in the per-unit cost of natural gas related to these natural gas utilities during the six months ended June 30, 2008, compared with the same period in 2007.
  - A combined 10.3% increase in natural gas throughput volumes at WPSC, MERC, and MGUC. This increase was driven by an 8.8% increase in residential volumes and a 9.2% increase in commercial and industrial volumes. The increase in sales volumes to residential and commercial and industrial customers was driven by colder weather conditions during the 2008 heating season, evidenced by an approximate 10% increase in heating degree days for the six months ended June 30, 2008, compared with the same period in 2007 across these three utilities.
  - WPSC receiving the benefit of its 2007 retail natural gas rate increase for the entire six months ended June 30, 2008, whereas this rate increase did not benefit 2007 natural gas utility results until its January 12, 2007 effective date.

### Margin

The regulated natural gas utility segment margin increased \$173.3 million, driven by:

- A period-over-period increase in the combined margin at PGL and NSG of \$162.6 million, from \$167.7 million for the six months ended June 30, 2007, to \$330.3 million for the same period in 2008. The increase in the margin at both of these natural gas utilities was driven by the fact that they were not acquired until February 21, 2007. Therefore, their operations for the entire heating season during the six months ended June 30, 2008, were included in the 2008 natural gas utility margin. However, only operations from the acquisition date through June 30, 2007, were included in the 2007 natural gas utility margin. Due to the seasonal nature of natural gas utilities, higher margins are generally derived during the heating season (first and fourth quarters). A 2008 rate increase for PGL and colder than normal weather conditions experienced by both PGL and NSG before the Volume Balancing Adjustment rider went into effect in March 2008 also favorably impacted margins.
- An increase in natural gas margin of \$10.7 million at the remaining natural gas utilities (WPSC, MERC, and MGUC), driven by the following:
  - An increase in natural gas throughput volumes at WPSC, MERC, and MGUC. Colder period-over-period weather conditions contributed \$8.5 million to the increase in margin.

- The delay in the effective date of WPSC's 2007 rate increase, which had an estimated \$1 million favorable impact on natural gas margin for the six months ended June 30, 2008, compared with the same period in 2007.

### Operating Income

Operating income increased \$68.2 million, driven by a \$173.3 million increase in the regulated natural gas utility margin, partially offset by a \$105.1 million increase in operating expenses.

The increase in operating expenses was primarily related to an increase in combined operating expenses at PGL and NSG of \$109.8 million, from \$146.9 million for the six months ended June 30, 2007, to \$256.7 million for the same period in 2008. The increase in operating expenses at PGL and NSG is primarily due to the fact that the natural gas operations of both of these businesses were first included in results of operations beginning February 22, 2007, compared with these operations contributing a full six months of operating expenses during 2008. In addition, a non-cash goodwill impairment of \$6.5 million after-tax was recognized in 2008 for NSG.

### **Regulated Electric Segment Operations**

<i>(Millions, except heating and cooling degree days)</i>	Three Months Ended		% Increase (Decrease)	Six Months Ended		% Increase (Decrease)
	June 30 2008	June 30 2007		June 30 2008	June 30 2007	
Revenues	\$311.1	\$305.2	1.9%	\$640.3	\$604.4	5.9%
Fuel and purchased power costs	149.0	160.4	(7.1)%	334.4	310.7	7.6%
Margins	162.1	144.8	11.9%	305.9	293.7	4.2%
Operating and maintenance expense	91.6	83.5	9.7%	188.7	167.4	12.7%
Depreciation and amortization expense	21.4	20.4	4.9%	40.2	40.6	(1.0)%
Taxes other than income	11.1	10.7	3.7%	22.2	21.6	2.8%
Operating income	\$ 38.0	\$ 30.2	25.8%	\$ 54.8	\$ 64.1	(14.5)%
<b>Sales in kilowatt-hours</b>						
Residential	668.2	723.5	(7.6)%	1,518.3	1,562.1	(2.8)%
Commercial and industrial	2,119.1	2,162.5	(2.0)%	4,297.9	4,265.7	0.8%
Wholesale	1,175.1	1,013.8	15.9%	2,305.6	1,995.5	15.5%
Other	8.3	8.5	(2.4)%	21.3	20.5	3.9%
Total sales in kilowatt-hours	3,970.7	3,908.3	1.6%	8,143.1	7,843.8	3.8%
<b>Weather</b>						
WPSC:						
Heating degree days	920	850	8.2%	4,875	4,402	10.7%
Cooling degree days	104	204	(49.0)%	104	204	(49.0)%
UPPCO:						
Heating degree days	1,518	1,296	17.1%	5,773	5,326	8.4%
Cooling degree days	29	112	(74.1)%	29	112	(74.1)%

## *Second Quarter 2008 Compared with Second Quarter 2007*

### Revenue

Regulated electric revenue increased \$5.9 million, driven by:

- A final rate order issued by the PSCW effective January 16, 2008, that allowed for a \$23.0 million (2.5%) retail electric rate increase. Per the PSCW's order approving the PEC merger, WPSC may not increase its base rates for natural gas or electric service prior to January 1, 2009. However, WPSC was allowed to adjust rates for changes in purchased power costs as well as fuel costs related to electric generation due to changes in NYMEX natural gas futures prices, delivered coal prices, and transmission costs. The increase also included recovery of deferred 2005 and 2006 MISO Day 2 costs over a one-year period.
- An interim rate increase approved by the PSCW for WPSC's retail electric customers effective March 22, 2008, related to higher fuel and purchased power costs. Contributing factors in the rate change, which obtained final approval from the PSCW on July 4, 2008, were increased purchased power costs due to lower-than-expected generation from the new Weston 4 power plant during the start-up phases, increased coal and coal transportation costs, and increased natural gas costs.
- A 1.6% increase in electric sales volumes, including a 15.9% increase in volumes sold to lower margin wholesale customers, partially offset by a 7.6% and 2.0% decrease in sales volumes, respectively, to higher margin residential and commercial and industrial customers. The increase in sales volumes to wholesale customers was driven by higher contracted sales volumes to a large wholesale customer quarter-over-quarter as well as an increase in opportunity sales as WPSC had more low-cost generation with Weston 4 generating power for much of the 2008 second quarter. The decrease in sales volumes to residential and commercial and industrial customers was driven by cooler than normal quarter-over-quarter weather conditions, which led to a decrease in air conditioning load. In addition, high energy prices and a general slowdown in the economy led to more energy conservation quarter-over-quarter.

### Margin

The regulated electric margin increased \$17.3 million, driven by the following:

- A \$13.5 million partial refund by WPSC to Wisconsin retail customers in the second quarter of 2007 of their portion of proceeds from the liquidation of the Kewaunee nonqualified decommissioning trust fund. Pursuant to regulatory accounting, the decrease in the 2007 margin related to the refund was offset by a corresponding decrease in operating and maintenance expenses in 2007 and, therefore, did not have an impact on earnings. WPSC completed the refund of proceeds received from the liquidation of the Kewaunee nonqualified decommissioning trust fund to Wisconsin retail customers in 2007.
- Fuel and purchased power costs at WPSC that were approximately \$7 million lower than what was recovered in rates during the quarter ended June 30, 2008, compared with fuel and purchased power costs that were approximately \$2 million higher than what was recovered in rates during the same quarter in 2007, which drove a \$9 million increase in margin quarter-over-quarter. As a result of approximately \$23 million of higher than anticipated fuel and purchased power costs in the first quarter of 2008, the PSCW approved an interim rate increase effective March 22, 2008, and subsequently approved a higher final rate increase effective July 4, 2008. In the second quarter of 2008, the interim rate increase enabled WPSC to recover approximately \$7 million of the \$23 million of under-recovered fuel and purchased power costs incurred in the first quarter of 2008. With the approved rate increase and assuming stable fuel costs, WPSC anticipates it will recover approximately 80% of the remaining \$16 million of unrecovered fuel and purchased power costs by year-end.

- The effect of the 2008 retail electric rate increase at WPSC that was effective January 16, 2008 (discussed above).
- Partially offsetting the increase in overall electric margin, unfavorable weather conditions drove an approximate \$2 million quarter-over-quarter decrease in WPSC's electric utility margin, and customer conservation efforts drove an approximate \$4 million quarter-over-quarter decrease in WPSC's electric utility margin.

### Operating Income

Operating income increased \$7.8 million, driven by the \$17.3 million increase in margin discussed above, partially offset by a \$7.9 million increase in operating and maintenance expenses at WPSC.

The increase in operating and maintenance expenses at WPSC was the result of:

- An increase in operating expenses of \$13.5 million quarter-over-quarter, related to the partial amortization in the second quarter of 2007 of the regulatory liability previously recorded for WPSC's obligation to refund proceeds received from the liquidation of the Kewaunee nonqualified decommissioning trust fund to Wisconsin retail electric ratepayers.
- An increase in regulated electric transmission expenses of \$2.5 million, primarily related to higher rates charged by MISO and ATC due to additional transmission costs.

The increase in operating and maintenance expenses at WPSC was offset by:

- A decrease in regulated electric maintenance expenses of \$5.8 million, primarily due to major planned outages at the Weston 3 generation station and the De Pere Energy Center in the second quarter of 2007, compared with fewer plant outages in the second quarter of 2008.
- A decrease in pension and postretirement benefits resulting from plan design changes and merger synergies.

### *Six Months 2008 Compared with Six Months 2007*

#### Revenue

Regulated electric revenue increased \$35.9 million, driven by:

- A final rate order by the PSCW, effective January 16, 2008, that allowed for a \$23.0 million (2.5%) retail electric rate increase (discussed in more detail above).
- An interim rate increase approved by the PSCW for WPSC's retail electric customers effective March 22, 2008 related to higher fuel and purchased power costs.
- A 3.8% increase in electric sales volumes, including a 15.5% increase in volumes sold to lower margin wholesale customers, partially offset by a 2.8% decrease in sales volumes to higher margin residential customers. The increase in sales volumes to wholesale customers was driven by higher contracted sales volumes to a large wholesale customer period-over-period as well as an increase in opportunity sales as WPSC had more low-cost generation with Weston 4 generating power for much of the 2008 second quarter. The decrease in sales volumes to residential customers was driven by high energy prices and a general slowdown in the economy, which led to more energy conservation during the six months ended June 30, 2008, compared with the same period in 2007.
- WPSC having the full benefit in 2008 of the 2007 retail electric rate increase effective January 12, 2007 for WPSC's electric customers in Wisconsin.

### Margin

The regulated electric margin increased \$12.2 million, driven by an increase in electric margin at WPSC.

The \$13.0 million (4.9%) increase in the electric margin at WPSC was a result of:

- The effect of the 2008 retail electric rate increase (that was effective January 16, 2008) and the 2007 retail electric rate increase (described above).
- A \$27.0 million partial refund to Wisconsin retail customers in the six months ended June 30, 2007, of their portion of proceeds from the liquidation of the Kewaunee nonqualified decommissioning trust fund. Pursuant to regulatory accounting, the decrease in the 2007 margin related to the refund was offset by a corresponding decrease in operating and maintenance expenses in 2007 and, therefore, did not have an impact on earnings.

The regulated electric margin increase at WPSC was offset by:

- Fuel and purchased power costs at WPSC that were approximately \$16 million higher than what was recovered in rates during the six months ended June 30, 2008, compared with fuel and purchased power costs that were approximately \$1 million less than what was recovered in rates during the same period in 2007. This drove a \$17 million decrease in margin period-over-period.
- An approximate \$4 million decrease in WPSC's regulated electric margin due to lower residential volumes discussed above.

### Operating Income

Regulated electric operating income decreased \$9.3 million, driven by a \$19.2 million increase in operating and maintenance expenses at WPSC, partially offset by the \$12.2 million increase in regulated electric margin discussed above.

The \$19.2 million (12.9%) increase in operating and maintenance expenses at WPSC was driven by the following:

- A \$27.0 million increase for the six months ended June 30, 2008, over the same period in 2007, relating to the partial amortization in 2007 of the regulatory liability previously recorded for WPSC's obligation to refund proceeds received from the liquidation of the Kewaunee nonqualified decommissioning trust fund to Wisconsin retail electric ratepayers.
- A \$5.1 million increase in regulated electric transmission expenses, primarily related to higher rates charged by MISO and ATC due to additional transmission costs.

The increases in operating and maintenance expenses at WPSC were offset by the following:

- A \$10.1 million decrease in regulated electric maintenance expenses at WPSC, primarily due to major planned outages at the Weston 2 and Weston 3 generation stations and the De Pere Energy Center in the first half of 2007, compared with fewer plant outages during the same period in 2008.
- A decrease in pension, postretirement expenses, and medical benefit costs resulting from plan design changes and merger synergies.

## Integrys Energy Services' Operations

Integrys Energy Services is a diversified nonregulated energy supply and services company serving residential, commercial, industrial, and wholesale customers in developed competitive markets in the United States and Canada.

### **Integrys Energy Services' Segment Results of Operations**

<i>(Millions, except natural gas sales volumes)</i>	Three Months Ended June 30		% Increase (Decrease)	Six Months Ended June 30		% Increase (Decrease)
	2008	2007		2008	2007	
Revenues	\$2,600.6	\$1,648.4	57.8%	\$5,014.7	\$3,423.8	46.5%
Cost of fuel, natural gas, and purchased power	2,544.1	1,649.9	54.2%	4,827.4	3,316.6	45.6%
<b>Margins</b>	<b>56.5</b>	<b>(1.5)</b>	<b>-%</b>	<b>187.3</b>	<b>107.2</b>	<b>74.7%</b>
<b>Margin Detail</b>						
Electric and other margins	100.8	(20.1)	-%	227.9	51.8	340.0%
Natural gas margins	(44.3)	18.6	-%	(40.6)	55.4	-%
Operating and maintenance expense	41.2	44.3	(7.0%)	81.4	75.9	7.2%
Depreciation and amortization	3.5	2.8	25.0%	7.0	5.6	25.0%
Taxes other than income taxes	1.4	1.7	(17.6%)	4.1	4.4	(6.8%)
<b>Operating Income</b>	<b>\$ 10.4</b>	<b>\$ (50.3)</b>	<b>-%</b>	<b>\$ 94.8</b>	<b>\$ 21.3</b>	<b>345.1%</b>

#### **Gross volumes (includes volumes both physically delivered and net settled)**

Wholesale electric sales volumes in kwh	41,125.2	29,412.1	39.8%	81,665.2	55,482.8	47.2%
Retail electric sales volumes in kwh	4,066.0	3,467.5	17.3%	8,044.7	5,954.5	35.1%
Wholesale natural gas sales volumes in bcf	148.6	112.4	32.2%	291.9	224.7	29.9%
Retail natural gas sales volumes in bcf	73.8	87.4	(15.6%)	181.9	199.3	(8.7%)

#### **Physical volumes (includes only transactions settled physically for the periods shown) \***

Wholesale electric sales volumes in kwh	1,072.8	607.9	76.5%	2,120.5	1,323.3	60.2%
Retail electric sales volumes in kwh	4,036.7	3,419.8	18.0%	7,989.4	5,859.2	36.4%
Wholesale natural gas sales volumes in bcf	137.4	105.5	30.2%	265.5	203.4	30.5%
Retail natural gas sales volumes in bcf	73.3	73.5	(0.3%)	180.9	165.0	9.6%

\* Represents gross physical volumes.

kwh – kilowatt-hours  
bcf – billion cubic feet

### Revenue

- Revenues increased \$952.2 million quarter-over-quarter and \$1,590.9 million for the six months ended June 30, 2008, compared with the same period in 2007, primarily resulting from higher energy prices and increased sales volumes (in part due to the addition of the nonregulated energy operations of PEC in February 2007).

## **Margins**

Integrys Energy Services' margins increased \$58.0 million in the second quarter of 2008, compared with the second quarter of 2007, and \$80.1 million for the six months ended June 30, 2008, compared with the six months ended June 30, 2007. The table below provides a summary of the significant items contributing to the change in margin. "Other significant items" in the table below are generally related to the timing of gain and loss recognition of certain transactions and, prior to January 1, 2008, the settlement of the derivative instruments used to protect the value of former Section 29/45K federal tax credits.

	Increase (Decrease) in Margin for Three Months Ended June 30, 2008 Compared with Three Months Ended June 30, 2007	Six Months Ended June 30, 2008 Compared with Six Months Ended June 30, 2007
<b><u>(Millions except natural gas sales volumes)</u></b>		
<b><u>Electric and other margins</u></b>		
Realized gains on structured origination contracts	\$ 1.6	\$ 2.7
Realized retail electric margin	1.2	20.3
All other realized wholesale electric margin	(2.4)	(8.2)
Other significant items:		
Oil option activity	(0.2)	(1.2)
Retail and wholesale fair value adjustments *	120.7	162.5
Net increase in electric and other margins	120.9	176.1
<b><u>Natural gas margins</u></b>		
Realized natural gas margins	21.9	25.9
Other significant items:		
Mass market supply options	(0.2)	(0.8)
Spot to forward differential	(2.0)	1.2
Other fair value adjustments *	(82.6)	(122.3)
Net decrease in natural gas margins	(62.9)	(96.0)
Net increase in Integrys Energy Services' margin	\$ 58.0	\$ 80.1

\* Combined, for the six months ended June 30, 2008, these two line items included a total of \$11.5 million of gains resulting from the adoption of SFAS No. 157 in the first quarter of 2008. See Note 18, "Fair Value," for more information.

### *Second Quarter 2008 Compared with Second Quarter 2007*

#### **Electric and Other Margins**

Integrys Energy Services' electric and other margins increased \$120.9 million in the second quarter 2008, compared with the second quarter 2007. The second quarter 2008 electric and other margins included the negative impact of \$3.9 million of amortization related to purchase accounting adjustments required as a result of the PEC merger, compared with a \$6.5 million negative impact in the second quarter of 2007. The following items were the most significant contributors to the change in Integrys Energy Services' electric and other margins.

#### **Realized gains on structured origination contracts**

Realized gains on structured origination contracts increased \$1.6 million, from \$4.4 million in the second quarter 2007, to \$6.0 million in the second quarter 2008. Origination contracts are physical, customer-based agreements with municipalities, merchant generators, cooperatives, and regulated utilities. The increase was primarily due to continued growth in existing markets in the Midwest and northeastern United States, as well as expansion into markets in the western United States.

### Realized retail electric margin

The realized retail electric margin increased \$1.2 million, from \$6.2 million in the second quarter 2007, to \$7.4 million in the second quarter 2008. The increase was driven by increased margins in Illinois and expansion into the Mid-Atlantic region, partially offset by lower margins in New England and Texas resulting from an increase in ancillary service cost. Because Integrys Energy Services has fixed price contracts with many of its electric customers, it was not able to pass all of the increased charges for ancillary services on to its customers.

### All other realized wholesale electric margin

All other realized wholesale electric margin decreased \$2.4 million, from \$19.3 million for quarter ended June 30, 2007, to \$16.9 million for the quarter ended June 30, 2008. Integrys Energy Services seeks to reduce market price risk and extract additional value from its generation and energy contract portfolios through various financial and physical instruments (such as forward contracts, options, financial transmission rights, and capacity contracts). Period-by-period variability in the margin contributed by Integrys Energy Services' optimization strategies, generation facilities, and trading activities is expected due to changing market conditions. A diverse mix of products and markets, combined with disciplined execution and exit strategies, allows Integrys Energy Services to generate economic value and earnings from these activities while staying within the value-at-risk (VaR) limits authorized by Integrys Energy Group's Board of Directors. For more information on VaR, see Item 3, "Quantitative and Qualitative Disclosures about Market Risk."

### Oil option activity

Oil option activity drove a \$0.2 million decrease in electric and other margins in the second quarter 2008, compared with the second quarter 2007. Gains related to derivative accounting required fair value adjustments on oil options were \$0.2 million in the second quarter of 2007. The oil options, which were used to protect the value of the former Section 29/45K tax credits, were settled at the end of 2007, as the legislation that provided for Section 29/45K federal tax credits from the production and sale of synthetic fuel expired effective December 31, 2007.

### Retail and wholesale fair value adjustments

Integrys Energy Services' margin from retail and wholesale fair value adjustments increased \$120.7 million in the second quarter of 2008, compared with the same quarter in 2007. Earnings volatility results from the application of derivative accounting rules to customer supply contracts (requiring that these derivative instruments be reflected at fair market value), without a corresponding offset related to the customer sales contracts, which are not considered derivative instruments. These non-cash gains and losses will vary each period, and ultimately reverse as the related customer sales contracts settle. As a result, Integrys Energy Services generally experiences unrealized losses on supply contracts in periods of declining market prices and unrealized gains in periods of increasing market prices.

### **Natural Gas Margins**

Integrys Energy Services' natural gas margins decreased \$62.9 million in the second quarter of 2008, compared with the second quarter of 2007. The second quarter 2008 natural gas margins included the positive impact of \$1.5 million of amortization related to purchase accounting adjustments required as a result of the PEC merger, compared with a \$0.5 million positive impact related to purchase accounting adjustments in the second quarter of 2007. The following items were the most significant contributors to the change in Integrys Energy Services' natural gas margins.

### Realized natural gas margins

Realized natural gas margins increased \$21.9 million, from \$18.0 million in the second quarter of 2007, to \$39.9 million during the same quarter in 2008. The increased natural gas margin was driven by realized wholesale natural gas margins that were \$15.8 million higher quarter-over-quarter primarily as a result of realized gains on natural gas storage transactions and increased emphasis on structured wholesale natural gas transactions through continued expansion into new markets. The structured transactions involve serving customers such as regulated utilities, pipelines, retail marketers, and other large end users of natural gas. The margin from retail natural gas operations in Illinois also increased \$4.6 million quarter-over-quarter, driven by further market penetration in Illinois and a quarter-over-quarter reduction in the amortization of certain customer contracts that were required to be marked to fair value and recorded as intangible assets as a result of the acquisition of the nonregulated operations of PEC.

### Mass-market supply options

Integrus Energy Services uses options to manage supply costs for mass-market customers and reduce the risk of price movements, customer migration, and changes in consumer consumption patterns. Earnings volatility results from the application of derivative accounting rules to the options (requiring that these derivative instruments be reflected at fair market value), without a corresponding offset related to the customer contracts. Full requirements natural gas contracts with Integrus Energy Services' customers are not considered derivatives and, therefore, no gain or loss is recognized on these contracts until settlement. The unrealized gains and losses on options will reverse as the related customer sales contracts settle.

In the second quarter of 2008, options utilized to manage supply costs for mass-market customers drove a \$0.2 million decrease in Integrus Energy Services' natural gas margin. These options had a negative \$0.1 million impact on margin in the second quarter 2008, compared with a \$0.1 million positive impact on margin in second quarter 2007.

### Spot to forward differential

Integrus Energy Services experiences earnings volatility associated with the natural gas storage cycle, which runs annually from April through March of the next year. Generally, injections of natural gas into storage inventory take place in the summer months and natural gas withdrawals take place in the winter months. Integrus Energy Services' policy is to hedge the value of natural gas storage with contracts in the over-the-counter and futures markets, effectively locking in a margin on the natural gas in storage. However, fair market value hedge accounting rules require the natural gas in storage to be reflected at fair market value using spot prices, while the future sales contracts are reflected at fair value using forward prices. When the spot price of natural gas changes disproportionately to the forward price of natural gas, Integrus Energy Services experiences volatility in its earnings. Consequently, earnings volatility may occur within the contract period for natural gas in storage. The accounting treatment does not affect the underlying cash flows or economics of these transactions.

The natural gas storage cycle had a \$2.0 million negative quarter-over-quarter impact on natural gas margins. For the second quarter of 2008, the natural gas storage cycle had a \$0.1 million positive impact on margin, compared with a \$2.1 million positive impact on margin for the same quarter in 2007. At June 30, 2008, the market value of natural gas in storage was \$1.3 million less than the market value of future sales contracts (net unrealized loss) related to the 2008/2009 natural gas storage cycle. This difference will vary with market conditions and will reverse entirely having a positive impact on margin when all of the natural gas is withdrawn from storage.

### Other fair value adjustments

Other derivative accounting required fair value adjustments primarily relates to changes in the fair market value of basis swaps utilized to mitigate market price risk associated with natural gas transportation contracts and certain natural gas sales contracts, as well as contracts utilized to mitigate market price risk related to certain natural gas storage contracts. Earnings volatility results from the application of derivative accounting rules to the basis and other swaps (requiring that these derivative instruments be reflected at fair market value), without a corresponding offset related to the physical natural gas transportation contracts, the natural gas sales contracts, or the natural gas storage contracts (as these contracts are not considered derivative instruments). Therefore, there is no gain or loss recognized on the transportation contracts, customer sales contracts, or natural gas storage contracts until physical settlement of these contracts occurs.

The impact of the fair value adjustments discussed above drove an \$82.6 million decrease in the natural gas margins as unrealized losses on these instruments were \$84.2 million in the second quarter of 2008, compared with unrealized losses of \$1.6 million for the second quarter of 2007.

### Operating Income

Second quarter operating income at Integrys Energy Services increased \$60.7 million, from a \$50.3 million operating loss in 2007 to \$10.4 million of operating income in 2008. This increase results primarily from the \$58.0 million quarter-over-quarter increase in margin discussed above, as well as a \$3.1 million quarter-over-quarter decrease in operating and maintenance expense. Operating and maintenance expense decreased from \$44.3 million in the second quarter of 2007 to \$41.2 million in the second quarter of 2008, driven by approximately \$3 million of costs incurred in the second quarter of 2007 to repair a failed blade at one of Integrys Energy Services' merchant generation plants.

### *Six Months 2008 Compared with Six Months 2007*

#### **Electric and Other Margins**

Integrys Energy Services' electric and other margins increased \$176.1 million during the six months ended June 30, 2008, compared with the six months ended June 30, 2007. For the six months ended June 30, 2008, electric and other margins included the negative impact of \$5.5 million of amortization related to purchase accounting adjustments required as a result of the PEC merger, compared with a \$9.4 million negative impact for the six months ended June 30, 2007. The following items were the most significant contributors to the change in Integrys Energy Services' electric and other margins.

#### **Realized gains on structured origination contracts**

Realized gains on structured origination contracts increased \$2.7 million, from \$8.8 million for the six months ended June 30, 2007, to \$11.5 million in the six months ended June 30, 2008. Origination contracts are physical, customer-based agreements with municipalities, merchant generators, cooperatives, and regulated utilities. The increase was primarily due to continued growth in existing markets in the Midwest and northeastern United States, as well as expansion into markets in the western United States.

#### **Realized retail electric margin**

The realized retail electric margin increased \$20.3 million from \$4.4 million during the six months ended June 30, 2007, to \$24.7 million during the six months ended June 30, 2008. The increase was driven by the addition of new customers in Illinois as a result of the PEC merger, expansion into the Mid-Atlantic region and the resolution of certain regulatory issues in Northern Maine.

### All other realized wholesale electric margin

All other wholesale electric margin decreased \$8.2 million, from \$30.4 million for six months ended June 30, 2007, to \$22.2 million for the six months ended June 30, 2008. Integrys Energy Services seeks to reduce market price risk and extract additional value from its generation and energy contract portfolios through various financial and physical instruments (such as forward contracts, options, financial transmission rights, and capacity contracts). Period-by-period variability in the margin contributed by Integrys Energy Services' optimization strategies, generation facilities, and trading activities is expected due to changing market conditions. A diverse mix of products and markets, combined with disciplined execution and exit strategies, allows Integrys Energy Services to generate economic value and earnings from these activities while staying within the value-at-risk (VaR) limits authorized by Integrys Energy Group's Board of Directors. For more information on VaR, see Item 3, "Quantitative and Qualitative Disclosures about Market Risk."

### Oil option activity

Oil option activity drove a \$1.2 million decrease in electric and other margins in the six months ended June 30, 2008, compared with the six months ended June 30, 2007. Unrealized gains on oil options were \$1.2 million in the six months ended June 30, 2007. The oil options used to protect the value of former Section 29/45K tax credits settled at the end 2007, as the legislation that provided for Section 29/45K federal tax credits from the production and sale of synthetic fuel expired effective December 31, 2007.

### Retail and wholesale fair value adjustments

Integrys Energy Services' margin from retail and wholesale derivative accounting required fair value adjustments increased \$162.5 million during the six months ended June 30, 2008, compared with the same period in 2007. Earnings volatility results from the application of derivative accounting rules to customer supply contracts (requiring that these derivative instruments be reflected at market value), without a corresponding offset related to the customer sales contracts, which are not considered derivative instruments. These non-cash gains and losses will vary each period, and ultimately reverse as the related customer sales contracts settle. As a result, Integrys Energy Services generally experiences unrealized losses on supply contracts in periods of declining market prices and unrealized gains in periods of increasing market prices.

### **Natural Gas Margins**

Integrys Energy Services' natural gas margins decreased \$96.0 million during the six months ended June 30, 2008, compared with the six months ended June 30, 2007. During the six months ended June 30, 2008, natural gas margins included the negative impact of \$6.5 million of amortization related to purchase accounting adjustments required as a result of the PEC merger, compared with no significant impact related to purchase accounting adjustments during the six months ended June 30, 2007. The following items were the most significant contributors to the change in Integrys Energy Services' natural gas margins.

### Realized natural gas margins

Realized natural gas margins increased \$25.9 million, from \$56.7 million in 2007, to \$82.6 million in 2008. The higher realized natural gas margin was primarily related to an \$18.6 million increase in realized wholesale natural gas margins, driven by realized gains on natural gas storage transactions and increased emphasis on structured wholesale natural gas transactions through continued expansion into new markets. The margin from retail natural gas operations in Illinois also increased \$7.2 million period-over-period, driven by further market penetration in Illinois.

### Mass-market supply options

During the six months ended June 30, 2008, options utilized to manage supply costs for mass-market customers drove a \$0.8 million decrease in Integrys Energy Services' natural gas margin. These options had a \$1.6 million positive impact on margin in the six months ended June 30, 2008, compared with a \$2.4 million positive impact on margin in six months ended June 30, 2007.

### Spot to forward differential

The natural gas storage cycle had a \$1.2 million positive impact on natural gas margins for the six months ended June 30, 2008, compared with the same period in 2007. For the six months ended June 30, 2008, the natural gas storage cycle had a \$4.3 million positive impact on margin, compared with a \$3.1 million positive impact on margin for the same period in 2007.

### Other fair value adjustments

Other fair value adjustments caused by derivative accounting treatment primarily relate to changes in the fair market value of basis swaps utilized to mitigate market price risk associated with natural gas transportation contracts and certain natural gas sales contracts, as well as contracts utilized to mitigate market price risk related to certain natural gas storage contracts. Earnings volatility results from the application of derivative accounting rules to the basis and other swaps (requiring that these derivative instruments be reflected at fair value), without a corresponding offset related to the physical natural gas transportation contracts, the natural gas sales contracts, or the natural gas storage contracts (as these contracts are not considered derivative instruments). Therefore, there is no gain or loss recognized on the transportation contracts, customer sales contracts, or natural gas storage contracts until physical settlement of these contracts occurs.

The impact of the fair value adjustments discussed above drove a \$122.3 million decrease in the natural gas margins as unrealized losses on these instruments were \$129.1 million in the six months ended June 30, 2008, compared with unrealized losses of \$6.8 million for the six months ended June 30, 2007.

### Operating Income

Integrys Energy Services' operating income for the six months ended June 30, 2008 increased \$73.5 million, from \$21.3 million in 2007 to \$94.8 million in 2008. This increase results from the \$80.1 million increase in margin discussed above, partially offset by a \$5.5 million increase in operating and maintenance expense. Operating and maintenance expense increased from \$75.9 million during the six months ended June 30, 2007 to \$81.4 million during the six months ended June 30, 2008. The increase in operating and maintenance expense was driven by higher payroll and benefit costs related to additional employees required as a result of continued business expansion activities at Integrys Energy Services (the most significant of which related to the integration of PEC's nonregulated operations into Integrys Energy Services).

### Holding Company and Other Segment Operations

<i>(Millions)</i>	Three Months Ended		% Increase (Decrease)	Six Months Ended		% Increase (Decrease)
	June 30 2008	June 30 2007		June 30 2008	June 30 2007	
Operating income (loss)	\$1.3	\$(7.3)	-%	\$3.0	\$(2.5)	-%

*Second Quarter 2008 Compared with Second Quarter 2007*

Operating income at the Holding Company and Other segment improved \$8.6 million during the quarter ended June 30, 2008 driven by reductions in operating expenses relating to severance, relocation, and other costs recorded in the first quarter of 2007 associated with the PEC merger. In addition, operating income of \$1.2 million was generated at IBS in the second quarter of 2008, related to return on capital included in its service charges. Operations at IBS, our wholly owned service company, did not commence until January 1, 2008.

*Six Months 2008 Compared with Six Months 2007*

Operating income at the Holding Company and Other segment improved \$5.5 million during the six months ended June 30, 2008.

The increase in operating income was driven by:

- Reductions in operating expenses related to severance, relocation, and other costs recorded during the first six months of 2007 associated with the PEC merger.
- Operating income of \$3.1 million generated at IBS during the six months ended June 30, 2008, which related to return on capital included in its service charges.
- Partially offsetting the increases discussed above was a \$7.8 million increase in operating expenses related to external costs to achieve merger synergies compared with the six months ended June 30, 2007. This increase was primarily because in March 2007 all external costs to achieve merger synergies incurred from July 2006 through March 2007 were reallocated from the Holding Company and Other segment (where they were initially recorded) to the other reportable segments, which are the beneficiaries of the synergy savings resulting from the costs to achieve. This had the impact of lowering operating expenses at the Holding Company and Other segment during the six months ended June 30, 2007.

**Consolidated Integrys Energy Group Other Income (Expense)**

<i>(Millions)</i>	Three Months Ended		% Increase (Decrease)	Six Months Ended		% Increase (Decrease)
	June 30 2008	June 30 2007		June 30 2008	June 30 2007	
Operating income (loss)	\$53.1	\$(33.9)	-%	\$287.8	\$149.2	92.9%
Miscellaneous income	22.7	21.6	5.1%	40.8	33.9	20.4%
Interest expense	(33.5)	(42.6)	(21.4)%	(71.4)	(79.0)	(9.6)%
Minority interest	-	-	-%	-	0.1	-
Other expense	(10.8)	(21.0)	(48.6)%	(30.6)	(45.0)	(32.0)%
Income (loss) before taxes	42.3	(54.9)	-%	257.2	104.2	146.8%
Provision (benefit) for income taxes	17.5	(15.3)	-%	95.8	26.6	260.2%
Income (loss) from continuing operations	24.8	(39.6)	-%	161.4	77.6	108.0%
Discontinued operations, net of tax	0.1	24.0	(99.6)%	0.1	47.0	(99.8)%
Income (loss) before preferred stock dividends of subsidiary	\$24.9	\$(15.6)	-%	\$161.5	\$124.6	29.6%

## *Second Quarter 2008 Compared with Second Quarter 2007*

### Miscellaneous Income

Miscellaneous income increased \$1.1 million, as a result of:

- A \$3.9 million increase in miscellaneous income from Integrys Energy Group's approximate 34% ownership interest in ATC. Integrys Energy Group recorded \$15.9 million of pre-tax equity earnings from ATC during the second quarter of 2008, compared with \$12.0 million of pre-tax equity earnings during the same quarter in 2007.
- A \$5.0 million loss recognized during the quarter ended June 30, 2007, related to Integrys Energy Services' former investment in a synthetic fuel facility. As of December 31, 2007, the synthetic fuel facility was shut down as the legislation that made Section 29/45K federal tax credits available as a result of the production and sale of synthetic fuel expired effective December 31, 2007, making continued operation of this facility uneconomical.
- The increase in miscellaneous income was partially offset by a \$5.4 million decrease in foreign currency gains at Integrys Energy Services' Canadian subsidiaries. These transactions are substantially hedged from an economic perspective and offset in margins, resulting in no significant impact on income available for common shareholders.

### Interest Expense

Interest expense decreased \$9.1 million, driven by the repayment of short-term borrowings used for working capital requirements at Integrys Energy Group. A portion of the proceeds received from the sale of PEP in September 2007 were used to pay down the short-term debt. Integrys Energy Services also experienced lower working capital requirements quarter-over-quarter.

### Provision for Income Taxes

	<b>Three Months Ended June 30</b>	
	<b>2008</b>	<b>2007</b>
Effective Tax Rate	<b>41.4%</b>	<b>27.9%</b>

Section 29/45K of the Internal Revenue Code that made tax credits available from the production and sale of synthetic fuel expired effective December 31, 2007, driving the change in the effective tax rate for the second quarter of 2008, compared with the second quarter of 2007.

### Discontinued Operations

Income from discontinued operations, net of tax, decreased \$23.9 million in the second quarter of 2008, compared with the second quarter of 2007.

- In September 2007, Integrys Energy Group completed the sale of PEP. During the quarter ended June 30, 2007, \$24.0 million of after-tax income from discontinued operations was recognized related to PEP.

For more information on the discontinued operations discussed above, see Note 4, "Discontinued Operations" and Note 21, "Segments of Business."

*Six Months 2008 Compared with Six Months 2007*

Miscellaneous Income

Miscellaneous income increased \$6.9 million, as a result of:

- A \$6.8 million increase in earnings from Integrys Energy Group's approximate 34% ownership interest in ATC. Integrys Energy Group recorded \$30.6 million of pre-tax equity earnings from ATC during the six months ended June 30, 2008, compared with \$23.8 million for the same period in 2007.
- A \$9.6 million loss recognized during the quarter ended June 30, 2007, related to Integrys Energy Services' former investment in a synthetic fuel facility.
- The increase in miscellaneous income was partially offset by a \$7.0 million decrease in foreign currency gains at Integrys Energy Services' Canadian subsidiaries. These transactions are substantially hedged from an economic perspective and offset in margins, resulting in no significant impact on income available for common shareholders.

Interest Expense

Interest expense decreased \$7.6 million and was primarily driven by:

- The repayment of short-term borrowings at Integrys Energy Group. A portion of the proceeds received from the sale of PEP in September 2007 was used to pay down the short-term debt. Integrys Energy Services also experienced lower working capital requirements quarter-over-quarter.
- The decrease in interest expense discussed above was partially offset by combined interest expense at PGL and NSG, which increased \$4.6 million from \$11.0 million during the six months ended June 30, 2007, to \$15.6 million for the same period in 2008. The increase in interest expense at PGL and NSG is primarily due to the fact that these companies were first acquired on February 21, 2007.

Provision for Income Taxes

	<b>Six Months Ended June 30 2008</b>	<b>2007</b>
Effective Tax Rate	<b>37.2%</b>	25.5%

Section 29/45K of the Internal Revenue Code that made tax credits available from the production and sale of synthetic fuel expired effective December 31, 2007, driving the increase in the effective tax rate for the six months ended June 30, 2008, compared with the six months ended June 30, 2007. For the six months ended June 30, 2007, our ownership in the synthetic fuel operation resulted in recognizing the tax benefit of Section 29/45K federal tax credits totaling \$8.0 million.

Discontinued Operations, Net of Tax

In September 2007, Integrys Energy Group completed the sale of PEP. During the six months ended June 30, 2007, \$32.2 million of after-tax income from discontinued operations was recognized related to PEP.

During 2007, Niagara Generation, LLC recognized after-tax income of \$14.8 million, due to the \$14.8 million after-tax gain recorded in discontinued operations related to the sale of this facility in January 2007.

For more information on the discontinued operations discussed above, see Note 4, "Discontinued Operations" and Note 21, "Segments of Business."

## LIQUIDITY AND CAPITAL RESOURCES

We believe that our cash balances, liquid assets, operating cash flows, access to equity capital markets, and available borrowing capacity provide adequate resources to fund ongoing operating requirements and future capital expenditures related to expansion of existing businesses and development of new projects. However, our operating cash flows and access to capital markets can be impacted by macroeconomic factors outside of our control. In addition, our borrowing costs can be impacted by short-term and long-term debt ratings assigned by independent rating agencies. Currently, we believe our credit ratings are among the best in the energy industry.

### Operating Cash Flows

During the six months ended June 30, 2008, net cash provided by operating activities was \$435.4 million, compared with \$350.6 million for the same period in 2007. This \$84.8 million increase in cash provided by operating activities was primarily due to an increase in income available for common shareholders (adjusted for non-cash items) during the six months ended June 30, 2008, compared to the same period in 2007. The increase was also driven by the partial refund of proceeds of \$27.0 million received in 2005 from the liquidation of the nonqualified decommissioning trust fund to Wisconsin retail electric customers in the first half of 2007. The refund of the proceeds received from the liquidation of this trust to Wisconsin retail electric customers was completed in the fourth quarter of 2007.

### Investing Cash Flows

Net cash used for investing activities was \$131.9 million during the six months ended June 30, 2008, compared with \$195.2 million for the same period in 2007. The \$63.3 million period-over-period decrease in cash used for investing activities was primarily driven by the reimbursement of \$99.7 million from ATC related to the construction of the transmission facilities required to support Weston 4, partially offset by an increase in capital expenditures of \$43.5 million related to the construction of a natural gas lateral infrastructure, discussed below.

#### *Capital Expenditures*

Capital expenditures by business segment for the six months ended June 30 were:

<b>Reportable Segment (millions)</b>	<b>2008</b>	<b>2007</b>	<b>Increase/Decrease</b>
Electric utility	\$ 75.2	\$ 86.4	\$(11.2)
Natural gas utility	105.6	53.0	52.6
Integrys Energy Services	9.8	7.5	2.3
Holding company and other	7.9	8.1	(0.2)
<b>Integrys Energy Group consolidated</b>	<b>\$198.5</b>	<b>\$155.0</b>	<b>\$ 43.5</b>

The decrease in capital expenditures at the electric utility for the six months ended June 30, 2008, compared with the same period in 2007, was mainly due to a decrease in capital expenditures associated with the construction of Weston 4. Weston 4 was commercially operational in June 2008. The increase in capital expenditures at the natural gas utility segment for the six months ended June 30, 2008, compared with the same period in 2007, was primarily due to an increase in capital expenditures at PGL and NSG due to the fact that they were not acquired until February 21, 2007, as well as construction of a natural gas lateral infrastructure that will connect WPSC's natural gas distribution system to the Guardian II natural gas pipeline.

## **Financing Cash Flows**

Net cash used for financing activities was \$298.7 million during the six months ended June 30, 2008, compared with \$150.0 million for the same period in 2007. The \$148.7 million period-over-period increase in cash used for financing activities was primarily driven by the repayment of short-term borrowings, made possible by the reimbursement of \$99.7 million from ATC related to the construction of the transmission facilities required to support Weston 4. WPSC was required to finance the cost of the ATC interconnection during construction prior to Weston 4 becoming operational.

### *Significant Financing Activities*

Dividends paid increased during the six months ended June 30, 2008, over that paid for the same period in 2007, primarily as a result of the PEC merger. Integrys Energy Group issued 31.9 million shares of common stock in conjunction with the PEC merger. Integrys Energy Group's quarterly common stock dividend was also increased in February 2008, from 66 cents per share to 67 cents per share.

Integrys Energy Group had outstanding commercial paper borrowings of \$105.9 million and \$694.1 million at June 30, 2008, and 2007, respectively. Integrys Energy Group had other outstanding short-term debt of \$154.6 million as of June 30, 2008, and \$171.5 million as of June 30, 2007.

On April 17, 2008, PGL completed the purchase of \$51.0 million of Illinois Development Finance Authority Series 2003D Bonds, due October 1, 2037, and backed by PGL Series PP bonds. Upon repurchase, the Auction Rate Mode was converted from a 35-day mode to a weekly mode. This transaction was treated as a repurchase of the Series PP bonds by PGL. As a result, the liability related to the Series PP bonds was extinguished. The Company intends to hold the bonds while it continues to monitor the tax-exempt market and assess potential remarketing or refinancing opportunities.

Prior to January 1, 2008, Integrys Energy Group issued new shares of common stock under its Stock Investment Plan and certain stock-based employee benefit and compensation plans. As a result of the plans, equity increased \$25.2 million for the six months ended June 30, 2007. In the first six months of 2008, Integrys Energy Group purchased shares of its common stock on the open market to meet the requirements of its Stock Investment Plan and certain stock-based employee benefit and compensation plans.

In January 2007, WPSC used the proceeds from its \$22.0 million 3.95% tax exempt senior notes issued in December 2006 to the Village of Weston, Wisconsin, to repay the outstanding principal balance of the 6.90% first mortgage bonds which originally matured in 2013.

### Credit Ratings

The current credit ratings for Integrys Energy Group, WPSC, PEC, PGL, and NSG are listed in the table below.

<b>Credit Ratings</b>	<b>Standard &amp; Poor's</b>	<b>Moody's</b>
<b>Integrys Energy Group</b>		
Corporate credit rating	A-	n/a
Senior unsecured debt	BBB+	A3
Commercial paper	A-2	P-2
Credit facility	n/a	A3
Junior subordinated notes	BBB	Baa1
<b>WPSC</b>		
Issuer credit rating	A	A1
First mortgage bonds	A+	Aa3
Senior secured debt	A+	Aa3
Preferred stock	BBB+	A3
Commercial paper	A-2	P-1
Credit facility	n/a	A1
<b>PEC</b>		
Issuer credit rating	A-	n/a
Senior unsecured debt	BBB+	A3
<b>PGL</b>		
Issuer credit rating	A-	n/a
Senior secured debt	A-	A1
Commercial paper	A-2	P-1
<b>NSG</b>		
Issuer credit rating	A-	n/a
Senior secured debt	A	A1

We believe these ratings continue to be among the best in the energy industry and allow us to access commercial paper and long-term debt markets on favorable terms. Credit ratings are not recommendations to buy and are subject to change, and each rating should be evaluated independently of any other rating. None of the credit ratings for the issuers listed above, except WPSC's senior secured debt rating, changed since Integrys Energy Group filed its 2007 Annual Report on Form 10-K.

On March 13, 2008, Standard and Poor's raised the senior secured debt rating for WPSC one notch from A to A+. The new rating was a result of a review and changes made to the collateral coverage requirements Standard and Poor's uses when assigning recovery ratings to United States Utility First Mortgage Bonds.

### Discontinued Operations

Net cash provided by discontinued operations was \$3.1 million in the six months ended June 30, 2007, primarily related to proceeds received from the sale of Niagara in the first quarter of 2007. For the six months ended June 30, 2008, there was no cash provided by discontinued operations.

## Future Capital Requirements and Resources

### Contractual Obligations

The following table summarizes the contractual obligations of Integrys Energy Group, including its subsidiaries, as of June 30, 2008.

(Millions)	Total Amounts Committed	Payments Due By Period			
		2008	2009-2010	2011-2012	2013 and Thereafter
Long-term debt principal and interest payments <sup>(1)</sup>	\$ 3,441.4	\$ 66.0	\$ 514.8	\$ 954.2	\$1,906.4
Operating lease obligations	42.1	4.7	14.8	13.0	9.6
Commodity purchase obligations <sup>(2)</sup>	9,460.6	3,242.0	4,008.9	1,112.6	1,097.1
Purchase orders <sup>(3)</sup>	708.1	689.8	12.4	4.3	1.6
Capital contributions to equity method investment	34.6	34.6	-	-	-
Minimum pension funding	319.3	21.6	60.4	49.7	187.6
<b>Total contractual cash obligations</b>	<b>\$14,006.1</b>	<b>\$4,058.7</b>	<b>\$4,611.3</b>	<b>\$2,133.8</b>	<b>\$3,202.3</b>

(1) Represents bonds issued, notes issued, and loans made to Integrys Energy Group and its subsidiaries. Integrys Energy Group records all principal obligations on the balance sheet. For purposes of this table, it is assumed that the current interest rates on variable rate debt will remain in effect until the debt matures.

(2) Energy supply contracts at Integrys Energy Services included as part of commodity purchase obligations are generally entered into to meet obligations to deliver energy to customers. The utility subsidiaries expect to recover the costs of their contracts in future customer rates.

(3) Includes obligations related to normal business operations and large construction obligations.

The table above does not reflect payments related to the manufactured gas plant remediation liability of \$695.3 million at June 30, 2008, as the amount and timing of payments are uncertain. See Note 12, "Commitments and Contingencies." Also, the table does not reflect any payments for the June 30, 2008, liability for uncertain tax positions. See Note 11, "Income Taxes."

### Capital Requirements

Estimated construction expenditures by company for the three-year period 2008 through 2010 are:

<b>(Millions)</b>	
<b>WPSC</b>	
Wind generation projects	\$ 249.0
Environmental projects	138.5
Electric and natural gas distribution projects	215.5
Natural gas laterals to connect to Guardian II pipeline	65.4
Weston 4 <sup>(1)</sup>	33.2
Other projects	139.6
<b>UPPCO</b>	
Electric distribution projects and repairs and safety measures at hydroelectric facilities	75.0
<b>MGUC</b>	
Natural gas pipe distribution system and underground natural gas storage facilities	26.0
<b>MERC</b>	
Natural gas pipe distribution system	49.5
<b>PGL</b>	
Natural gas pipe distribution system and underground natural gas storage facilities <sup>(2)</sup>	391.0
<b>NSG</b>	
Natural gas pipe distribution system	30.5
<b>Integrus Energy Services</b>	
Landfill natural gas project, infrastructure project, and miscellaneous projects	42.9
<b>IBS</b>	
Corporate services infrastructure projects	80.3
<b>Total capital expenditures</b>	<b>\$1,536.4</b>

<sup>(1)</sup> As of June 30, 2008, WPSC incurred a total cost of approximately \$533 million related to its ownership interest in the project. WPSC incurred a total cost of \$99.7 million related to the construction of the transmission facilities required to support Weston 4, and received reimbursement for these costs from ATC in April 2008. The Weston 4 power plant was commercially operational in June 2008.

<sup>(2)</sup> Includes approximately \$40 million of expenditures related to the accelerated replacement of cast iron mains at PGL. The expenditures were initially included in a request for recovery in a rider to PGL's rate case; however, the ICC rejected the rider. The company is investigating alternative recovery options.

Integrus Energy Group expects to provide additional capital contributions to ATC (not included in the above table) of approximately \$49 million in 2008 and 2009. No additional capital contributions are expected in 2010.

### Capital Resources

As of June 30, 2008, Integrus Energy Group and each of its subsidiaries were in compliance with all of their respective covenants under their lines of credit and other debt obligations.

For the period 2008 through 2010, Integrys Energy Group plans to use internally generated funds and debt and equity financings to fund capital requirements. Management believes Integrys Energy Group has adequate financial flexibility and resources to meet its future needs.

See Note 8, "*Short-Term Debt and Lines of Credit*," for more information on our credit facilities and other short-term credit agreements.

Integrys Energy Group has the ability to publicly issue debt, equity, certain types of hybrid securities, and other financial instruments under an existing shelf registration statement. Specific terms and conditions of securities issued will be determined prior to the actual issuance of any specific security. Integrys Energy Group's Board of Directors has authorized the issuance of up to \$700.0 million of equity, debt, or other securities under this shelf registration statement, \$300.0 million of which was used in December 2006 when Integrys Energy Group issued junior subordinated notes.

In May 2008, WPSC filed a shelf registration statement, which was declared effective by the SEC in July 2008. Under this Form S-3, WPSC may issue up to \$250.0 million of senior debt securities within the next three years with amounts, prices and terms to be determined at the time of future offerings.

### **Other Future Considerations**

#### *Regulatory Matters and Rate Trends*

To mitigate the volatility of natural gas prices, electric fuel generation, and purchased power costs in 2008 and beyond, WPSC is employing risk management techniques pursuant to its PSCW-approved Risk Plan and Policy, including the use of derivative instruments such as futures and options.

On February 1, 2007, the five utilities subject to the current Wisconsin fuel rules filed proposed changes to the fuel rules with the PSCW. The primary proposed change was to implement a 1% "dead band" to limit a utility's annual exposure or opportunity to a maximum of 1% of fuel costs. The proposed "dead band" differs from the current trigger mechanism in that it would allow a utility to recover or refund all fuel costs outside of the band, rather than only those costs after the trigger date. A proposed rule for PSCW Chapter 116, "Cost of Fuel," was issued by the Commission on July 3, 2008, incorporating many of the components of the utilities' proposal, with a 2% bandwidth as opposed to the 1% bandwidth recommended by the utilities. Comments on the proposed rules could be filed through August 6, 2008. WPSC filed comments on the proposed fuel rules, continuing to support a true "dead band" of 1%. The PSCW will need to agree on a proposed rule that will then be forwarded to the legislature for review and promulgation.

For a discussion of regulatory filings and decisions, see Note 20, "*Regulatory Environment*."

#### *Uncollectible Accounts at the Natural Gas Utilities*

The reserves for uncollectible accounts at the natural gas utilities reflect management's best estimate of probable losses on the accounts receivable balances. The reserves are based on known troubled accounts, historical experience, and other currently available evidence. Provisions for bad debt expense are affected by changes in various factors, including the impacts of natural gas prices and weather.

The impact of higher natural gas prices and a declining economic environment on natural gas customers could cause more accounts receivable to be uncollectible at the natural gas utilities. Higher levels of uncollectible balances from natural gas customers at the utilities would negatively impact Integrys Energy Group's results of operations and could result in higher working capital requirements.

## Industry Restructuring

-Illinois-

Integrys Energy Services markets natural gas to small commercial and industrial customers in Illinois. Legislation had been circulating in the Illinois legislature that could have had a significant detrimental effect on Integrys Energy Services' ability to compete in this market. All of the proposals have been voted down, and none are currently pending.

### Michigan 21st Century Energy Plan

On January 31, 2007, the MPSC Chairman presented the "21<sup>st</sup> Century Energy Plan" to Michigan's Governor. The plan recognizes the increased need for energy in the next 20 years. The plan proposes a new method of receiving pre-construction approval for significant generating plant additions as opposed to the alternative method of seeking approval for recovery of costs after building a generation plant. The plan calls for legislation to implement a 10% renewable energy portfolio standard by 2015 as well as a state-wide energy efficiency program. Discussions have moved to the legislature and several bills have been introduced, though none have been enacted at this time.

## MARKET PRICE RISK MANAGEMENT ACTIVITIES

Market price risk management activities include the electric and natural gas marketing and related risk management activities of Integrys Energy Services. Integrys Energy Services' marketing and trading operations manage electricity and natural gas procurement as an integrated portfolio with its retail and wholesale sales commitments. Derivative instruments are utilized in these operations.

Integrys Energy Services measures the fair value of derivative instruments on a mark-to-market basis. The fair value is included in assets or liabilities from risk management activities on Integrys Energy Group's Condensed Consolidated Balance Sheets, with an offsetting entry to other comprehensive income (for the effective portion of cash flow hedges) or to earnings. The following table provides an assessment of the factors impacting the change in the net value of Integrys Energy Services' assets and liabilities from risk management activities for the six months ended June 30, 2008.

<b>Integrys Energy Services Mark-to-Market Roll Forward (Millions)</b>	<b>Oil Options</b>	<b>Natural Gas</b>	<b>Electric</b>	<b>Total</b>
Fair value of contracts at December 31, 2007 <sup>(1)</sup>	\$ (0.2)	\$ 89.5	\$ 42.8	\$132.1
Less: Contracts realized or settled during period <sup>(2)</sup>	(0.2)	22.0	36.0	57.8
Plus: Changes in fair value of contracts in existence at June 30, 2008 <sup>(3)</sup>	-	(224.3)	270.1	45.8
<b>Fair value of contracts at June 30, 2008<sup>(1)</sup></b>	<b>\$ -</b>	<b>\$(156.8)</b>	<b>\$276.9</b>	<b>\$120.1</b>

(1) Reflects the values reported on the balance sheet for net mark-to-market current and long-term risk management assets and liabilities as of those dates.

(2) Includes the value of contracts in existence at December 31, 2007, that were no longer included in the net mark-to-market assets as of June 30, 2008.

(3) Includes unrealized gains and losses on contracts that existed at December 31, 2007, and contracts that were entered into subsequent to December 31, 2007, which are included in Integrys Energy Services' portfolio at June 30, 2008, as well as gains and losses at the inception of contracts.

There were, in many cases, derivative positions entered into and settled during the period resulting in gains or losses being realized during the current period. The realized gains or losses from these derivative positions are not reflected in the table above.

The table below shows Integrys Energy Services' risk management instruments categorized by fair value hierarchy levels and by maturity. For more information on the fair value hierarchy, see Note 18, "Fair Value."

**Integrys Energy Services**  
**Risk Management Contract Aging at Fair Value**  
**As of June 30, 2008 (Millions)**

<b>Fair Value Hierarchy Level</b>	<b>Maturity Less Than 1 Year</b>	<b>Maturity 1 to 3 Years</b>	<b>Maturity 4 to 5 Years</b>	<b>Maturity In Excess of 5 years</b>	<b>Total Fair Value</b>
Level 1	\$(104.7)	\$102.6	\$10.3	\$ -	\$ 8.2
Level 2	204.2	15.5	1.1	4.4	225.2
Level 3	(85.4)	(23.2)	(6.6)	1.9	(113.3)
<b>Total fair value</b>	<b>\$ 14.1</b>	<b>\$ 94.9</b>	<b>\$ 4.8</b>	<b>\$6.3</b>	<b>\$ 120.1</b>

**CRITICAL ACCOUNTING POLICIES**

We have reviewed our critical accounting policies for new critical accounting estimates and other significant changes. We found that the disclosures made in our Annual Report on Form 10-K for the year ended December 31, 2007, are still current and that there have been no significant changes, except as follows:

**Risk Management Activities**

In conjunction with the implementation of SFAS No. 157, on January 1, 2008, Integrys Energy Group categorized its fair value measurements into three levels within a fair value hierarchy. See Note 18, "Fair Value," for more information.

Integrys Energy Group has based its valuations on observable inputs whenever possible. However, the valuation of certain derivative instruments requires the use of internally developed valuation techniques and/or significant unobservable inputs. These valuations require a significant amount of management judgment and are classified as Level 3 measurements. The majority of Integrys Energy Group's Level 3 measurements relate to risk management activities. Of the total risk management assets on Integrys Energy Group's Condensed Consolidated Balance Sheets, \$1,195.4 million (24.9%) utilized Level 3 measurements. Of the total risk management liabilities, \$1,299.4 million (28.7%) utilized Level 3 measurements. Integrys Energy Group believes these valuations represent the fair values of these instruments as of the reporting date; however, the actual amounts realized upon settlement of these instruments could vary materially from the reported amounts due to movements in market prices and changes in the liquidity of certain markets. There were no significant changes in the valuation techniques used by Integrys Energy Group to value its risk management instruments during the six months ended June 30, 2008.

### Item 3. Quantitative and Qualitative Disclosures about Market Risk

IntegrYS Energy Group has potential market risk exposure related to commodity price risk (including regulatory recovery risk), interest rate risk, equity return risk, and principal preservation risk. IntegrYS Energy Group has risk management policies in place to monitor and assist in controlling these market risks and may use derivative and other instruments to manage some of these exposures.

#### Interest Rate Risk

Due mainly to decreases in commercial paper borrowings, IntegrYS Energy Group has decreased its exposure to variable interest rates. Based on the variable rate debt of IntegrYS Energy Group outstanding at June 30, 2008, a hypothetical increase in market interest rates of 100 basis points in 2008 would increase annual interest expense by \$3.9 million. Comparatively, based on the variable rate debt outstanding at June 30, 2007, an increase in interest rates of 100 basis points would have increased interest expense in 2007 by \$10.4 million. This sensitivity analysis was performed assuming a constant level of variable rate debt during the period and an immediate increase in interest rates, with no other changes for the remainder of the period. In the event of a significant change in interest rates, management would take action to mitigate IntegrYS Energy Group's exposure to the change.

#### Commodity Price Risk

To measure commodity price risk exposure, IntegrYS Energy Group employs a number of controls and processes, including a value-at-risk (VaR) analysis of certain of its exposures. VaR is estimated using a delta-normal approximation based on a one-day holding period and 95% confidence level. For further explanation of our VaR calculation, see the 2007 Annual Report on Form 10-K.

The VaR for IntegrYS Energy Services' trading portfolio is presented in the following table:

<i>(Millions)</i>	June 2008	June 2007
95% confidence level, one-day holding period	\$2.2	\$1.2
Average for 12 months ended	1.3	1.1
High for 12 months ended	2.2	1.2
Low for 12 months ended	0.9	0.9

Other than the above-mentioned changes, IntegrYS Energy Group's market risks have not changed materially from the market risks reported in the 2007 Annual Report on Form 10-K.

#### **Item 4. Controls and Procedures**

##### **Evaluation of Disclosure Controls and Procedures**

As of the end of the period covered by this Quarterly Report on Form 10-Q, Integrys Energy Group's management, with the participation of Integrys Energy Group's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of Integrys Energy Group's disclosure controls and procedures (as defined in the Securities Exchange Act of 1934 Rules 13a-15(e) and 15d-15(e)). Integrys Energy Group's management has concluded that, as of the date of such evaluation, Integrys Energy Group's disclosure controls and procedures were effective in accumulating and alerting management about information relating to Integrys Energy Group (including its consolidated subsidiaries) as appropriate to allow timely decisions regarding required disclosures to be included in its periodic SEC filings, particularly during the period in which this Quarterly Report on Form 10-Q was being prepared.

##### **Changes in Internal Controls**

There were no changes in Integrys Energy Group's internal controls over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934) during the quarter ended June 30, 2008, that have materially affected, or are reasonably likely to materially affect, its internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

For information on material legal proceedings and matters related to Integrys Energy Group and its subsidiaries, see Note 12, "Commitments and Contingencies" in the Condensed Consolidated Financial Statements.

### Labor Contracts

Union employees at PGL are represented by Local 18007 of the Utility Workers Union of America. The collective bargaining agreement with PGL union employees expired on April 30, 2008. PGL and the union reached agreement on a new 5-year collective bargaining agreement which extends to May 1, 2013.

Local 2285 of the International Brotherhood of Electrical Workers AFL-CIO represents union employees at NSG. The collective bargaining agreement was due to expire on June 30, 2008. NSG and the union reached agreement on a new 5-year collective bargaining agreement, which extends to June 30, 2013.

### Item 1A. Risk Factors

There were no material changes in the risk factors previously disclosed in the 2007 Annual Report on Form 10-K for Integrys Energy Group filed on February 28, 2008.

### Item 4. Submission of Matters to a Vote of Security Holders

At the May 15, 2008 Integrys Energy Group Annual Meeting of Shareholders, Mr. Richard A. Bemis, Mr. William J. Brodsky, Mr. Albert J. Budney, Jr., Mr. Robert C. Gallagher, and Mr. John C. Meng were elected to three-year terms on the Board of Directors. The vote was:

	Class B Directors - Term Expiring in 2011				
	Bemis	Brodsky	Budney	Gallagher	Meng
Votes For	61,693,558	62,810,191	63,199,998	62,040,823	62,135,782
Votes Withheld	4,347,127	3,230,494	2,840,687	3,999,863	3,904,903
Shares Not Voted	10,383,410	10,383,410	10,383,410	10,383,409	10,383,410
Total Shares Outstanding	76,424,095	76,424,095	76,424,095	76,424,095	76,424,095

Election of Directors requires a plurality of the votes cast at a meeting of the common shareholders at which a quorum is present.

The continuing Board members are:

#### **Class C Directors** **Term Expires in 2009**

Keith E. Bailey  
Kathryn M. Hasselblad-Pascale  
John W. Higgins  
James L. Kemerling

#### **Class A Directors** **Term Expires in 2010**

Pastora San Juan Cafferty  
Ellen Carnahan  
Michael E. Lavin  
William F. Protz, Jr.  
Larry L. Weyers

In addition, shareholders ratified the appointment of Deloitte & Touche LLP as the independent registered public accounting firm for Integrys Energy Group and its subsidiaries for 2008. The shareholders voted as follows:

<b>Voted</b>	<b>Shares</b>
For	63,381,328
Against	567,219
Abstained	2,092,138
Shares Not Voted	10,383,410
Total	76,424,095

**Item 6. Exhibits**

The following documents are attached as exhibits or incorporated by reference herein:

- 3 Integrys Energy Group, Inc. By-laws as in effect at May 15, 2008 (Incorporated by reference to Exhibit 3.2 to Integrys Energy Group's Current Report on Form 8-K dated May 15, 2008 and filed on May 20, 2008)
- 10 Integrys Energy Group, Inc. Pension Restoration and Supplemental Retirement Plan, as amended and Restated Effective April 1, 2008 (Incorporated by reference to Exhibit 10.1 to Integrys Energy Group's Current Report on Form 8-K dated April 10, 2008 and filed on April 15, 2008)
- 12 Ratio of Earnings to Fixed Charges
- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act and Rule 13a-14(a) or 15d-14(a) under the Securities Exchange Act of 1934 for Integrys Energy Group
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act and Rule 13a-14(a) or 15d-14(a) under the Securities Exchange Act of 1934 for Integrys Energy Group
- 32 Written Statement of the Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 for Integrys Energy Group

## SIGNATURE

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

Integrys Energy Group, Inc.

Date: August 6, 2008

/s/ Diane L. Ford

Diane L. Ford  
Vice President and Corporate Controller

(Duly Authorized Officer and  
Chief Accounting Officer)

**INTEGRYS ENERGY GROUP  
EXHIBIT INDEX TO FORM 10-Q  
FOR THE QUARTER ENDED JUNE 30, 2008**

<b><u>Exhibit No.</u></b>	<b><u>Description</u></b>
12	Ratio of Earnings to Fixed Charges
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act and Rule 13a-14(a) or 15d-14(a) under the Securities Exchange Act of 1934 for Integrys Energy Group
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act and Rule 13a-14(a) or 15d-14(a) under the Securities Exchange Act of 1934 for Integrys Energy Group
32	Written Statement of the Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 for Integrys Energy Group

**Integrys Energy Group**  
**Ratio of Earnings to Fixed Charges**

<b>(Millions)</b>	<b>2008</b>					
	<b>6 months</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>	<b>2004</b>	<b>2003</b>
<b>EARNINGS</b>						
Income available to common shareholders	\$159.9	\$251.3	\$155.8	\$157.4	\$139.7	\$94.7
Discontinued operations, net of tax	(0.1)	(73.3)	(7.3)	(11.5)	13.8	15.7
Cumulative effect of change in accounting principles, net of tax	-	-	-	1.6	-	(3.2)
Federal and state income taxes	95.8	86.0	45.0	39.6	30.4	33.3
<b>Pretax earnings from continuing operations</b>	<b>255.6</b>	<b>264.0</b>	<b>193.5</b>	<b>187.1</b>	<b>183.9</b>	<b>140.5</b>
Loss (income) from less than 50% equity investees	(30.0)	(32.8)	(16.6)	(10.3)	(3.6)	4.2
Distributed earnings of less than 50% equity investees	23.5	36.6	29.6	17.8	11.7	7.5
<b>Fixed charges</b>	<b>77.3</b>	<b>174.6</b>	<b>107.0</b>	<b>69.5</b>	<b>61.5</b>	<b>63.2</b>
<b>Subtract:</b>						
Preferred dividend requirement	2.5	5.2	5.3	4.9	4.7	4.9
Minority interest	-	0.1	3.8	4.5	3.4	5.6
<b>Total earnings as defined</b>	<b>\$323.9</b>	<b>\$437.1</b>	<b>\$304.4</b>	<b>\$254.7</b>	<b>\$245.4</b>	<b>\$204.9</b>
<b>FIXED CHARGES</b>						
Interest on long-term debt, including related amortization	\$64.6	\$118.1	\$54.3	\$51.2	\$48.9	\$47.6
Other interest	7.3	46.7	45.1	11.2	6.0	5.5
Distributions - preferred securities of subsidiary trust	-	-	-	-	-	3.5
Interest factor applicable to rentals	2.9	4.6	2.3	2.2	1.9	1.7
Preferred dividends (grossed up) (see below)	2.5	5.2	5.3	4.9	4.7	4.9
<b>Total fixed charges</b>	<b>\$77.3</b>	<b>\$174.6</b>	<b>\$107.0</b>	<b>\$69.5</b>	<b>\$61.5</b>	<b>\$63.2</b>
<b>Ratio of earnings to fixed charges</b>	<b>4.2</b>	<b>2.5</b>	<b>2.8</b>	<b>3.7</b>	<b>4.0</b>	<b>3.2</b>
<b>PREFERRED DIVIDEND CALCULATION:</b>						
Preferred dividends	\$1.6	\$3.1	\$3.1	\$3.1	\$3.1	\$3.1
Tax rate *	36.8%	40.6%	41.7%	36.9%	33.7%	36.5%
Preferred dividends (grossed up)	\$2.5	\$5.2	\$5.3	\$4.9	\$4.7	\$4.9

\* The tax rate has been adjusted to exclude the impact of tax credits.

**Certification of Chief Executive Officer  
Pursuant to Section 302 of the Sarbanes-Oxley Act and Rule 13a-14(a)  
or 15d-14(a) under the Securities Exchange Act of 1934**

I, Larry L. Weyers, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Integrys Energy Group, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an Annual Report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 6, 2008

/s/ Larry L. Weyers  
Larry L. Weyers  
Chairman, President and Chief Executive Officer

**Certification of Chief Financial Officer  
Pursuant to Section 302 of the Sarbanes-Oxley Act and Rule 13a-14(a)  
or 15d-14(a) under the Securities Exchange Act of 1934**

I, Joseph P. O'Leary, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Integrys Energy Group, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an Annual Report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 6, 2008

/s/ Joseph P. O'Leary  
Joseph P. O'Leary  
Senior Vice President and Chief Financial Officer

**Written Statement of the Chief Executive Officer and Chief Financial Officer  
Pursuant to 18 U.S.C. Section 1350**

Solely for the purposes of complying with 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, we, the undersigned Chief Executive Officer and Chief Financial Officer of Integrys Energy Group, Inc. (the "Company"), hereby certify, based on our knowledge, that the Quarterly Report on Form 10-Q of the Company for the quarter ended June 30, 2008 (the "Report") fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934 and that information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Larry L. Weyers  
Larry L. Weyers  
Chairman, President and Chief Executive Officer

/s/ Joseph P. O'Leary  
Joseph P. O'Leary  
Senior Vice President and Chief Financial Officer

Date: August 6, 2008

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D. C. 20549**

**FORM 10-Q**

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2008

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

<u>Commission File Number</u>	<u>Registrant; State of Incorporation; Address; and Telephone Number</u>	<u>IRS Employer Identification No.</u>
1-11337	INTEGRYS ENERGY GROUP, INC. (A Wisconsin Corporation) 130 East Randolph Drive Chicago, Illinois 60601-6207 (312) 228-5400	39-1775292

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer   
Non-accelerated filer  Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

Indicate the number of shares outstanding of the issuer's classes of common stock, as of the latest practicable date:

Common stock, \$1 par value,  
76,423,037 shares outstanding at  
November 5, 2008

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**INTEGRYS ENERGY GROUP, INC.**  
**FORM 10-Q FOR THE QUARTER ENDED SEPTEMBER 30, 2008**

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12	Ratio of Earnings to Fixed Charges
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32	Written Statement of the Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 for Integrys Energy Group, Inc.

#### Commonly Used Acronyms

ATC	American Transmission Company LLC
EPA	United States Environmental Protection Agency
FASB	Financial Accounting Standards Board
FERC	Federal Energy Regulatory Commission
GAAP	Generally Accepted Accounting Principles
IBS	Integrys Business Support, LLC
ICC	Illinois Commerce Commission
ICE	Intercontinental Exchange
IRS	United States Internal Revenue Service
LIFO	Last-in, first-out
MERC	Minnesota Energy Resources Corporation
MGUC	Michigan Gas Utilities Corporation
MISO	Midwest Independent Transmission System Operator
MPSC	Michigan Public Service Commission
NSG	North Shore Gas Company
NYMEX	New York Mercantile Exchange
PEC	Peoples Energy Corporation
PEP	Peoples Energy Production Company
PGL	The Peoples Gas Light and Coke Company
PSCW	Public Service Commission of Wisconsin
SEC	United States Securities and Exchange Commission
SFAS	Statement of Financial Accounting Standards
UPPCO	Upper Peninsula Power Company
VBA	Volume Balancing Adjustment
WDNR	Wisconsin Department of Natural Resources
WPSC	Wisconsin Public Service Corporation

## Forward-Looking Statements

In this report, Integrys Energy Group and its subsidiaries make statements concerning expectations, beliefs, plans, objectives, goals, strategies, and future events or performance. Such statements are "forward-looking statements" within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended. Although Integrys Energy Group and its subsidiaries believe that these forward-looking statements and the underlying assumptions are reasonable, they cannot provide assurance that such statements will prove correct. Except to the extent required by the federal securities laws, Integrys Energy Group and its subsidiaries undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

In addition to statements regarding trends or estimates in Management's Discussion and Analysis of Financial Condition and Results of Operations, forward-looking statements included or incorporated in this report include, but are not limited to, statements regarding future:

- Revenues or expenses,
- Capital expenditure projections, and
- Financing sources.

Forward-looking statements involve a number of risks and uncertainties. There are many factors that could cause actual results to differ materially from those expressed or implied in this report. Some risk factors that could cause results to differ from any forward-looking statement include those described in Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2007, as may be amended or supplemented in Part II, Item 1A of this report. Other factors include:

- Unexpected costs and/or unexpected liabilities related to the PEC merger;
- Integrys Energy Group may be unable to achieve the forecasted synergies anticipated from the PEC merger, or it may take longer or cost more than expected to achieve these synergies;
- Resolution of pending and future rate cases and negotiations (including the recovery of deferred costs) and other regulatory decisions impacting Integrys Energy Group's regulated businesses;
- The impact of recent and future federal and state regulatory changes, including legislative and regulatory initiatives regarding deregulation and restructuring of the electric and natural gas utility industries and possible future initiatives to address concerns about global climate change, changes in environmental, tax, and other laws and regulations to which Integrys Energy Group and its subsidiaries are subject, as well as changes in the application of existing laws and regulations;
- Current and future litigation, regulatory investigations, proceedings or inquiries, including but not limited to, manufactured gas plant site cleanup and the contested case proceeding regarding the Weston 4 air permit;
- Resolution of audits or other tax disputes with the IRS and various state, local, and Canadian revenue agencies;
- The effects, extent, and timing of additional competition or regulation in the markets in which our subsidiaries operate;
- Available sources and costs of fuels and purchased power;
- Investment performance of employee benefit plan assets;
- Advances in technology;
- Effects of and changes in political and legal developments, as well as economic conditions and the related impact on customer demand;
- Potential business strategies, including mergers, acquisitions, and construction or disposition of assets or businesses, which cannot be assured to be completed timely or within budgets;
- The direct or indirect effects of terrorist incidents, natural disasters, or responses to such events;
- The impacts of changing financial market conditions, credit ratings, and interest rates on our liquidity and financing efforts;
- The risks associated with changing commodity prices (particularly natural gas and electricity), including counterparty credit risk and the impact on general market liquidity;
- Weather and other natural phenomena, in particular the effect of weather on natural gas and electricity sales;
- The effect of accounting pronouncements issued periodically by standard-setting bodies; and
- Other factors discussed elsewhere herein and in other reports filed by the registrant from time to time with the SEC.

**Forward-looking statements are subject to assumptions and uncertainties; therefore, actual results may differ materially from those expressed or implied by such forward-looking statements.**

PART 1. FINANCIAL INFORMATION

Item 1. Financial Statements

INTEGRYS ENERGY GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME (LOSS) (Unaudited)	Three Months Ended		Nine Months Ended	
	September 30		September 30	
(Millions, except per share data)	2008	2007	2008	2007
Nonregulated revenue	\$2,543.0	\$1,556.5	\$7,556.4	\$4,983.2
Utility revenue	680.1	566.0	3,073.1	2,247.6
<b>Total revenues</b>	<b>3,223.1</b>	<b>2,122.5</b>	<b>10,629.5</b>	<b>7,230.8</b>
Nonregulated cost of fuel, natural gas, and purchased power	2,640.9	1,488.7	7,470.2	4,803.3
Utility cost of fuel, natural gas, and purchased power	338.0	286.8	1,927.6	1,358.8
Operating and maintenance expense	242.3	218.9	780.7	657.5
Goodwill impairment loss	-	-	6.5	-
Depreciation and amortization expense	56.7	52.5	163.8	143.3
Taxes other than income taxes	21.4	21.5	69.1	64.6
<b>Operating income (loss)</b>	<b>(76.2)</b>	<b>54.1</b>	<b>211.6</b>	<b>203.3</b>
Miscellaneous income	23.7	15.5	64.5	49.4
Interest expense	(39.5)	(48.2)	(110.9)	(127.2)
Minority interest	-	-	-	0.1
<b>Other expense</b>	<b>(15.8)</b>	<b>(32.7)</b>	<b>(46.4)</b>	<b>(77.7)</b>
Income (loss) before taxes	(92.0)	21.4	165.2	125.6
Provision (benefit) for income taxes	(33.6)	9.8	62.2	36.4
<b>Income (loss) from continuing operations</b>	<b>(58.4)</b>	<b>11.6</b>	<b>103.0</b>	<b>89.2</b>
Discontinued operations, net of tax	-	32.3	0.1	79.3
<b>Income (loss) before preferred stock dividends of subsidiary</b>	<b>(58.4)</b>	<b>43.9</b>	<b>103.1</b>	<b>168.5</b>
Preferred stock dividends of subsidiary	0.7	0.7	2.3	2.3
<b>Income (loss) available for common shareholders</b>	<b>(\$59.1)</b>	<b>\$43.2</b>	<b>\$100.8</b>	<b>\$166.2</b>
<b>Average shares of common stock</b>				
Basic	76.7	76.2	76.5	70.0
Diluted	76.7	76.5	76.9	70.2
<b>Earnings (loss) per common share (basic)</b>				
Income (loss) from continuing operations	(\$0.77)	\$0.14	\$1.32	\$1.24
Discontinued operations, net of tax	-	\$0.43	-	\$1.13
<b>Earnings (loss) per common share (basic)</b>	<b>(\$0.77)</b>	<b>\$0.57</b>	<b>\$1.32</b>	<b>\$2.37</b>
<b>Earnings (loss) per common share (diluted)</b>				
Income (loss) from continuing operations	(\$0.77)	\$0.14	\$1.31	\$1.24
Discontinued operations, net of tax	-	\$0.42	-	\$1.13
<b>Earnings (loss) per common share (diluted)</b>	<b>(\$0.77)</b>	<b>\$0.56</b>	<b>\$1.31</b>	<b>\$2.37</b>
<b>Dividends per common share declared</b>	<b>\$0.670</b>	<b>\$0.660</b>	<b>\$2.010</b>	<b>\$1.903</b>

The accompanying condensed notes are an integral part of these statements.

## INTEGRYS ENERGY GROUP, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS (Unaudited) (Millions)	September 30 2008	December 31 2007
<b>Assets</b>		
Cash and cash equivalents	\$55.4	\$41.2
Accounts receivable, net of reserves of \$71.2 and \$51.3, respectively	1,333.6	1,405.3
Accrued unbilled revenues	234.5	464.7
Inventories	1,127.9	663.4
Assets from risk management activities	1,771.1	840.7
Regulatory assets	256.9	141.7
Other current assets	259.3	169.3
<b>Current assets</b>	<b>5,038.7</b>	<b>3,726.3</b>
Property, plant, and equipment, net of accumulated depreciation of \$2,693.6 and \$2,602.2, respectively	4,645.4	4,463.8
Regulatory assets	1,052.7	1,102.3
Assets from risk management activities	489.0	459.3
Goodwill	943.7	948.3
Pension assets	72.5	101.4
Other	456.9	433.0
<b>Total assets</b>	<b>\$12,698.9</b>	<b>\$11,234.4</b>
<b>Liabilities and Shareholders' Equity</b>		
Short-term debt	\$1,100.3	\$468.2
Current portion of long-term debt	4.9	55.2
Accounts payable	1,355.5	1,331.8
Liabilities from risk management activities	1,675.3	813.5
Regulatory liabilities	24.0	77.9
Deferred income taxes	43.1	13.9
Other current liabilities	358.1	487.7
<b>Current liabilities</b>	<b>4,561.2</b>	<b>3,248.2</b>
Long-term debt	2,258.7	2,265.1
Deferred income taxes	515.7	494.4
Deferred investment tax credits	37.0	38.3
Regulatory liabilities	311.4	292.4
Environmental remediation liabilities	677.9	705.6
Pension and postretirement benefit obligations	219.1	247.9
Liabilities from risk management activities	429.6	372.0
Asset retirement obligations	145.6	140.2
Other	316.6	143.4
<b>Long-term liabilities</b>	<b>4,911.6</b>	<b>4,699.3</b>
<b>Commitments and contingencies</b>		
Preferred stock of subsidiary with no mandatory redemption	51.1	51.1
Common stock equity	3,175.0	3,235.8
<b>Total liabilities and shareholders' equity</b>	<b>\$12,698.9</b>	<b>\$11,234.4</b>

The accompanying condensed notes are an integral part of these statements.

## INTEGRYS ENERGY GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)	Nine Months Ended September 30	
(Millions)	2008	2007
<b>Operating Activities</b>		
Income before preferred stock dividends of subsidiary	\$103.1	\$168.5
Adjustments to reconcile income before preferred stock dividends of subsidiary to net cash (used for) provided by operating activities		
Discontinued operations, net of tax	(0.1)	(79.3)
Goodwill impairment loss	8.5	-
Depreciation and amortization expense	163.8	143.3
Recovery of MISO Day 2 expenses	14.6	0.9
Refund of non-qualified decommissioning trust	(0.4)	(57.0)
Recoveries and refunds of other regulatory assets and liabilities	36.0	41.5
Amortization of nonregulated customer contract intangibles	10.3	12.1
Net unrealized gains on nonregulated energy contracts	(37.9)	(19.4)
Nonregulated lower of cost or market inventory adjustments	119.5	13.9
Pension and postretirement expense	36.6	51.4
Pension and postretirement funding	(27.0)	(25.4)
Deferred income taxes and investment tax credit	65.8	(114.1)
Gains due to settlement of contracts pursuant to the merger with PEC	-	(4.0)
Loss on sale of property, plant and equipment	1.5	-
Equity income, net of dividends	(11.3)	3.8
Other	(37.3)	(52.2)
Changes in working capital		
Receivables, net	223.1	697.7
Inventories	(696.3)	(181.0)
Other current assets	(95.0)	56.2
Accounts payable	18.6	(434.4)
Temporary LIFO liquidation credit	-	(132.7)
Other current liabilities	(193.2)	220.2
<b>Net cash (used for) provided by operating activities</b>	<b>(299.2)</b>	<b>310.0</b>
<b>Investing Activities</b>		
Capital expenditures	(355.2)	(250.5)
Proceeds from the sale of property, plant and equipment	9.2	6.8
Purchase of equity investments and other acquisitions	(27.6)	(52.9)
Cash paid for transaction costs pursuant to the merger with PEC	-	(14.0)
Cash paid for transmission interconnection	(17.4)	(23.9)
Restricted cash for repayment of long-term debt	-	22.0
Proceeds received from transmission interconnection	99.7	-
Other	4.0	8.5
<b>Net cash used for investing activities</b>	<b>(287.3)</b>	<b>(304.0)</b>
<b>Financing Activities</b>		
Short-term debt, net	632.1	(489.1)
Gas loans, net	180.8	3.7
Repayment of long-term debt	(54.7)	(23.8)
Payment of dividends		
Preferred stock	(2.3)	(2.3)
Common stock	(152.9)	(126.9)
Issuance of common stock	-	36.0
Other	(2.3)	5.6
<b>Net cash provided by (used for) financing activities</b>	<b>600.7</b>	<b>(596.8)</b>
<b>Change in cash and cash equivalents - continuing operations</b>	<b>14.2</b>	<b>(590.8)</b>
Change in cash and cash equivalents - discontinued operations		
Net cash provided by operating activities	-	24.3
Net cash provided by investing activities	-	799.6
<b>Change in cash and cash equivalents</b>	<b>14.2</b>	<b>233.1</b>
Cash and cash equivalents at beginning of period	41.2	23.2
<b>Cash and cash equivalents at end of period</b>	<b>\$55.4</b>	<b>\$256.3</b>

The accompanying condensed notes are an integral part of these statements

**INTEGRYS ENERGY GROUP, INC. AND SUBSIDIARIES**  
**CONDENSED NOTES TO FINANCIAL STATEMENTS**  
**September 30, 2008**

**NOTE 1--FINANCIAL INFORMATION**

We have prepared the Condensed Consolidated Financial Statements of Integrys Energy Group, Inc. under the rules and regulations of the SEC.

These financial statements on Form 10-Q have not been audited. Management believes that these financial statements include all adjustments (which, unless otherwise noted, include only normal recurring adjustments) necessary for a fair presentation of the financial results for each period shown. We have condensed or omitted certain financial information and note disclosures normally included in our annual audited financial statements. These condensed financial statements should be read along with the audited financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2007.

**Mergers and Acquisitions**

Effective February 21, 2007, the PEC merger was completed, and the assets and liabilities, results of operations, and cash flows of PEC were included in Integrys Energy Group's Condensed Consolidated Financial Statements beginning February 22, 2007. See Note 5, "*Acquisitions and Sales of Assets*," for more information.

**Dispositions**

PEP's results of operations and cash flows were recorded as discontinued operations for the three and nine months ended September 30, 2007. The sale of PEP was completed in September 2007. Refer to Note 4, "*Discontinued Operations*," for more information.

WPS Niagara Generation, LLC's (Niagara) results of operations and cash flows were classified as discontinued operations in the first quarter of 2007. The sale of Niagara was completed in January 2007. Refer to Note 4, "*Discontinued Operations*," for more information.

**NOTE 2--CASH AND CASH EQUIVALENTS**

Short-term investments with an original maturity of three months or less are reported as cash equivalents.

The following is supplemental disclosure to the Integrys Energy Group Condensed Consolidated Statements of Cash Flows:

<i>(Millions)</i>	<b>Nine Months Ended September 30</b>	
	<b>2008</b>	<b>2007</b>
Cash paid for interest	<b>\$101.2</b>	\$88.5
Cash paid for income taxes	<b>123.1</b>	30.0

Significant non-cash transactions were:

<i>(Millions)</i>	<b>Nine Months Ended September 30</b>	
	<b>2008</b>	<b>2007</b>
Construction costs funded through accounts payable	<b>\$38.0</b>	\$ 29.8
Equity issued for net assets acquired in PEC merger	-	1,559.3
Realized gain on settlement of contracts due to PEC merger	-	4.0

### NOTE 3--RISK MANAGEMENT ACTIVITIES

The following table shows Integrys Energy Group's assets and liabilities from risk management activities as of September 30, 2008, and December 31, 2007:

<i>(Millions)</i>	<b>Assets</b>		<b>Liabilities</b>	
	<b>September 30, 2008</b>	<b>December 31, 2007</b>	<b>September 30, 2008</b>	<b>December 31, 2007</b>
<b>Utility Segments</b>				
Commodity contracts	\$ 233.4	\$ 8.2	\$ 356.5	\$ 30.4
Financial transmission rights	12.3	13.4	6.2	4.4
Cash flow hedges – commodity contracts	-	-	0.8	0.3
<b>Nonregulated Segments</b>				
Non-hedge derivatives	1,871.7	1,241.4	1,687.4	1,125.7
Fair value hedges				
Commodity contracts	21.0	7.4	-	2.0
Interest rate swaps	1.1	-	-	0.3
Cash flow hedges				
Commodity contracts	120.6	29.6	50.4	18.3
Interest rate swaps	-	-	3.6	4.1
<b>Total</b>	<b>\$2,260.1</b>	<b>\$1,300.0</b>	<b>\$2,104.9</b>	<b>\$1,185.5</b>
<b>Balance Sheet Presentation</b>				
Current	\$1,771.1	\$ 840.7	\$1,675.3	\$ 813.5
Long-term	489.0	459.3	429.6	372.0
<b>Total</b>	<b>\$2,260.1</b>	<b>\$1,300.0</b>	<b>\$2,104.9</b>	<b>\$1,185.5</b>

Assets and liabilities from risk management activities are classified as current or long-term based upon the maturities of the underlying contracts.

FASB Interpretation No. 39, "Offsetting of Amounts Related to Certain Contracts," as amended, provides the option to present certain asset and liability derivative positions net on the balance sheet and to net the related cash collateral against these net derivative positions. Integrys Energy Group elected not to net these items in its Condensed Consolidated Balance Sheets. The following table shows Integrys Energy Group's cash collateral positions:

<i>(Millions)</i>	<b>September 30, 2008</b>	<b>December 31, 2007</b>
Cash collateral provided to others	\$84.4	\$23.5
Cash collateral received from others	18.9	49.1

On the Condensed Consolidated Balance Sheets, cash collateral provided to others is reflected in accounts receivable, and cash collateral received from others is reflected in other current liabilities.

#### Utility Segments

Derivative instruments at the utilities are entered into in accordance with the terms of the risk management policies approved by Integrys Energy Group's Board of Directors and, if applicable, by the respective regulators. For most energy-related physical and financial derivatives in our regulated operations, our regulators allow the effects of mark-to-market accounting to be deferred as regulatory assets and liabilities. Management believes any gains or losses resulting from the eventual settlement of these derivative instruments will be collected from or refunded to customers.

The derivatives listed in the above table as "commodity contracts" include natural gas purchase contracts as well as financial derivative contracts (NYMEX futures, options, and swaps) used by both the electric and natural gas utility segments to mitigate the risk associated with market price volatility of natural gas.

The electric utility segment also uses financial instruments to manage transmission congestion costs, which are shown in the above table as "financial transmission rights."

### **Nonregulated Segments**

The derivatives in the nonregulated segments not designated as hedges under generally accepted accounting principles are primarily commodity contracts used to manage price risk associated with natural gas and electric energy purchase and sale activities and foreign currency contracts used to manage foreign currency exposure related to Integrys Energy Services' Canadian operations. Changes in the fair value of non-hedge derivatives are recognized currently in earnings.

Integrys Energy Services also enters into commodity derivative contracts that are designated as either fair value or cash flow hedges. Integrys Energy Services uses fair value hedges to mitigate the risk of changes in the price of natural gas held in storage. The changes in the fair value of these hedges are recognized currently in earnings, as are the changes in fair value of the hedged items. Fair value hedge ineffectiveness recorded in nonregulated revenue on the Condensed Consolidated Statements of Income (Loss) was not significant for the three months ended September 30, 2008, and 2007. Fair value hedge ineffectiveness recorded in nonregulated revenue on the Condensed Consolidated Statements of Income (Loss) was a pre-tax loss of \$2.8 million for the nine months ended September 30, 2008, and was not significant for the nine months ended September 30, 2007. Changes in the difference between the spot and forward prices of natural gas were excluded from the assessment of hedge effectiveness and reported directly in nonregulated revenue. The amount excluded was a pre-tax loss of \$2.5 million during the three months ended September 30, 2008, and was a pre-tax loss of \$9.8 million during the three months ended September 30, 2007. The amount excluded was not significant during the nine months ended September 30, 2008, and was a pre-tax loss of \$6.7 million during the nine months ended September 30, 2007.

Commodity contracts that are designated as cash flow hedges extend through April 2014, and are used to mitigate the risk of cash flow variability associated with future purchases and sales of natural gas and electricity. To the extent they are effective, the changes in the values of these contracts are included in other comprehensive income, net of taxes. Cash flow hedge ineffectiveness recorded in nonregulated revenue on the Condensed Consolidated Statements of Income (Loss) related to commodity contracts was a pre-tax gain of \$3.5 million during the three months ended September 30, 2008, and was not significant during the three months ended September 30, 2007. Cash flow hedge ineffectiveness recorded in nonregulated revenue on the Condensed Consolidated Statements of Income (Loss) related to commodity contracts was not significant during the nine months ended September 30, 2008, and was a pre-tax loss of \$5.7 million during the nine months ended September 30, 2007. When testing for effectiveness, no portion of the derivative instruments was excluded. Amounts recorded in other comprehensive income related to these cash flow hedges will be recognized in earnings when the hedged transactions occur, which is typically as the related contracts are settled, or if it is probable that the hedged transaction will not occur. The amount reclassified from other comprehensive income into earnings as a result of the discontinuance of cash flow hedge accounting for certain hedge transactions was not significant during the three months ended September 30, 2008, and 2007. The amount reclassified from other comprehensive income into earnings as a result of the discontinuance of cash flow hedge accounting for certain hedge transactions was a pre-tax loss of \$2.6 million during the nine months ended September 30, 2008, and was not significant during the nine months ended September 30, 2007. In the next 12 months, subject to changes in market prices of natural gas and electricity, we expect that a pre-tax gain of \$25.8 million will be recognized in earnings as the hedged transactions occur. We expect this amount to be substantially offset by settlement of the related nonderivative contracts that are being hedged.

## NOTE 4--DISCONTINUED OPERATIONS

### *PEP*

In September 2007, Integrys Energy Group completed the sale of PEP, an oil and natural gas production subsidiary acquired in the PEC merger, for \$869.2 million, net of certain post-closing adjustments.

Components of discontinued operations recorded in the Condensed Consolidated Statements of Income (Loss) related to PEP were:

<i>(Millions)</i>	Three Months Ended September 30, 2007	February 22, 2007 through September 30, 2007
Nonregulated revenue	\$43.4	\$114.2
Operating and maintenance expense	12.5	28.5
Gain on PEP sale	(22.7)	(22.7)
Taxes other than income taxes	1.4	5.1
Other expense	0.1	0.1
Income before taxes	52.1	103.2
Provision for income taxes	19.7	38.6
Discontinued operations, net of tax	\$32.4	\$ 64.6

It is Integrys Energy Group's policy to not allocate interest to discontinued operations unless the asset group being sold has external debt obligations. PEP had no external debt obligations during the periods shown above.

### *Niagara*

In January 2007, Integrys Energy Services completed the sale of Niagara for approximately \$31 million. This facility was a merchant generation facility and sold power on a wholesale basis. The gain recorded in 2007 was \$24.6 million (\$14.8 million after-tax) and was included as a component of discontinued operations.

During the nine months ended September 30, 2008, Integrys Energy Services recorded \$0.1 million of operating and maintenance expenses in discontinued operations related to amortization of an environmental indemnification guarantee included as part of the sale agreement.

Components of discontinued operations recorded in the Condensed Consolidated Statements of Income (Loss) related to Niagara for the nine months ended September 30, 2007 were:

<i>(Millions)</i>	<b>Nine Months Ended September 30, 2007</b>
Nonregulated revenue	\$ 1.5
Nonregulated cost of fuel, natural gas, and purchased power	1.0
Operating and maintenance expense	0.5
Gain on Niagara sale	(24.6)
Income before taxes	24.6
Provision for income taxes	9.9
<b>Discontinued operations, net of tax</b>	<b>\$14.7</b>

No interest expense was allocated to discontinued operations as Niagara had no external debt obligations during the period shown above.

#### **NOTE 5--ACQUISITIONS AND SALES OF ASSETS**

##### *PEC Merger*

The PEC merger was completed on February 21, 2007. The merger was accounted for under the purchase method of accounting, with Integrys Energy Group as the acquirer. In the merger, shareholders of PEC received 0.825 shares of Integrys Energy Group common stock, \$1 par value, for each share of PEC common stock, no par value, which they held immediately prior to the merger. The total purchase price was approximately \$1.6 billion. The results of operations attributable to PEC are included in the Condensed Consolidated Financial Statements for the three and nine months ended September 30, 2008, and for the period from February 22, 2007, through September 30, 2007.

The purchase price was allocated based on the estimated fair market value of the assets acquired and liabilities assumed. The excess of the purchase price over the estimated fair values of the tangible net assets acquired was allocated to identifiable intangible assets, with the remainder allocated to goodwill.

In order to achieve Integrys Energy Group's anticipated merger synergies, a restructuring plan was implemented, which included a process to eliminate duplicative positions within Integrys Energy Group. Costs associated with the merger-related involuntary termination of employees at PEC (the acquired company) were recognized as a liability assumed in the merger and included in the purchase price allocation in accordance with Emerging Issues Task Force Issue No. 95-3 "Recognition of Liabilities in Connection with a Purchase Business Combination." The following table summarizes the activity related to these specific costs for the three and nine months ended September 30, 2008 and 2007.

<i>(Millions)</i>	Three Months Ended September 30		Nine Months Ended September 30	
	2008	2007	2008	2007
Accrued employee severance costs at beginning of period	\$0.2	\$5.0	\$1.3	\$ -
Adjustments to purchase price	-	(3.7)	-	1.4
Cash payments	(0.1)	(0.1)	(1.2)	(0.2)
<b>Accrued employee severance costs at end of period</b>	<b>\$0.1</b>	<b>\$1.2</b>	<b>\$0.1</b>	<b>\$1.2</b>

Costs related to the involuntary termination of the acquirer's employees are expensed following the guidance of SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." Costs associated with the relocation or voluntary terminations of both Integrys Energy Group and PEC employees are expensed in accordance with SFAS No. 88, "Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits." These costs are shown in the table below.

<i>(Millions)</i>	Three Months Ended September 30		Nine Months Ended September 30	
	2008	2007	2008	2007
Accrued employee severance costs at beginning of period	\$4.3	\$5.0	\$4.8	\$ -
Severance expense recorded	0.2	0.1	2.3	5.2
Cash payments	(2.5)	(1.0)	(5.1)	(1.1)
<b>Accrued employee severance costs at end of period</b>	<b>\$2.0</b>	<b>\$4.1</b>	<b>\$2.0</b>	<b>\$4.1</b>

#### *Supplemental Pro Forma information*

The following table shows pro forma results of operations for Integrys Energy Group for the nine months ended September 30, 2007, as if the acquisition of PEC had been completed at January 1, 2007. Pro forma results are presented for informational purposes only and are not necessarily indicative of what the actual results would have been had the acquisition actually occurred on January 1, 2007.

<i>(Millions, except per share amounts)</i>	Pro Forma for the Nine Months Ended September 30, 2007
Total revenues	\$7,936.1
Income from continuing operations	\$ 119.3
Income available for common shareholders	\$ 198.3
Basic earnings per share – continuing operations	\$1.54
Basic earnings per share	\$2.61
Diluted earnings per share – continuing operations	\$1.53
Diluted earnings per share	\$2.60

#### **NOTE 6-- NATURAL GAS IN STORAGE**

PGL and NSG price natural gas storage injections at the calendar year average of the cost of natural gas supply purchased. Withdrawals from storage are priced on the LIFO cost method. For interim periods, the difference between current projected replacement cost and the LIFO cost for quantities of natural gas temporarily withdrawn from storage is recorded as a temporary LIFO liquidation credit. At September 30, 2008 and 2007, all LIFO layers were replenished and the LIFO liquidation credit balance was zero.

## NOTE 7--GOODWILL AND OTHER INTANGIBLE ASSETS

Integrys Energy Group had the following changes to the carrying amount of goodwill for the nine months ended September 30, 2008:

<i>(Millions)</i>	Natural Gas Utility Segment	Integrys Energy Services	Total
Goodwill recorded at December 31, 2007	\$936.8	\$11.5	\$948.3
Adjustments to PEC purchase price allocation related to income taxes	2.0	(0.1)	1.9
Impairment loss *	(6.5)	-	(6.5)
<b>Goodwill recorded at September 30, 2008</b>	<b>\$932.3</b>	<b>\$11.4</b>	<b>\$943.7</b>

\* A goodwill impairment loss in the amount of \$6.5 million, after-tax, was recognized for NSG in the second quarter of 2008. On at least an annual basis, Integrys Energy Group is required by generally accepted accounting principles to test goodwill for impairment at each of its reporting units. Reporting units at Integrys Energy Group that have a goodwill balance and are subject to these impairment tests include PGL, NSG, MGUC, MERC, WPSC's natural gas utility, and Integrys Energy Services. PGL, NSG, MGUC, and MERC were recorded at their approximate fair market values at the date of acquisition. Since the acquisitions of PGL, NSG, MGUC, and MERC all occurred within the last few years, even a slight decline in fair value can result in a potential impairment loss. In order to identify a potential impairment, the estimated fair value of a reporting unit is compared with its carrying amount, including goodwill. A present value technique was utilized to estimate the fair value of NSG at April 1, 2008. The goodwill impairment recognized for NSG was due to a decline in the estimated fair value of NSG, caused primarily by a decrease in forecasted results as compared to the forecast at the time of the acquisition. Worsening economic factors also contributed to the decline in fair value.

Identifiable intangible assets other than goodwill are included as a component of other assets within the Condensed Consolidated Balance Sheets as listed below.

<i>(Millions)</i>	September 30, 2008			December 31, 2007		
	Gross Carrying Amount	Accumulated Amortization	Net	Gross Carrying Amount	Accumulated Amortization	Net
<b>Amortized intangible assets (liabilities)</b>						
Customer-related <sup>(1)</sup>	\$32.6	\$(13.0)	\$19.6	\$32.6	\$ (9.3)	\$23.3
Natural gas and electric contract assets <sup>(2), (3)</sup>	60.1	(50.2)	9.9	60.1	(34.1)	26.0
Natural gas and electric contract liabilities <sup>(2), (4)</sup>	(33.6)	18.8	(14.8)	(33.6)	13.1	(20.5)
Emission allowances <sup>(5)</sup>	2.2	(0.1)	2.1	2.4	(0.2)	2.2
Renewable energy credits <sup>(6)</sup>	2.3	(1.7)	0.6	0.4	(0.4)	-
Other	3.1	(0.9)	2.2	3.4	(0.8)	2.6
<b>Total</b>	<b>66.7</b>	<b>(47.1)</b>	<b>19.6</b>	<b>65.3</b>	<b>(31.7)</b>	<b>33.6</b>
<b>Unamortized intangible assets</b>						
Trade name <sup>(7)</sup>	5.2	-	5.2	5.2	-	5.2
<b>Total intangible assets</b>	<b>\$71.9</b>	<b>\$(47.1)</b>	<b>\$24.8</b>	<b>\$70.5</b>	<b>\$(31.7)</b>	<b>\$38.8</b>

(1) Includes customer relationship assets associated with both PEC's former nonregulated retail natural gas and electric operations and MERC's non-utility home services business. The remaining weighted-average amortization period for customer-related intangible assets is approximately 8 years.

(2) Represents the fair value of certain PEC natural gas and electric customer contracts acquired in the merger that were not considered to be derivative instruments and, as a result, were recorded as intangible assets.

- (3) Includes both short-term and long-term intangible assets related to customer contracts in the amount of \$6.9 million and \$3.0 million, respectively, which have a weighted-average amortization period of 1 year.
- (4) Includes both short-term and long-term intangible liabilities related to customer contracts in the amount of \$6.3 million and \$8.5 million, respectively, which have a weighted-average amortization period of 2.3 years.
- (5) Emission allowances do not have a contractual term or expiration date.
- (6) Used at Integrys Energy Services to comply with state Renewable Portfolio Standards, as well as for trading purposes.
- (7) Represents the fair value of the MGUC trade name acquired from Aquila.

Intangible asset amortization expense, excluding amortization related to natural gas and electric contracts, was recorded as a component of depreciation and amortization. Amortization for the three months ended September 30, 2008, and 2007, was \$2.1 million and \$1.7 million, respectively. Amortization for the nine months ended September 30, 2008, and 2007, was \$5.8 million and \$4.1 million, respectively.

Amortization expense for the next five fiscal years is estimated to be:

<b>(Millions)</b>	
For three months ending December 31, 2008	\$1.4
For year ending December 31, 2009	4.3
For year ending December 31, 2010	3.7
For year ending December 31, 2011	3.1
For year ending December 31, 2012	2.1

Amortization of natural gas and electric contract intangible assets and liabilities was recorded as a component of nonregulated cost of fuel, natural gas, and purchased power. Amortization of these contracts for the three months ended September 30, 2008, resulted in an increase to nonregulated cost of fuel, natural gas, and purchased power of \$0.2 million, while amortization of these contracts for the three months ended September 30, 2007, resulted in a reduction to nonregulated cost of fuel, natural gas, and purchased power of \$3.2 million. Amortization of these contracts for the nine months ended September 30, 2008, and 2007, resulted in an increase to nonregulated cost of fuel, natural gas, and purchased power of \$10.3 million and \$12.1 million, respectively.

Amortization of these contracts for the next five fiscal years is estimated to be:

<b>(Millions)</b>	
For three months ending December 31, 2008	\$3.0
For year ending December 31, 2009	(2.9)*
For year ending December 31, 2010	(2.7)*
For year ending December 31, 2011	(2.0)*
For year ending December 31, 2012	(0.3)*

\* Amortization of these contracts is anticipated to decrease nonregulated cost of fuel, natural gas, and purchased power because the fair value of the portion of the contracts that relates to these periods was negative (or "out-of-the-money") at the date the respective businesses were acquired.

## NOTE 8--SHORT-TERM DEBT AND LINES OF CREDIT

Integrys Energy Group's short-term borrowings consist of sales of commercial paper, borrowings under revolving credit facilities, and short-term notes.

<i>(Millions, except percentages)</i>	September 30, 2008	December 31, 2007
Commercial paper outstanding	\$808.2	\$308.2
Average discount rate on outstanding commercial paper	5.23%	5.51%
Short-term notes payable outstanding	\$10.0	\$10.0
Average interest rate on short-term notes payable	2.44%	5.20%
Borrowings under revolving credit facilities	\$282.1	\$150.0
Average discount rate on revolving credit facilities	3.73%	3.56%

The commercial paper at September 30, 2008, had varying maturity dates ranging from October 1, 2008, through November 4, 2008.

Integrys Energy Group manages its liquidity by maintaining adequate external financing commitments. The information in the table below relates to Integrys Energy Group's short-term debt, lines of credit, and remaining available capacity.

<i>(Millions)</i>	Maturity	September 30, 2008	December 31, 2007
Credit agreements and revolving notes			
Revolving credit facility (Integrys Energy Group) <sup>(1)</sup>	06/02/10	\$ 500.0	\$ 500.0
Revolving credit facility (Integrys Energy Group) <sup>(1)</sup>	06/09/11	500.0	500.0
Revolving credit facility (WPSC) <sup>(2)</sup>	06/02/10	115.0	115.0
Revolving credit facility (PEC) <sup>(1) (4)</sup>	06/13/11	400.0	400.0
Revolving credit facility (PGL) <sup>(3)</sup>	07/12/10	250.0	250.0
Revolving credit facility (Integrys Energy Services) <sup>(4) (5)</sup>	04/08/09	175.0	150.0
Revolving short-term notes payable (WPSC) <sup>(6)</sup>	05/01/09	10.0	10.0
Uncommitted secured cross-exchange agreement (Integrys Energy Services) <sup>(7)</sup>	04/15/09	25.0	25.0
<b>Total short-term credit capacity</b>		<b>\$1,975.0</b>	<b>\$1,950.0</b>
Less:			
Uncollateralized portion of gross margin credit agreement		17.9	10.8
Letters of credit issued inside credit facilities		290.5	138.9
Loans outstanding under credit agreements		292.1	160.0
Commercial paper outstanding		809.0	308.2
Accrued interest or original discount on outstanding commercial paper		0.8	0.5
<b>Available capacity under existing agreements</b>		<b>\$ 564.7</b>	<b>\$1,331.6</b>

(1) Provides support for Integrys Energy Group's commercial paper borrowing program.

(2) Provides support for WPSC's commercial paper borrowing program.

(3) Provides support for PGL's seasonal commercial paper borrowing program.

(4) Borrowings under these agreements are guaranteed by Integrys Energy Group.

(5) This facility matured in April 2008, at which time the available borrowing capacity under the facility was increased to \$175.0 million and the maturity date was extended to April 8, 2009.

(6) This facility is renewed every six months.

- (7) This facility matured in April 2008, at which time the facility was renewed and the maturity date was extended. However, in October 2008 borrowings under this facility were paid in full as the facility was terminated and borrowings under this facility are no longer available.

In November 2008, Integrys Energy Group entered into an approximately \$150 million short-term debt agreement extending through March 2009 to finance its working capital requirements and for general corporate purposes. The agreement requires principal and interest payments to be made in Yen, which exposes Integrys Energy Group to foreign currency exchange risk. In order to mitigate this risk, Integrys Energy Group entered into foreign currency exchange contracts intended to hedge the exposure related to changes in the United States Dollar to Japanese Yen exchange rate.

In November 2008, Integrys Energy Group entered into a \$250 million revolving credit agreement, which extends to May 2009.

#### NOTE 9--LONG-TERM DEBT

<i>(Millions)</i>	September 30, 2008	December 31, 2007
WPSC	\$ 747.1	\$ 747.1
UPPCO	12.6	12.6
PEC	326.1	325.3
PGL <sup>(1) (2)</sup>	451.0	502.0
NSG	69.0	69.1
Integrys Energy Group	550.0	550.0
Unsecured term loan due 2010 – Integrys Energy Group	65.6	65.6
Term loans – nonrecourse, collateralized by nonregulated assets	8.6	10.5
Integrys Energy Services' loan	-	0.1
Other term loan	27.0	27.0
Senior secured note <sup>(3)</sup>	-	1.7
<b>Total</b>	<b>2,257.0</b>	<b>2,311.0</b>
Unamortized discount and premium on bonds and debt	6.6	9.3
<b>Total debt</b>	<b>2,263.6</b>	<b>2,320.3</b>
Less current portion <sup>(2)</sup>	(4.9)	(55.2)
<b>Total long-term debt</b>	<b>\$2,258.7</b>	<b>\$2,265.1</b>

- (1) PGL has outstanding \$51.0 million of Adjustable Rate, Series OO bonds, due October 1, 2037, which are currently in a 35-day Auction Rate mode (the interest rate is reset every 35 days through an auction process). The weighted-average interest rate for the period beginning January 1, 2008, and ending September 30, 2008, was 4.775% for these bonds. On April 17, 2008, PGL completed the purchase of \$51.0 million of Illinois Development Finance Authority Series 2003D Bonds, due October 1, 2037, and backed by PGL Series PP bonds. Upon repurchase, the Auction Rate Mode was converted from a 35-day mode to a weekly mode. This transaction was treated as a repurchase of the Series PP bonds by PGL. As a result, the liability related to the Series PP bonds was extinguished. The Company intends to hold the bonds while it continues to monitor the tax-exempt market and assess potential remarketing or refinancing opportunities.
- (2) On February 1, 2008, the interest rate on the \$50.0 million 3.05% Series LL first mortgage bonds at PGL, which support the Illinois Development Finance Authority Adjustable-Rate Gas Supply Refunding Revenue Bonds, Series 2003B, was established at a term rate of 3.75% through January 31, 2012, adjustable after February 1, 2012. These bonds were subject to a mandatory tender for purchase for remarketing on February 1, 2008, and, as a result, were presented in the current portion of long-term debt on Integrys Energy Group's Consolidated Balance Sheet at December 31, 2007. These bonds were included as long-term debt in the September 30, 2008 Condensed Consolidated Balance Sheet.
- (3) On June 26, 2008, Upper Peninsula Building Development Corporation, a subsidiary of Integrys Energy Group, repaid the outstanding principal balance on its 9.25% senior secured note. The note was secured by a first mortgage lien on a building sold in July 2008 that was previously owned and leased to UPPCO for use as their corporate headquarters.

In November 2008, PGL issued \$45 million of 7.0%, 5-year first and refunding mortgage bonds and \$5 million of 8.0%, 10-year first and refunding mortgage bonds. The net proceeds from the issuance of these bonds were used to reduce short-term debt and for other general corporate utility purposes.

In November 2008, NSG issued \$6.5 million of 7.0%, 5-year first mortgage bonds. The net proceeds from the issuance of the first mortgage bonds were used for other general corporate utility purposes.

#### **NOTE 10--ASSET RETIREMENT OBLIGATIONS**

The following table shows changes to the asset retirement obligations of Integrys Energy Group through September 30, 2008.

<i>(Millions)</i>	<b>Utilities</b>	<b>Integrys Energy Services</b>	<b>Total</b>
Asset retirement obligations at December 31, 2007	\$139.5	\$0.7	\$140.2
Accretion	5.9	-	5.9
Other	-	(0.5)	(0.5)
<b>Asset retirement obligations at September 30, 2008</b>	<b>\$145.4</b>	<b>\$0.2</b>	<b>\$145.6</b>

#### **NOTE 11--INCOME TAXES**

Integrys Energy Group's effective tax rates for the three and nine months ended September 30, 2008, were 36.5% and 37.7%, respectively. The effective tax rates for the three and nine months ended September 30, 2007, were 45.8% and 29.0%, respectively. Integrys Energy Group calculates its provision for income taxes based on an interim effective tax rate that reflects its projected annual effective tax rate. The effective tax rate for the three and nine months ended September 30, 2008, differs from the federal tax rate of 35%, primarily due to the quarterly adjustment required to adjust the interim effective tax rate to reflect the annual projected effective tax rate, state income taxes, and the impact of certain permanent book to tax return differences. The effective tax rate for the three and nine months ended September 30, 2007, differs from the federal tax rate of 35%, primarily due to the effects of Section 29/45K federal tax credits related to Integrys Energy Services' ownership in a synthetic fuel production facility, the quarterly adjustment required to adjust the interim effective tax rate to reflect the annual projected effective tax rate, and state income taxes. Section 29/45K of the Internal Revenue Code, which provided for Section 29/45K federal tax credits from the production and sale of synthetic fuel, expired effective December 31, 2007.

For the three and nine months ended September 30, 2008, the liability for uncertain tax positions increased \$7.3 million and \$6.6 million, respectively. These changes reflect the filing of the 2007 Federal tax return in the third quarter of 2008. The year-to-date increase also reflects the settlement and re-measurement of the obligations associated with uncertain tax positions as part of closing and settling examinations with the IRS and the State of Wisconsin during the second quarter of 2008.

#### **NOTE 12--COMMITMENTS AND CONTINGENCIES**

##### **Commodity Purchase Obligations and Purchase Order Commitments**

Integrys Energy Group routinely enters into long-term purchase and sale commitments that have various quantity requirements and durations. The regulated natural gas utilities have obligations to sell natural gas to their customers, and the regulated electric utilities have obligations to distribute and sell electricity to their customers. The utilities expect to recover costs related to these obligations in future customer rates. Additionally, the majority of the energy supply contracts entered into by our nonregulated segment, Integrys Energy Services, are to meet its obligations to deliver energy to customers.

The obligations described below are as of September 30, 2008.

- The electric utility segment has obligations related to coal supply and transportation that extend through 2016 and total \$622.1 million, obligations of \$1.4 billion for either capacity or energy related to purchased power that extend through 2027, and obligations for other commodities totaling \$14.3 million, which extend through 2013.
- The natural gas utility segment has obligations related to natural gas supply and transportation contracts totaling \$1.3 billion, some of which extend through 2028.
- Integrys Energy Services has obligations related to energy supply contracts that extend through 2017 and total \$4.8 billion. The majority of these obligations end by 2010, with obligations totaling \$611.7 million extending beyond 2010.
- Integrys Energy Group also has commitments in the form of purchase orders issued to various vendors, which totaled \$659.7 million, and relate to normal business operations as well as large construction projects.

## **Environmental**

### EPA Section 114 Request

In 2000, WPSC received a request from the EPA under Section 114 of the Clean Air Act, seeking information related to work performed on the coal-fired boilers located at WPSC's Pulliam and Weston electric generation stations. WPSC filed a response with the EPA in early 2001.

In May 2002, WPSC received a follow-up request from the EPA seeking additional information regarding specific boiler-related work performed on Pulliam Units 3, 5, and 7, as well as information on WPSC's life extension program for Pulliam Units 3-8 and Weston Units 1 and 2. WPSC filed a final response to the EPA's follow-up request in June 2002.

In 2000 and 2002, Wisconsin Power and Light Company (WP&L) received a similar series of EPA information requests relating to work performed on certain coal-fired boilers and related equipment at the Columbia generation station (a facility located in Portage, Wisconsin, jointly owned by WP&L, Madison Gas and Electric Company, and WPSC). WP&L is the operator of the plant and is responsible for responding to governmental inquiries relating to the operation of the facility. WP&L filed its response for the Columbia facility in July 2002.

Depending upon the results of the EPA's review of the information provided by WPSC and WP&L, the EPA may perform any of the following:

- issue notices of violation (NOV) asserting that a violation of the Clean Air Act occurred,
- seek additional information from WPSC, WP&L, and/or third parties who have information relating to the boilers, and/or
- close out the investigation.

In addition, under the Clean Air Act, citizen groups may pursue a claim. WPSC has no notice of such a claim based on the information submitted to the EPA.

To date, the EPA has not responded to the 2001 and 2002 filings made by WPSC and WP&L. However, in March 2008, a data request was received from the EPA seeking information related to operations and projects for the Pulliam and Weston coal-fired boilers from January 2000 to the present. WPSC has submitted its response.

In response to the EPA's Clean Air Act enforcement initiative, several utilities elected to settle with the EPA, while others are in litigation. The fines and penalties (including the cost of supplemental environmental projects) associated with settlements involving comparably-sized facilities range between \$7 million and \$30 million. The regulatory interpretations upon which the lawsuits or settlements are based may change based on future court decisions of the pending litigations.

If the federal government brings a claim against WPSC and if it were determined by a court that historic projects at WPSC's Pulliam and Weston plants required either a state or federal Clean Air Act permit, WPSC may, under the applicable statutes, be required to:

- shut down any unit found to be operating in non-compliance,
- install additional pollution control equipment,
- pay a fine, and/or
- pay a fine and conduct a supplemental environmental project in order to resolve any such claim.

#### Pulliam Air Notice of Violation

In September 2007, a NOV was issued to WPSC by the WDNR alleging various violations of the Pulliam facility's Title V permit, primarily pertaining to certain recordkeeping and monitoring requirements. WPSC met with the WDNR in November 2007 to discuss and attempt to resolve the matters identified in the NOV, and subsequently submitted additional information pursuant to the WDNR's request. While not finally confirmed by the WDNR, WPSC understands that this issue is essentially resolved.

#### Weston 4 Air Permit

In November 2004, the Sierra Club filed a petition with the WDNR under Section 285.61 of the Wisconsin Statutes seeking a contested case hearing on the construction permit issued for the Weston 4 generation station, which is a necessary predicate to plant construction under the pertinent air emission regulations (hereinafter referred to as the "Weston 4 air permit"). In February 2006, the administrative law judge affirmed the Weston 4 air permit with changes to the emission limits for sulfur dioxide and nitrogen oxide from the coal-fired boiler and particulate from the cooling tower. The changes, which were implemented by the WDNR in a revised permit issued on March 28, 2007, set limits that are more stringent than those originally set by the WDNR (hereinafter referred to as the "March 28, 2007 permit language").

On April 27, 2007, the Sierra Club filed a second petition requesting a contested case hearing regarding the March 28, 2007 permit language, which was granted by the WDNR. Both parties subsequently moved for summary judgment. In a decision issued on November 8, 2007, the administrative law judge granted WPSC's motion for summary judgment in that proceeding, upholding the March 28, 2007 permit language. The Sierra Club filed petitions with the Dane County Circuit Court on April 27, 2007, and November 14, 2007, for judicial review of the Weston 4 air permit and the underlying proceedings before the administrative law judge. These two judicial review proceedings were consolidated by the court, briefing is completed, and the parties presented oral arguments on November 3, 2008.

These activities did not stay the construction and startup of the Weston 4 facility or the administrative law judge's decision on the Weston 4 air permit. WPSC believes that it has substantial defenses to the Sierra Club's challenges. Until the Sierra Club's challenge is finally resolved, Integrys Energy Group will not be able to make a final determination of the probable cost impact, if any, of compliance with any changes to the Weston 4 air permit on its future costs.

There is a possibility that an event at the Weston 4 facility may have resulted in a permit limit exceedance for carbon monoxide and sulfur dioxide during startup that may result in an enforcement action by the WDNR. Corrective actions have been taken and the WDNR has requested additional information prior to determining what enforcement action will be taken. It is possible that the WDNR will issue a NOV and impose a fine, but the amount cannot be estimated at this time.

#### Weston Operating Permits

In July 2005 and February 2006, NOVs were issued to WPSC by the WDNR alleging various violations of the operating permit requirements applicable to the then existing Weston facility. Subsequently, by letter dated April 11, 2007, the WDNR referred the matters set forth in the NOVs to the Wisconsin Attorney General's office. The referral letter alleged that the Weston facility was not in compliance with the following provisions of the facility's Title V operating permit: (i) limitations on the sulfur content of the fuel

oil stored at the Weston facility; (ii) the carbon monoxide and nitrogen oxide limits for certain of the facility's combustion turbines; (iii) the particulate matter emission limits applicable to the coal handling equipment; (iv) opacity monitoring requirements; and (v) a requirement to conduct an elemental metals analysis. WPSC has completed corrective measures to address the issues and settled the matter with the Wisconsin Attorney General's office. The settlement included a penalty of \$0.2 million and a commitment to fund \$0.3 million of energy efficiency projects.

In early November 2006, it came to the attention of WPSC that previous ambient air quality computer modeling done by the WDNR for the Weston facility (and other nearby air sources) did not take into account the emissions from the existing Weston 3 facility for purposes of evaluating air quality increment consumption under the required Prevention of Significant Deterioration. WPSC believes it has undertaken and completed corrective measures to address any identified modeling issues and anticipates issuance of a revised Title V permit in the near future that will resolve this issue. Integrys Energy Group currently is not able to make a final determination of the probable cost impact of this issue, if any.

### Mercury and Interstate Air Quality Rules

#### *Mercury*

In October 2004, the mercury emission control rule became effective in Wisconsin (Chapter NR 446), requiring WPSC to control annual system mercury emissions in phases with the first phase beginning in 2008. In this phase, the annual mercury emissions are capped at the average annual system mercury emissions for the period 2002 through 2004. The next phase will run from 2010 through 2014 and require a 40% reduction from average annual 2002 through 2004 mercury input amounts. After 2015, a 75% reduction is required with a goal of an 80% reduction by 2018. The current version of Chapter NR 446 applies to all WPSC units except Weston 4. Weston 4 installed mercury control technology which will achieve a mercury emission rate that meets the permit limit for mercury.

The State of Wisconsin has recently developed a revised draft rule to Chapter NR 446 that requires a 40% reduction from the 2002 through 2004 baseline beginning January 1, 2010, through the end of 2014. Beginning in 2015, electric generating units above 150 megawatts will be required to reduce emissions by 90%. Reductions can be phased in and the 90% target can be delayed until 2021 if additional sulfur dioxide and nitrogen oxide reductions are implemented. By 2015, electric generating units above 25 megawatts but less than 150 megawatts must reduce their mercury emissions to a level defined as the Best Available Control Technology rule. This rule has been approved by the state Natural Resources Board and is expected to become final in December 2008. WPSC estimates capital costs of approximately \$30 million for phase one, which includes estimates for both wholly owned and jointly owned plants, to achieve the proposed reductions in the State's revised draft rule. These costs may change based on the requirements of the final rule. The capital costs are expected to be recovered in future rate cases. In May 2008, a group of industry stakeholders filed suit, claiming that the WDNR's mercury rulemaking process violates a state statute. The court ruled against the challenge but a new suit is likely to be filed.

Following the promulgation of a federal mercury control and monitoring rule in 2005 by the EPA, the State of Wisconsin filed suit along with other states in opposition of the rule. On February 8, 2008, the United States Court of Appeals for the District of Columbia Circuit ruled in favor of the petitioners and vacated the federal rule. In May 2008, the EPA's appeal of the ruling was denied. The EPA is reviewing options for a new rulemaking.

#### *Sulfur Dioxide and Nitrogen Oxide*

The EPA issued the Clean Air Interstate Rule (formerly known as the Interstate Air Quality Rule) in 2005. The rule was intended to reduce sulfur dioxide and nitrogen oxide emissions from utility boilers located in 29 states, including Wisconsin, Michigan, Pennsylvania, and New York. The Clean Air Interstate Rule required reduction of sulfur dioxide and nitrogen oxide emissions in two phases. The first phase required about a 50% reduction beginning in 2009 for nitrogen oxide and beginning in 2010 for sulfur dioxide. The

second phase was to begin in 2015 for both pollutants and required about a 65% reduction in emissions. The rule allowed the State of Wisconsin to either require utilities located in the state to participate in the EPA's interstate cap and trade program or meet the state's emission budget for sulfur dioxide and nitrogen oxide through measures to be determined by the state. Wisconsin's rule, which incorporates the cap and trade approach, had completed the state legislative review and had been forwarded to the EPA for final review.

On July 11, 2008, the United States Court of Appeals for the District of Columbia issued a decision vacating the Clean Air Interstate Rule and the associated Federal Implementation Plan. The EPA has requested a rehearing of the decision and is waiting for the court to respond to its request.

Prior to the court's vacatur decision, WPSC was evaluating a number of options, including using the cap and trade program and/or installing controls. Since the vacatur decision, the value of annual nitrogen oxide emission allowances that were to be utilized in the cap and trade program under the Clean Air Interstate Rule has decreased significantly and trading in annual nitrogen oxide emission allowances has all but ceased. WPSC does not currently own any annual nitrogen oxide emission allowances; however, at the time of the court decision, WPSC had entered into contracts for the purchase of a small amount of ozone seasonal nitrogen oxide emission allowances in 2009 through 2012 and was in the process of negotiating the purchase of annual nitrogen oxide emission allowances in 2009. Whether WPSC ultimately acquires any annual nitrogen oxide emission allowances or not, WPSC does not expect any material impact as a result of the vacatur of the Clean Air Interstate Rule with respect to nitrogen oxide emission allowances. The vacatur decision has also affected the status of the Best Available Retrofit Technology rule. The status of WPSC units under that rule is currently being evaluated. For planning purposes, it is still assumed that additional sulfur dioxide and nitrogen oxide controls will be needed on existing units or the existing units will need to be converted to natural gas by 2015. The installation of any controls and/or any conversion to natural gas will need to be scheduled as part of WPSC's long-term maintenance plan for its existing units. As such, controls or conversions may need to take place before 2015. On a preliminary basis, and assuming controls or conversion are still required, WPSC estimates capital costs of \$533 million, which includes estimates for both wholly owned and jointly owned plants, in order to meet an assumed 2015 compliance date. This estimate is based on costs of current control technology and current information regarding the final state and federal rules. The capital costs are anticipated to be recovered in future rate cases.

#### Manufactured Gas Plant Remediation

Integrus Energy Group's natural gas utilities, their predecessors, and certain former affiliates operated facilities in the past at multiple sites for the purpose of manufacturing and storing manufactured gas and, as such, are responsible for the environmental impacts at 55 manufactured gas plant sites located in Wisconsin, Michigan, and Illinois. All are former regulated utility sites and are being remediated, with costs charged to existing ratepayers at WPSC, MGUC, PGL, and NSG. Nine of these sites have been transferred to the EPA Superfund Alternative Sites Program, and 11 sites have been transferred to the EPA's Superfund Removal Program, with the intent of being transferred to the EPA Superfund Alternative Sites Program. Integrus Energy Group estimated and accrued for \$676.4 million of future undiscounted investigation and cleanup costs as of September 30, 2008. Integrus Energy Group recorded a regulatory asset of \$728.7 million, net of insurance recoveries received of \$54.0 million, related to the recovery of both unrecovered expenditures and estimated future expenditures as of September 30, 2008.

The natural gas utilities are coordinating the investigation and the cleanup of the manufactured gas plant sites under what is called a "multi-site" program. This program involves prioritizing the work to be done at the sites, preparation and approval of documents common to all of the sites, and utilization of a consistent approach in selecting remedies.

The EPA has identified NSG as a potentially responsible party (PRP) under the Comprehensive Environmental Response, Compensation and Liability Act of 1980, as amended (CERCLA), at the Waukegan Coke Plant Site located in Waukegan, Illinois (Waukegan Site). The Waukegan Site is part of the Outboard Marine Corporation (OMC) Superfund Site. The EPA also identified OMC, General Motors

Corporation, and certain other parties as PRPs at the Waukegan Site. NSG and the other PRPs are parties to a consent decree that requires NSG and General Motors, jointly and severally, to perform the remedial action and establish and maintain financial assurance of \$27.0 million (in the form of certain defined net worth levels that NSG has met). The soil component of the remedial action was completed in August 2005. The final design for the groundwater component of the remedial action has been completed, and construction of the groundwater treatment plan was completed in August 2008. Operation of the groundwater treatment unit began in September 2008 and is expected to be up to full capacity during the first quarter of 2009. The EPA reduced the financial assurance requirement to \$21.0 million to reflect completion of the soil component of the remedial action.

With respect to portions of certain sites in the City of Chicago (Chicago), PGL received demands from site owners and others asserting standing regarding the investigation or remediation of their parcels. Some of these demands seek to require PGL to perform extensive investigations or remediations. These demands include notice letters sent to PGL by River Village West. In April 2005, River Village West filed suit against PGL in the United States District Court for the Northern District of Illinois under Resource Conservation and Recovery Act (RCRA). The suit, River Village West LLC et al. v. The Peoples Gas Light and Coke Company, No. 05-C-2103 (N.D. Ill. 2005) (RVW II), seeks an order directing PGL to remediate three former sites: the former South Station, the former Throop Street Station, and the former Hough Place Station.

In August 2006, a member of River Village West individually filed suit against PGL in the United States District Court for the Northern District of Illinois under the RCRA. The suit, Thomas A. Snitzer v. The Peoples Gas Light and Coke Company, No. 06-C-4465 (N.D. Ill. 2006) (Snitzer I), seeks an order directing PGL to remediate the Willow Street Station former manufactured gas plant site which is located along the Chicago River. In October 2006, the same individual filed another suit in the United States District Court for the Northern District of Illinois under RCRA and CERCLA. The suit, Thomas A. Snitzer v. The Peoples Gas Light and Coke Company, No. 06-C-5901 (N.D. Ill. 2006) (Snitzer II), seeks an order directing PGL to remediate four former manufactured gas plant sites, which are located on or near the Chicago River: 22<sup>nd</sup> Street Station, Division Street Station, Hawthorne Station, and North Shore Avenue Station. This individual also notified PGL of his intent to file suit under RCRA and CERCLA seeking an order directing PGL to remediate two other such sites: Calumet Station and North Station.

In February 2007, Snitzer I and Snitzer II were consolidated with the RVW II case. In June 2007, PGL filed a motion to dismiss, or in the alternative, stay the consolidated litigation on the basis of the transfer of the sites at issue in the litigation to the EPA Superfund Removal program. On September 28, 2007, the federal district court issued a ruling staying the litigation "pending the conclusion of the United States EPA actions" at these sites. The plaintiffs filed a motion for reconsideration. The court reconsidered the stay and on September 25, 2008, granted PGL's motion for a judgment on the pleadings dismissing the suit. On October 24, 2008, the plaintiffs filed their notice of appeal of the district court's ruling. Management cannot predict the outcome of the appeal.

Management believes that any costs incurred for environmental activities relating to former manufactured gas plant operations that are not recoverable through contributions from other entities or from insurance carriers have been prudently incurred and are, therefore, recoverable through rates for WPSC, MGUC, PGL, and NSG. Accordingly, management believes that the costs incurred in connection with former manufactured gas plant operations will not have a material adverse effect on the financial position or results of operations of Integrys Energy Group.

### Flood Damage

In May 2003, a fuse plug at the Silver Lake reservoir owned by UPPCO was breached. This breach resulted in subsequent flooding downstream on the Dead River, which is located in Michigan's Upper Peninsula near Marquette, Michigan. Several lawsuits were filed related to this incident, all of which have been settled and for which insurance recovery was received in excess of the applicable self-insured retention.

UPPCO has completed significant environmental restoration activities and is working with the Michigan Department of Environmental Quality to determine what additional activities and mitigation projects are necessary to resolve the impacts associated with this event. Integrys Energy Group maintains a comprehensive insurance program that includes UPPCO that it believes is sufficient to cover its responsibilities related to this event. The self-insured retention on this policy is not material to Integrys Energy Group.

In November 2003, UPPCO received approval from the MPSC and the FERC for deferral of incremental operating and maintenance costs that are not reimbursable through insurance. At this time, it is expected that all of these costs will be recovered by third party settlements. UPPCO also received approval from the MPSC to defer incremental power supply costs associated with the incident. Recovery of the deferred power supply costs is the subject of a current rate proceeding.

Construction has commenced in order to restore Silver Lake for power generation. UPPCO continues to work with a board of consultants and the FERC to oversee the design and construction process. It is anticipated that construction will be finished by the end of 2008, but completion depends largely on site conditions.

#### Former Mineral Processing Site in Denver, Colorado

In 1994, NSG received a demand for reimbursement, indemnification, and contribution for response costs incurred with respect to the cleanup of a former mineral processing site in Denver, Colorado. The demand from the S.W. Shattuck Chemical Company, Inc. alleges that NSG is a successor to the liability of a former entity that was allegedly responsible during the period 1934 through 1941 for the disposal of mineral processing wastes containing radium and other hazardous substances at the site. In 1992, the EPA issued a record of decision (ROD) for the Denver site and remediation work began. The remedy selected in the ROD consisted of the on-site stabilization, solidification, and capping of soils containing radioactive wastes. In 1998, the remedial action under the 1992 ROD was completed. In 2002, the EPA issued an amended ROD that required removing the monolith cap and undertaking additional soil excavation. The work performed under the amended ROD began in September 2002 and was completed in September 2006.

NSG does not believe that it has liability for the costs related to this site, but cannot determine the matter with certainty. At this time, NSG cannot reasonably estimate what range of loss, if any, may occur. In the event that NSG incurs liability, it would pursue reimbursement from insurance carriers and other responsible parties, if any.

### Greenhouse Gases

There is increasing concern over the issue of climate change and the effect of emissions of greenhouse gases, in particular from the combustion of fossil fuels. Integrys Energy Group is evaluating both the technical and cost implications which may result from future state, regional, or federal greenhouse gas regulatory programs. This evaluation indicates that it is probable that any regulatory program that caps emissions or imposes a carbon tax will increase costs for Integrys Energy Group and its customers. The greatest impact is likely to be on fossil fuel-fired generation, with a less significant impact on natural gas storage and distribution operations. Efforts are underway within the utility industry to find a feasible method for capturing carbon dioxide from pulverized coal-fired units and to develop cleaner ways to burn coal. The use of alternate fuels is also being explored by the industry, but there are many cost and availability issues. Based on the complexity and uncertainty of the climate issues, a risk exists that future carbon regulation will increase the cost of electricity produced at coal-fired generation units. However, we believe the capital expenditures we are making at our generation units are appropriate under any reasonable mandatory greenhouse gas program and that future expenditures by our regulated electric utilities will be recoverable in rates. Integrys Energy Group will continue to monitor and manage potential risks and opportunities associated with future greenhouse gas regulatory actions.

### Escanaba Water Permit Issues

UPPCO operates the Escanaba Generating Station (EGS) under contract with its owner, the City of Escanaba (City). While the City owns the water permits for EGS, UPPCO's personnel provide testing and certification of waste water discharges. In September 2008, UPPCO became aware of potential water discharge permit violations regarding reported pH and oil and grease readings at EGS. Corrective actions have been implemented at the plant, notification has been provided to the City, and UPPCO has self reported the potential permit violations to the Michigan Department of Environmental Quality (MDEQ). The MDEQ has requested additional information prior to determining what enforcement action will be taken.

Depending upon the results of the MDEQ's review of the information provided by UPPCO, the MDEQ, in consultation with the Michigan Attorney General Office, may perform any of the following:

- assess a fine and/ or seek criminal charges against UPPCO,
- assess a fine and /or seek criminal charges against the former manager who certified the reports, and /or
- close out the investigation.

### **Natural Gas Charge Reconciliation Proceedings and Related Matters**

#### Natural Gas Charge Settlement

For PGL and NSG, the ICC conducts annual proceedings regarding the reconciliation of revenues from the natural gas charge and related natural gas costs. The natural gas charge represents the cost of natural gas and transportation and storage services purchased by PGL and NSG, as well as gains, losses, and costs incurred under PGL's and NSG's hedging program (Gas Charge). In these proceedings, interested parties review the accuracy of the reconciliation of revenues and costs and the prudence of natural gas costs recovered through the Gas Charge. If the ICC were to find that the reconciliation was inaccurate or any natural gas costs were imprudently incurred, the ICC would order the utility companies to refund the affected amount to customers through subsequent Gas Charge filings.

Pursuant to a 2006 settlement agreement related to fiscal year 2001-2004 natural gas costs, PEC agreed to make payments of up to \$30.0 million toward the funding of conservation and weatherization programs for low and moderate income customers. PGL and NSG will not seek recovery in any future rate or reconciliation cases of any amounts associated with these conservation programs. At the date of the PEC merger, \$25.0 million of that amount had not yet been paid, and was recorded as a preacquisition contingency. As of September 30, 2008, \$15.4 million remained unpaid, of which \$5.0 million was

included in other current liabilities, and \$10.4 million was included in other long-term liabilities. PGL and NSG also refunded certain amounts related to fiscal 2001 through 2004 natural gas costs, but those refunds had been completed prior to the PEC merger.

The settlement agreement provided that PGL and NSG would cooperate with Chicago and the Illinois Attorney General (AG) to identify those customers who were not receiving natural gas as of the date of the Agreement that were financial hardship cases. The hardship cases were identified by the utilities, the AG, and Chicago. Following identification, PGL and NSG reconnected the hardship cases. PGL and NSG forgave all outstanding debt for reconnected customers. Although PGL and NSG believe they have fully complied with this provision of the settlement agreement, Chicago and the AG have indicated that they believe the terms of the hardship program are broader than what PGL and NSG believe they are obligated to implement. Management continues to believe that it has fully complied with the obligations of the settlement agreement with respect to the hardship program.

In the settlement agreement, PGL and NSG agreed to conduct internal and external audits of their natural gas procurement practices. An annual internal audit is required for five years, and the first two are completed. The external audit was performed by a consulting firm retained by the ICC. The ICC staff filed the auditor's report on April 10, 2008. The report included 32 recommendations, most of which are for PGL and NSG to prepare various studies and analyses or implement changes to certain practices and procedures. None of the recommendations quantified natural gas costs that the auditor believed should not be recovered by PGL and NSG. PGL and NSG filed a response to the auditor's report on June 30, 2008, in which they agreed to implement 25 of the recommendations. As of September 30, 2008, PGL and NSG had submitted implementation documentation for 20 of these recommendations. The remaining five are expected to be completed by March 31, 2009. The ICC staff may file a reply to PGL's and NSG's response.

The fiscal 2005 Gas Charge reconciliation cases were initiated in November 2005. The settlement of the prior fiscal years' Gas Charge reconciliation proceedings did not affect these cases, except for PGL's agreement to credit fiscal 2005 Hub revenues as an offset to utility customers' natural gas charges. The ICC staff and intervener witnesses recommended disallowances. The majority of the recommended disallowances were for adjustments to the amount recorded as transportation customers' bank (storage) natural gas liability balances. For PGL, the ICC issued its order, which accepted the administrative law judges' recommendations and ICC staff's recommended disallowances in their entirety, on January 16, 2008. The natural gas cost disallowance for PGL was \$20.5 million. For NSG, the ICC issued its order, which accepted the administrative law judges' recommendations and ICC staff's recommended disallowances in their entirety, on January 16, 2008. The natural gas cost disallowance for NSG was \$1.0 million. On February 14, 2008, PGL and NSG filed for rehearing on one of the two bank (storage) natural gas liability issues. The ICC denied rehearing on February 27, 2008, and PGL and NSG did not appeal this matter. The customer refunds from the 2005 Gas Charge reconciliation cases have been accounted for as a preacquisition contingency. Pursuant to the ICC orders, PGL and NSG refunded customers \$22.6 million and \$1.1 million, respectively, including interest, during the nine months ended September 30, 2008.

The fiscal 2006 Gas Charge reconciliation cases were initiated on November 21, 2006. PGL and NSG filed their direct testimony on April 10, 2007. On May 16, 2007, the ICC initiated Gas Charge reconciliation cases for the period of October 2006 through December 2006 to cover the gap created by PGL and NSG's move to a calendar year reconciliation period. The ICC staff moved to consolidate the new cases with the fiscal 2006 cases, and the administrative law judge granted the motion in July 2007. PGL's and NSG's direct testimony for the October through December 2006 period was filed on October 17, 2007. On July 22, 2008, the ICC staff and intervenors (the AG, the Citizens Utility Board, and the City of Chicago, filing jointly) each filed testimony recommending disallowances for PGL and NSG for a bank (storage) natural gas liability adjustment similar to that addressed in the fiscal 2005 Gas Charge reconciliation case. In addition, the intervenors recommended a disallowance for PGL of \$13.9 million associated with PGL's provision of interstate hub services. On August 29, 2008, PGL and NSG filed rebuttal testimony in which they agreed not to contest the bank (storage) natural gas liability proposal. The amount recorded at PGL and NSG at September 30, 2008, related to the bank (storage)

natural gas liability was not significant. PGL contested the hub services' proposal. The ICC staff and intervenors' rebuttal testimony is due November 6, 2008, and PGL's and NSG's surrebuttal testimony is due December 2, 2008. A hearing is set for December 11, 2008.

The ICC initiated the calendar year 2007 Gas Charge reconciliation cases on November 28, 2007. PGL and NSG filed direct testimony on April 15, 2008. At an October 8, 2008 status hearing, the administrative law judge granted PGL's motion for leave to file supplemental direct testimony. The ICC staff in PGL's 2006 Gas Charge case requested such testimony to address PGL's new pipeline interconnection and contract with Kinder Morgan Illinois Pipeline. A status hearing is scheduled for January 13, 2009.

### Class Action

In February 2004, a purported class action was filed in Cook County Circuit Court against PEC, PGL, and NSG by customers of PGL and NSG, alleging, among other things, violation of the Illinois Consumer Fraud and Deceptive Business Practices Act related to matters at issue in the utilities' fiscal year 2001 Gas Charge reconciliation proceedings. In the suit, Alport et al. v. Peoples Energy Corporation, the plaintiffs seek unspecified compensatory and punitive damages. PGL and NSG have been dismissed as defendants and the only remaining counts of the suit allege violations of the Consumer Fraud and Deceptive Business Practices Act by PEC and that PEC acted in concert with others to commit a tortious act. PEC denies the allegations and is vigorously defending the suit. On July 30, 2008, the plaintiffs filed a motion for class certification and PEC responded in opposition of this motion. There is a status hearing scheduled for November 17, 2008.

### **Corrosion Control Inspection Proceeding**

Illinois state, as well as federal laws require natural gas utilities to conduct periodic corrosion control inspections on natural gas pipelines. On April 19, 2006, the ICC initiated a citation proceeding related to such inspections that were required to be performed by PGL during 2003 and 2004, but which were not completed in the requisite timeframe. On December 20, 2006, the ICC entered an order approving a stipulation between the parties to this proceeding under which PGL agreed that it had not been in compliance with applicable regulations, and further agreed to pay a penalty of \$1.0 million, pay for a consultant to conduct a comprehensive investigation of its compliance with ICC pipeline safety regulations, remain compliant with those regulations, not seek recovery in future rate cases of certain costs related to non-compliance, and hold meetings with the city of Chicago to exchange information. This order resolved only the ICC proceeding and did not constitute a release of any other potential actions outside of the ICC proceeding. With respect to the comprehensive investigation, the ICC selected an auditor for this matter and the auditor, issued a final report on August 14, 2008, containing 65 recommendations and an additional placeholder for a possible recommendation. The ICC conducted a public hearing on October 8, 2008, at which time the auditor presented the report to the ICC for its acceptance. PGL submitted a draft plan to the ICC staff in which PGL accepted most of the recommendations and offered an alternative proposal for the remainder. PGL anticipates negotiating implementation plans with the ICC staff and the consultant for each of the recommendations. The auditor's agreement with the ICC provides for a two-year monitoring phase to verify PGL's compliance with the prospective implementation plan.

On May 16, 2006, the AG served a subpoena requesting documents relating to PGL's corrosion inspections. PGL's counsel has met with representatives of the AG's office and provided documents relating to the subpoena. On July 10, 2006, the United States Attorney for the Northern District of Illinois served a grand jury subpoena on PGL requesting documents relating to PGL's corrosion inspections. PGL's counsel has met with the United States Attorney's office and provided documents relating to corrosion inspections. PGL has had no further communication with the United States Attorney's office since that time. Management cannot predict the outcome of this investigation and has not recorded a liability associated with this contingency.

## Builders Class Action

In June 2005, a purported class action was filed against PEC and its utility subsidiaries by Birchwood Builders, LLC in the Circuit Court of Cook County, Illinois alleging that PGL and NSG were fraudulently and improperly charging fees to customers with respect to utility connections, disconnections, reconnections, relocations, extensions of natural gas service pipes, extensions of distribution natural gas mains, and failing to return related customer deposits. PGL and NSG filed two motions to dismiss the lawsuit. On January 25, 2007, the judge entered an order dismissing the complaint, but allowing the plaintiffs the option of filing an amended complaint (except as to the plaintiffs' claim for declaratory relief, which was dismissed with prejudice). The judge also ruled that the plaintiffs could file their claims directly with the ICC. On June 28, 2007, plaintiffs filed a second amended complaint with the Circuit Court. PGL and NSG responded by filing a motion to dismiss on August 31, 2007. This motion was granted on April 16, 2008, and this matter was dismissed. The plaintiffs filed a motion for reconsideration of the dismissal, and this motion was denied on August 4, 2008. The plaintiffs filed a notice of appeal with the Illinois appellate court on August 25, 2008. The plaintiffs also have the right to file individual complaints with the ICC, but Integrys Energy Group does not know if, or when, any such complaints will be filed. In October 2008, the parties agreed to the terms of a settlement and are currently finalizing the settlement documents. Based upon the terms agreed to, the amount of the settlement will not be material to Integrys Energy Group.

## NOTE 13--GUARANTEES

The following table shows outstanding guarantees at Integrys Energy Group at September 30, 2008:

<i>(Millions)</i>	Total Amounts Committed at September 30, 2008	Expiration			
		Less Than 1 Year	1 to 3 Years	4 to 5 Years	Over 5 Years
Guarantees supporting commodity transactions of subsidiaries <sup>(1)</sup>	\$2,328.2	\$1,733.2	\$ 457.2	\$28.9	\$108.9
Guarantees of subsidiary debt and revolving line of credit <sup>(2)</sup>	928.1	175.0	725.0	-	28.1
Standby letters of credit <sup>(3)</sup>	289.2	283.5	5.7	-	-
Surety bonds <sup>(4)</sup>	1.7	1.7	-	-	-
Other guarantees <sup>(5)</sup>	4.2	-	4.2	-	-
Total guarantees	\$3,551.4	\$2,193.4	\$1,192.1	\$28.9	\$137.0

(1) Consists of parental guarantees of \$2,149.9 million to support the business operations of Integrys Energy Services, of which \$5.0 million received specific authorization from Integrys Energy Group's Board of Directors and was not subject to the guarantee limit discussed below; \$93.4 million and \$79.9 million, respectively, related to natural gas supply at MERC and MGUC, of an authorized \$150.0 million and \$100.0 million, respectively; and \$5.0 million, of an authorized \$125.0 million, to support business operations at PEC. These guarantees are not reflected in the Condensed Consolidated Balance Sheets.

(2) Consists of an agreement to fully and unconditionally guarantee PEC's \$400.0 million revolving line of credit; an agreement to fully and unconditionally guarantee, on a senior unsecured basis, PEC's obligations under its \$325.0 million, 6.90% notes due January 15, 2011; a \$175.0 million credit agreement at Integrys Energy Services used to finance natural gas in storage and margin requirements related to natural gas and electric contracts traded on the NYMEX and the ICE, as well as for general corporate purposes; and \$28.1 million of guarantees supporting outstanding debt at Integrys Energy Services' subsidiaries, of which \$1.1 million is subject to Integrys Energy Services' parental guarantee limit discussed below. Parental guarantees related to subsidiary debt and credit agreements outstanding are not included in the Condensed Consolidated Balance Sheets.

(3) Comprised of \$284.0 million issued to support Integrys Energy Services' operations, including \$2.5 million that received specific authorization from Integrys Energy Group's Board of Directors; \$4.3 million issued for workers compensation coverage in Illinois; and \$0.9 million related to letters of credit at UPPCO, MGUC, MERC, and PEC. These amounts are not reflected in the Condensed Consolidated Balance Sheets.

- (4) Primarily for workers compensation coverage and obtaining various licenses, permits, and rights of way. Surety bonds are not included in the Condensed Consolidated Balance Sheets.
- (5) Includes (1) a liability related to WPSC's agreement to indemnify Dominion for certain costs arising from the resolution of design bases documentation issues incurred prior to Kewaunee nuclear power plant's scheduled maintenance period in 2009. As of September 30, 2008, WPSC had paid \$6.9 million to Dominion related to this guarantee, reducing the liability to \$1.9 million; and (2) a \$2.3 million indemnification provided by Integrys Energy Services related to the sale of Niagara. This indemnification related to potential environmental contamination from ash disposal at this facility. A \$0.1 million liability was recorded related to this indemnification at September 30, 2008.

Integrys Energy Group has provided total parental guarantees of \$2,637.9 million on behalf of Integrys Energy Services. Integrys Energy Group's exposure under these guarantees related to open transactions at September 30, 2008 was approximately \$673 million. At September 30, 2008, management was authorized to issue corporate guarantees up to an aggregate amount of \$2.95 billion to support the business operations of Integrys Energy Services. The following outstanding amounts were subject to this limit:

<i>(Millions)</i>	<b>September 30, 2008</b>
Guarantees supporting commodity transactions of subsidiaries	<b>\$2,144.9</b>
Guarantees of subsidiary debt	<b>176.1</b>
Standby letters of credit	<b>281.5</b>
Surety bonds	<b>0.9</b>
<b>Total guarantees subject to \$2.95 billion limit</b>	<b>\$2,603.4</b>

#### **NOTE 14--EMPLOYEE BENEFIT PLANS**

On September 30, 2008, the PEC Service Annuity System was merged into the PEC Retirement Plan, which was then renamed the Integrys Energy Group Retirement Plan. The merger had no effect on the level of plan benefits provided to participants or the management of plan assets. Integrys Energy Group and its subsidiaries now maintain two non-contributory qualified retirement plans covering substantially all employees, as well as several unfunded nonqualified retirement plans. In addition, Integrys Energy Group and its subsidiaries offer multiple postretirement benefit plans to employees.

The following table shows the components of net periodic benefit cost for Integrys Energy Group's benefit plans for the three and nine months ended September 30, 2008, and 2007. Costs related to the PEC benefit plans are included after the February 21, 2007 merger date.

<i>(Millions)</i>	<b>Pension Benefits</b>				<b>Other Postretirement Benefits</b>			
	<b>Three Months Ended</b>		<b>Nine Months Ended</b>		<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30 2008</b>	<b>2007</b>	<b>September 30 2008</b>	<b>2007</b>	<b>September 30 2008</b>	<b>2007</b>	<b>September 30 2008</b>	<b>2007</b>
Service cost	\$ 9.6	\$10.4	\$28.8	\$28.9	\$4.0	\$4.0	\$11.8	\$10.7
Interest cost	19.1	18.6	57.2	51.2	6.5	6.3	19.3	17.6
Expected return on plan assets	(25.3)	(23.7)	(75.7)	(61.7)	(4.6)	(4.3)	(13.8)	(12.7)
Amortization of transition obligation	-	-	-	-	0.1	0.4	0.2	1.0
Amortization of prior service cost (credit)	1.3	1.9	3.8	5.3	(1.0)	(0.6)	(2.9)	(1.6)
Amortization of net actuarial loss (gain)	0.1	3.2	0.5	10.4	(0.1)	0.9	(0.2)	2.4
Amortization of merger-related regulatory adjustment	1.9	-	6.0	-	0.5	(0.1)	1.6	(0.1)
<b>Net periodic benefit cost</b>	<b>\$ 6.7</b>	<b>\$10.4</b>	<b>\$20.6</b>	<b>\$34.1</b>	<b>\$5.4</b>	<b>\$6.6</b>	<b>\$16.0</b>	<b>\$17.3</b>

Transition obligations, prior service costs (credits), and net actuarial losses (gains) that have not yet been recognized as a component of net periodic benefit cost are included in accumulated other comprehensive income for Integrys Energy Group's nonregulated entities and are recorded as net regulatory assets for the utilities, pursuant to SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation." All

amounts amortized for merger-related regulatory adjustments are from regulatory assets, as these relate to the utilities.

Contributions to the plans are made in accordance with legal and tax requirements and do not necessarily occur evenly throughout the year. For the nine months ended September 30, 2008, \$24.8 million and \$2.2 million of contributions were made to the pension and other postretirement benefit plans, respectively. Integrys Energy Group does not expect to contribute additional amounts to its pension benefit plans during the remainder of 2008. Integrys Energy Group expects to contribute \$8.7 million to its other postretirement benefit plans during the remainder of 2008.

## NOTE 15--STOCK-BASED COMPENSATION

### Stock Options

The fair value of stock option awards granted in February 2008 was estimated using a binomial lattice model. The expected term of option awards is calculated based on historical exercise behavior. The risk-free interest rate is based on the United States Treasury yield curve. The expected dividend yield incorporates the current dividend rate as well as historical dividend increase patterns. Integrys Energy Group's expected stock price volatility was estimated using its 10-year historical volatility. The following table shows the weighted-average fair value along with the assumptions incorporated into the valuation model:

	<b>February 2008 Grant</b>
Weighted-average fair value	<b>\$4.52</b>
Expected term	<b>7 years</b>
Risk-free interest rate	<b>3.40%</b>
Expected dividend yield	<b>5.00%</b>
Expected volatility	<b>17%</b>

Pre-tax compensation cost recognized for stock options during the three months ended September 30, 2008, and 2007, was not significant. Pre-tax compensation cost recognized for stock options was \$2.0 million for the nine months ended September 30, 2008, and the amount recorded for the nine months ended September 30, 2007, was not significant. Compensation cost capitalized during the same periods was not significant. As of September 30, 2008, \$2.3 million of pre-tax compensation cost related to unvested and outstanding stock options was expected to be recognized over a weighted-average period of 2.8 years.

Cash received from option exercises during the three months ended September 30, 2008 was not significant, and was \$2.2 million for the three months ended September 30, 2007. Cash received from option exercises during the nine months ended September 30, 2008, and 2007 was \$3.2 million, and \$7.0 million, respectively. The tax benefit realized from option exercises during the three and nine months ended September 30, 2008, and 2007, was not significant.

A summary of stock option activity for the nine months ended September 30, 2008, and information related to outstanding and exercisable stock options at September 30, 2008, is presented below:

	<b>Stock Options</b>	<b>Weighted- Average Exercise Price Per Share</b>	<b>Weighted-Average Remaining Contractual Life (in Years)</b>	<b>Aggregate Intrinsic Value (Millions)</b>
Outstanding at December 31, 2007	2,215,999	\$47.81		
Granted	684,404	48.36		
Exercised	72,892	43.76		\$0.5
Forfeited	112,393	51.29		0.1
<b>Outstanding at September 30, 2008</b>	<b>2,715,118</b>	<b>\$47.91</b>	<b>6.72</b>	<b>\$9.8</b>
<b>Exercisable at September 30, 2008</b>	<b>1,466,879</b>	<b>\$42.65</b>	<b>4.85</b>	<b>\$8.7</b>

The aggregate intrinsic value for outstanding and exercisable options in the above table represents the total pre-tax intrinsic value that would have been received by the option holders had they all exercised their options at September 30, 2008. This is calculated as the difference between Integrys Energy Group's closing stock price on September 30, 2008, and the option exercise price, multiplied by the number of in-the-money stock options.

### Performance Stock Rights

The fair value of performance stock rights granted in February 2008 was estimated using a Monte Carlo valuation model, incorporating the assumptions in the table below. The risk-free interest rate is based on the United States Treasury yield curve. The expected dividend yield incorporates the dividend rate at the measurement date. The expected volatility was estimated using three years of historical data.

<b>February 2008 Grant</b>	
Expected term	<b>3 years</b>
Risk-free interest rate	<b>2.18%</b>
Expected dividend yield	<b>5.50%</b>
Expected volatility	<b>17%</b>

Pre-tax compensation cost recorded for performance stock rights for the three months ended September 30, 2008, and 2007, was not significant. Pre-tax compensation cost recorded for performance stock rights for the nine months ended September 30, 2008, and 2007, was \$4.0 million and \$2.6 million, respectively. Compensation cost capitalized during the same periods was not significant. As of September 30, 2008, \$3.7 million of pre-tax compensation cost related to unvested and outstanding performance stock rights is expected to be recognized over a weighted-average period of 1.9 years.

A summary of activity related to performance stock rights for the nine months ended September 30, 2008, is presented below:

	<b>Performance Stock Rights</b>	<b>Weighted-Average Grant Date Fair Value</b>
Outstanding at December 31, 2007	217,458	\$48.72
Granted	125,600	49.22
Expired	54,207	41.62
Forfeited	23,191	51.61
<b>Outstanding at September 30, 2008</b>	<b>265,660</b>	<b>\$50.15</b>

No performance shares were distributed during the nine months ended September 30, 2008.

### Restricted Shares and Restricted Share Units

The fair value of restricted share unit awards granted in February 2008 was based on Integrys Energy Group's closing stock price on the day the awards were granted.

During the three months ended September 30, 2008, and 2007, compensation cost recorded related to restricted share and restricted share unit awards was not significant. Compensation cost recorded for restricted share and restricted share unit awards was \$3.2 million for the nine months ended September 30, 2008, and the amount recorded for the nine months ended September 30, 2007, was not significant. Compensation cost capitalized during the same periods was not significant. As of September 30, 2008, \$7.2 million of pre-tax compensation cost related to these awards is expected to be recognized over a weighted-average period of 2.9 years.

A summary of activity related to restricted share and restricted share unit awards for the nine months ended September 30, 2008, is presented below:

	Restricted Share and Restricted Share Unit Awards	Weighted-Average Grant Date Fair Value
Outstanding at December 31, 2007	101,145	\$54.70
Granted	172,815	48.36
Distributed	13,611	56.33
Forfeited	14,225	51.09
<b>Outstanding at September 30, 2008</b>	<b>246,124</b>	<b>\$50.37</b>

#### NOTE 16--COMPREHENSIVE INCOME

Integrys Energy Group's total comprehensive income was as follows:

<i>(Millions)</i>	Three Months Ended September 30		Nine Months Ended September 30	
	2008	2007	2008	2007
Income (loss) available for common shareholders	\$(59.1)	\$43.2	\$100.8	\$166.2
Cash flow hedges, net of tax *	(8.6)	(1.5)	(17.6)	0.6
Foreign currency translation, net of tax	0.1	4.1	(0.7)	6.2
Unrealized loss on available-for-sale securities, net of tax	(0.3)	-	(0.4)	-
SFAS No. 158 amortizations, net of tax	0.1	0.9	0.1	1.5
Total comprehensive income (loss)	\$(67.8)	\$46.7	\$ 82.2	\$174.5

\* Taxes on cash flow hedges were \$(5.4) million and \$(0.9) million for the three months ended September 30, 2008, and 2007, respectively, and were \$(10.9) million and \$0.6 million for the nine months ended September 30, 2008, and 2007, respectively.

The following table shows the changes to Integrys Energy Group's accumulated other comprehensive loss from December 31, 2007, to September 30, 2008.

<i>(Millions)</i>	
December 31, 2007 balance	\$ (1.3)
Cash flow hedges	(17.6)
Foreign currency translation	(0.7)
Available-for-sale securities	(0.4)
SFAS No. 158 amortizations	0.1
<b>September 30, 2008 balance</b>	<b>\$(19.9)</b>

#### NOTE 17--COMMON EQUITY

Integrys Energy Group shares issued at September 30, 2008, and December 31, 2007, were:

	September 30, 2008	December 31, 2007
Common stock, \$1 par value, 200,000,000 shares authorized	76,353,305	76,340,756
Treasury shares	7,000	10,000
Average cost of treasury shares	\$25.19	\$25.19
Shares in deferred compensation rabbi trust	361,561	338,522
Average cost of deferred compensation rabbi trust shares	\$44.39	\$43.48
Restricted stock	77,042	93,339
Average cost of restricted stock	\$54.39	\$54.76