Weston Air Permits

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 was 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 were 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 WPS'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. On February 12, 2009, the court upheld the administrative law judge's final order, which affirmed the WDNR's actions. The Sierra Club appealed this decision. On May 13, 2010, the Wisconsin Court of Appeals issued a ruling affirming that the WDNR's decisions on BACT, sulfur dioxide, and nitrogen oxide were reasonable. One issue, visible emissions, was sent back to the WDNR for further proceedings. The WDNR and WPS filed a Motion for Clarification on the issue of further proceedings on the visibility issue. The Court of Appeals withdrew its May 13, 2010 decision, and on June 24, 2010, it reaffirmed its decision on all other matters but clarified the visibility issue and directed the WDNR to reopen the permit and establish specific visibility limits. Integrys Energy Group is currently unsure how the WNDR will respond and is considering all of its options, including appeal.

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. WPS believes that it has substantial defenses to the Sierra Club's challenges. Until the Sierra Club's challenges are finally resolved, Integrys Energy Group will not be able to make a final determination of the probable impact, if any, of compliance with any changes to the Weston 4 air permit on its future costs.

In December 2008, an NOV was issued to WPS by the WDNR alleging various violations of the air permits for Weston 4, as well as Weston 1 and 2. The alleged violations include an exceedance of the carbon monoxide and volatile organic compound limits at Weston 4, exceedances of the hourly sulfur dioxide limit in ten three-hour periods during startup/shutdown and during one separate event at Weston 4, and two that address baghouse operation at Weston 1 and 2. On July 22, 2009, an NOV was issued to WPS by the WDNR alleging violations of the opacity limits during two six-minute periods (one each at Weston 2 and 4) and of the sulfur dioxide average limit during one three-hour period at Weston 4. An NOV was issued to WPS in September 2009 relating to one event involving baghouse operation at Weston 1 and 2 that occurred in December 2008. A fourth NOV was issued on December 14, 2009, for a clerical error involving pages missing from a quarterly report. Corrective actions have been taken for the events in the four NOVs. An enforcement conference was held on January 7, 2009, for the December 2008 NOV and on August 26, 2009, for the July 2009 NOV. Discussions with the WDNR on the severity classification of the events continue. Management believes it is very likely that the WDNR will refer the NOVs to the state Justice Department for enforcement. Management does not believe that these matters will have a material adverse impact on the condensed consolidated financial statements of Integrys Energy Group.

In early November 2006, it came to the attention of WPS 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 PSD. WPS believes it has undertaken and completed corrective measures to address any identified modeling issues and anticipates issuance of a revised Title V permit 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.

Pulliam Air Permit

The renewal of the Title V air permit for the Pulliam generating station was issued by the WDNR on April 30, 2009. On June 28, 2010, the EPA issued an order granting the Sierra Club's petition to object to the Title V permit. The order directs the WDNR to respond to the comments raised by the Sierra Club in its Petition (filed June 25, 2009). Integrys Energy Group will be working with the WDNR to address the order.

Columbia Air Permit

The renewal of the Title V air permit for the Columbia generation station, jointly owned by WP&L, MG&E, and WPS and operated by WP&L, was issued by the WDNR on September 2, 2008. On October 8, 2009, the EPA issued an order objecting to the Title V air permit. The order responds to a petition filed by the Sierra Club and determined that a project in 2006 to replace the economizer, final superheater, and related components on Unit 1 should have been permitted as a "major modification." The order directs the WDNR to resolve the EPA's objections within 90 days and "terminate, modify, or revoke and reissue" the Title V permit accordingly. As of March 22, 2010, the WDNR has reopened the permit to address the EPA's order and, although final resolution is unknown, potential outcomes could include a revised permit. The parties continue to discuss the matter with the WDNR to seek a resolution. On July 14, 2010, WPS, along with its co-owners, received from the Sierra Club a copy of an NOI to file a civil lawsuit against the EPA based on the EPA's unreasonable delay in performing its duties related to the granting or denial of the Title V permit. Specifically, they allege that the EPA has failed to take actions against the WDNR for its failure to take action regarding the Title V permit as ordered by the EPA. Integrys Energy Group is reviewing the allegations but is currently unable to predict the impact on its condensed consolidated financial statements.

Mercury and Interstate Air Quality Rules

Mercury

The State of Wisconsin's mercury rule, Chapter NR 446, requires a 40% reduction from the 2002 through 2004 baseline mercury emissions in Phase I, beginning January 1, 2010, through the end of 2014. In Phase II, which begins in 2015, electric generating units above 150 megawatts will be required to reduce mercury 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 by the BACT rule. As of June 30, 2010, WPS estimates capital costs of approximately $19 million for Phase I and Phase II, which includes estimates for both wholly owned and jointly owned plants, to achieve the required reductions. The capital costs are expected to be recovered in future rate cases. Because of the vacatur of the federal mercury control and monitoring rule in February 2008, the EPA is reviewing options for a new rulemaking to address hazardous air pollutants, including mercury, and is expected to issue a draft rule in 2011.

Sulfur Dioxide and Nitrogen Oxide

The EPA issued the Clean Air Interstate Rule (CAIR) in 2005. CAIR was originally intended to reduce sulfur dioxide and nitrogen oxide emissions from utility boilers located in 29 states, including Wisconsin, Michigan, Pennsylvania, and New York. The first phase of CAIR required about a 50% reduction beginning in 2009 for nitrogen oxide and beginning in 2010 for sulfur dioxide. The second phase required about a 65% reduction in emissions of both pollutants by 2015. The State of Wisconsin's rule to implement CAIR, which incorporates the cap and trade approach, has been forwarded to the EPA for final review.

On July 11, 2008, the Court of Appeals issued a decision vacating CAIR, the EPA appealed, and in December 2008, the Court of Appeals reversed the CAIR vacatur and CAIR was reinstated. The Court of Appeals directed the EPA to address the deficiencies noted in its July 11, 2008 ruling, and the EPA issued a draft CAIR replacement rule for comment on July 6, 2010. As a result of the Court of Appeals' decision, CAIR is in place for 2010. WPS has not acquired any nitrogen oxide allowances for vintage years beyond 2010 other than those allocated by the EPA and does not expect any material impact as a result of the vacatur and subsequent reinstatement of CAIR. Integrys Energy Group will continue to evaluate the impacts of any subsequent rulemaking.

The reinstatement of CAIR also affected the status of the Best Available Retrofit Technology (BART) rule, which is a rule that addresses regional haze and visibility. The WDNR is evaluating whether air quality improvements under CAIR will be adequate to demonstrate compliance with BART.

For planning purposes, it is still assumed that additional sulfur dioxide and nitrogen oxide controls will be needed on existing units. The installation of any controls will need to be scheduled as part of WPS's long-term maintenance plan for its existing units. As such, controls may need to be installed before 2015. On a preliminary basis, and assuming controls are still required, WPS estimates capital costs of $596 million, which includes estimates for both wholly owned and WPS's share of 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.

<u>Manufactured Gas Plant Remediation</u>

Integrys 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. In connection with manufacturing and storing manufactured gas, waste materials were produced that may have resulted in soil and groundwater contamination at these sites. Under certain laws and regulations relating to the protection of the environment, Integrys Energy Group's natural gas utilities are required to undertake remedial action with respect to some of these materials.

Integrys Energy Group's natural gas utilities 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 WPS, MGU, PGL, and NSG. Twenty of these sites have been transferred to the EPA Superfund Alternative Sites Program. Under the EPA's program, the remedy decisions at these sites will be based on risk-based criteria typically used at Superfund sites. Integrys Energy Group estimated and accrued for $653.9 million of future undiscounted investigation and cleanup costs for all sites as of June 30, 2010. Integrys Energy Group may adjust these estimates in the future, contingent upon remedial technology, regulatory requirements, remedy determinations, and any claims of natural resource damages. Integrys Energy Group recorded a regulatory asset of $665.7 million, which is net of insurance recoveries received of $56.9 million, related to the expected recovery of both deferred expenditures and estimated future expenditures as of June 30, 2010.

Integrys Energy Group's natural gas utilities are coordinating the investigation and cleanup of the manufactured gas plant sites subject to EPA jurisdiction 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 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 (GM), 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 GM, jointly and severally, to perform the remedial action and establish and maintain financial assurance of $27.0 million. The EPA reduced the financial assurance requirement to $21.0 million to reflect completion of the soil component of the remedial action in August 2005. NSG has met its financial assurance requirement in the form of a net worth test while GM met the requirement by providing a performance and payment bond in favor of the EPA. As a result of the GM bankruptcy, the EPA contacted the surety and the surety stated that it will provide the EPA access to the surety bond funds which are expected to fund a significant portion of GM's liability. The potential exposure related to the GM bankruptcy that is not expected to be covered by the bond proceeds has been reflected in the accrual identified above.

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 WPS, MGU, 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 condensed consolidated financial statements of Integrys Energy Group.

Greenhouse Gases

Integrys Energy Group is evaluating both the technical and cost implications that may result from future state, regional, or federal greenhouse gas regulatory programs. This evaluation indicates it is probable that any regulatory program which 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.

Unless there is a successful legal challenge that stays the rule (several lawsuits have been filed), the EPA will begin regulating greenhouse gas emissions under the CAA in 2011. At that time, the EPA and the states will apply the BACT requirements associated with the new source review program to new and modified larger greenhouse gas emitters. Technology to remove and sequester greenhouse gas emissions is not commercially available at scale, hence, the EPA is considering defining BACT in terms of improvements in energy efficiency as opposed to relying on pollution control equipment. In addition, federal legislation related to greenhouse gas emissions may be enacted in the future, and efforts have been initiated to develop state and regional greenhouse gas programs, to create federal legislation to limit carbon dioxide emissions, and to create national or state renewable portfolio standards. A risk exists that such legislation or regulation will increase the cost of energy. However, Integrys Energy Group believes the capital expenditures being made at its generation units are appropriate under any reasonable mandatory greenhouse gas program and that future expenditures related to control of greenhouse gas emissions or renewable portfolio standards by its 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 legislative or 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 were implemented at the plant, notification was provided to the City, and UPPCO self reported the potential permit violations to the Michigan Department of Environmental Quality (MDEQ – now called the Michigan Department of Natural Resources and Environment, MDNRE). UPPCO filed a final report with the MDNRE on November 25, 2008, and a copy was sent to the City.

In March 2009, MDNRE began its investigation into this matter. Depending upon the results of the MDNRE's review of the information provided by UPPCO, the MDNRE, in consultation with the Michigan Attorney General's Office, may 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. In October 2009, the matter was referred to the Delta County District Attorney's office for potential criminal charges against the former manager. Those charges have been resolved on a misdemeanor basis. To date, UPPCO has responded to all information requests from the MDNRE, no charges have been brought against UPPCO, and UPPCO believes that this matter is now closed.

Natural Gas Charge Reconciliation Proceedings and Related Matters

Natural Gas Charge Settlement and Pending Natural Gas Charge Cases

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 PGL and NSG to refund the affected amount to customers through subsequent Gas Charge filings.

In March 28, 2006 orders, the ICC adopted a settlement agreement related to fiscal years 2001 through 2004 natural gas costs. Under the settlement agreement, PEC agreed to provide the Illinois Attorney General (AG) and the City of Chicago (Chicago) up to $30.0 million for conservation and weatherization programs for which PGL and NSG may not seek rate recovery. The balance of the conservation and weatherization funding that remained unpaid as of June 30, 2010, was $10.0 million, of which $5.0 million was included in other current liabilities, and $5.0 million was included in other long-term liabilities. PEC also agreed to implement a reconnection program for certain customers, and PGL and NSG implemented this program. Finally, PEC agreed to internal audits and an external audit of natural gas supply practices. Four of the five annual internal audits required by the settlement agreement have been completed. The external audit was completed in April 2008, and PGL and NSG completed their responses to the external auditor's recommendations in March 2009.

The fiscal 2006 Gas Charge reconciliation cases were initiated on November 21, 2006. The ICC staff and interveners (the AG, the Citizens Utility Board, and Chicago, filing jointly) each filed testimony recommending disallowances for PGL and NSG for a bank natural gas adjustment similar to that addressed in the fiscal 2005 Gas Charge reconciliation cases, which PGL and NSG did not contest. In addition, the interveners recommended a disallowance for PGL of $13.9 million (reduced to $11.0 million in their brief) associated with PGL's provision of interstate hub services. The ICC staff does not support the interveners' proposal, and PGL does not believe the proposal has merit. The Administrative Law Judge's proposed order rejected the interveners' proposal. Briefing on the proposed order concluded on June 4, 2010. For NSG, there were no contested issues, and the ICC issued an order on May 25, 2010.

Reconciliations of subsequent periods had been held in abeyance pending the outcome of the fiscal 2006 Gas Charge reconciliation cases, but a procedural schedule has been set for the 2007 Gas Charge reconciliation cases.

Class Action

In February 2004, a purported class action suit 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 disgorgement 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 November 19, 2009, the court entered an order certifying a class composed of customers of PGL and NSG during the period April 26, 2000, through September 30, 2002. On May 26, 2010, the Illinois Supreme Court denied PEC's Petition for Leave to Appeal challenging class certification. The case remains pending in the Circuit Court and the parties are currently engaged in settlement discussions.

NOTE 14--GUARANTEES

The following table shows outstanding guarantees at Integrys Energy Group:

(Millions)	Total Amounts Committed at June 30, 2010	Expiration: Less Than 1 Year	1 to 3 Years	4 to 5 Years	Over 5 Years
Guarantees supporting commodity transactions of subsidiaries (1)	**$ 854.3**	$529.8	$53.1	$ -	$271.4
Standby letters of credit (2)	**175.3**	174.8	0.4	0.1	-
Surety bonds (3)	**3.2**	2.1	1.1	-	-
Other guarantees (4)	**73.8**	-	-	50.0	23.8
Total guarantees	**$1,106.6**	$706.7	$54.6	$50.1	$295.2

(1) Consists of parental guarantees of $659.4 million to support the business operations of Integrys Energy Services; $126.0 million and $58.9 million, respectively, related to natural gas supply at MERC and MGU; and $5.0 million at both PEC and IBS to support business operations. These guarantees are not reflected on the Condensed Consolidated Balance Sheets.

(2) At Integrys Energy Group's request, financial institutions have issued standby letters of credit for the benefit of third parties that have extended credit to Integrys Energy Group. Amount consists of $158.5 million issued to support Integrys Energy Services' operations; $10.4 million issued for workers compensation coverage in Illinois; $4.8 million related to letters of credit at WPS; and $1.6 million related to letters of credit at UPPCO, MGU, NSG, MERC, and PGL. These amounts are not reflected on the Condensed Consolidated Balance Sheets.

(3) Primarily for workers compensation coverage and obtaining various licenses, permits, and rights of way. Surety bonds are not included on the Condensed Consolidated Balance Sheets.

(4) Consists of (1) $50.0 million related to the sale agreement for Integrys Energy Services' United States wholesale electric marketing and trading business, which included a number of customary representations, warranties, and indemnification provisions. In addition, for a two-year period, counterparty payment default risk was retained with approximately 50% of the counterparties associated with the commodity contracts transferred in this transaction. An insignificant liability was recorded related to the fair value of this counterparty payment default risk; (2) $10.0 million related to the sale agreement for Integrys Energy Services' Texas retail marketing business, which included a number of customary representations, warranties, and indemnification provisions. An insignificant liability was recorded related to the possible imposition of additional miscellaneous gross receipts tax in the event of a change in law or interpretation of the tax law; (3) a $5.0 million environmental

indemnification provided by Integrys Energy Services related to the sale of the Stoneman generation facility, under which Integrys Energy Group expects that the likelihood of required performance is remote; and (4) $8.8 million related to other indemnifications and workers compensation coverage. This amount is not reflected on the Condensed Consolidated Balance Sheets.

Integrys Energy Group has provided total parental guarantees of $912.3 million on behalf of Integrys Energy Services, as shown in the table below. Integrys Energy Group's exposure under these guarantees related to open transactions at June 30, 2010, was approximately $610 million based on an assumption that 60 days of payables are outstanding, as well as the valuation of forward contracts.

(Millions)	**June 30, 2010**
Guarantees supporting commodity transactions	**$659.4**
Standby letters of credit	**158.5**
Guarantees of subsidiary debt *	**27.0**
Surety bonds	**1.7**
Other	**65.7**
Total guarantees	**$912.3**

* Consists of outstanding debt at an Integrys Energy Services subsidiary, which is not included in the total Integrys Energy Group guarantee amounts above, because the debt is reflected on the Condensed Consolidated Balance Sheets.

NOTE 15--EMPLOYEE BENEFIT PLANS

The following table shows the components of net periodic benefit cost for Integrys Energy Group's benefit plans:

	Pension Benefits				Other Postretirement Benefits			
	Three Months Ended June 30		Six Months Ended June 30		Three Months Ended June 30		Six Months Ended June 30	
(Millions)	2010	2009	2010	2009	2010	2009	2010	2009
Service cost	**$ 9.2**	$10.1	**$20.1**	$19.4	**$3.7**	$3.4	**$ 8.2**	$ 7.1
Interest cost	**19.4**	20.7	**40.0**	40.5	**6.6**	6.2	**13.7**	13.3
Expected return on plan assets	**(23.8)**	(23.1)	**(46.1)**	(46.3)	**(4.8)**	(4.5)	**(9.5)**	(8.9)
Amortization of transition obligation	**-**	-	**-**	-	**-**	-	**0.1**	0.1
Amortization of prior service cost (credit)	**1.3**	1.3	**2.6**	2.5	**(0.9)**	(0.9)	**(1.9)**	(1.9)
Amortization of net actuarial loss (gain)	**1.2**	0.7	**4.1**	0.9	**0.2**	(1.0)	**0.9**	(0.7)
Amortization of merger related regulatory adjustment [1]	**-**	3.5	**-**	6.3	**-**	1.2	**-**	1.7
Regulatory deferral [2]	**1.1**	(0.8)	**2.2**	(1.6)	**(0.3)**	(0.4)	**(0.6)**	(0.8)
Net periodic benefit cost	**$ 8.4**	$12.4	**$22.9**	$21.7	**$4.5**	$4.0	**$10.9**	$ 9.9

(1) Effective with the 2010 rate order, PGL and NSG reflect pension and other postretirement benefit costs in rates using Integrys Energy Group's accounting basis, which was established at the time of the February 2007 PEC merger. As a result, the merger related regulatory adjustment was eliminated. Pursuant to the 2010 rate order, a new regulatory asset was established for the remaining cumulative difference that existed between the accounting bases of PGL/NSG and Integrys Energy Group in the pension and other postretirement benefit obligations. The amortization of this regulatory asset over the average remaining service lives of the participating employees is not included as a component of net periodic benefit cost.

(2) The PSCW authorized WPS to recover its net increased 2009 pension costs and to refund its net decreased 2009 other postretirement benefit costs as part of the limited rate case re-opener for 2010. Amortization and recovery/refund of these costs will occur throughout 2010.

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 OCI for Integrys Energy Group's nonregulated entities and are recorded as net regulatory assets for 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 six months ended June 30, 2010, $61.5 million of contributions were made to the pension plans, and contributions made to the other postretirement benefit plans were not significant. Integrys Energy Group expects to contribute $4.2 million to its pension plans and $35.6 million to its other postretirement benefit plans during the remainder of 2010.

NOTE 16--STOCK-BASED COMPENSATION

Stock Options

Compensation cost recognized for stock options during the three and six months ended June 30, 2010, and 2009, was not significant. As of June 30, 2010, $2.6 million of compensation cost related to unvested and outstanding stock options was expected to be recognized over a weighted-average period of 3.1 years.

Cash received from option exercises during the six months ended June 30, 2010, was $12.2 million. The tax benefit realized from these option exercises was $4.9 million.

A summary of stock option activity for the six months ended June 30, 2010, and information related to outstanding and exercisable stock options at June 30, 2010, is presented below:

	Stock Options	Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Contractual Life *(in Years)*	Aggregate Intrinsic Value *(Millions)*
Outstanding at December 31, 2009	3,133,286	$47.06		
Granted	554,092	41.58		
Exercised	327,542	37.13		$2.2
Forfeited	149,875	43.03		0.3
Expired	58,249	49.68		-
Outstanding at June 30, 2010	**3,151,712**	**$47.28**	**6.60**	**$2.7**
Exercisable at June 30, 2010	**1,930,718**	**$48.94**	**5.36**	**$0.5**

The aggregate intrinsic value for outstanding and exercisable options in the above table represents the total pre-tax value that would have been received by the option holders had they all exercised their options at June 30, 2010. This is calculated as the difference between Integrys Energy Group's closing stock price on June 30, 2010, and the option exercise price, multiplied by the number of in-the-money stock options.

Performance Stock Rights

Compensation cost recorded for performance stock rights during the three months ended June 30, 2010, and 2009, was not significant. Compensation cost recorded for performance stock rights during the six months ended June 30, 2010, and 2009, was $2.5 million and $2.2 million, respectively. As of June 30, 2010, $4.6 million of compensation cost related to unvested and outstanding performance stock rights was expected to be recognized over a weighted-average period of 2.2 years.

A summary of the activity related to performance stock rights for the six months ended June 30, 2010, is presented below:

	Performance Stock Rights	Weighted-Average Grant Date Fair Value
Outstanding at December 31, 2009	301,090	$45.33
Granted	150,481	42.45
Distributed	45,847	53.29
Forfeited	37,849	42.54
Expired	26,009	53.45
Outstanding at June 30, 2010	**341,866**	**$42.69**

Restricted Shares and Restricted Share Units

Compensation cost recognized for restricted share and restricted share unit awards during the three months ended June 30, 2010, and 2009, was not significant. Compensation cost recognized for these awards during the six months ended June 30, 2010, and 2009, was $2.8 million and $2.4 million, respectively. As of June 30, 2010, $10.2 million of compensation cost related to these awards was expected to be recognized over a weighted-average period of 2.8 years.

A summary of the activity related to restricted share and restricted share unit awards for the six months ended June 30, 2010, is presented below:

	Restricted Share and Restricted Share Unit Awards	Weighted-Average Grant Date Fair Value
Outstanding at December 31, 2009	346,858	$45.55
Granted	210,452	41.66
Vested	93,994	46.17
Forfeited	44,893	45.19
Outstanding at June 30, 2010	**418,423**	**$43.49**

NOTE 17--COMPREHENSIVE INCOME (LOSS)

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

	Three Months Ended June 30		Six Months Ended June 30	
(Millions)	2010	2009	2010	2009
Net income (loss) attributed to common shareholders	**$78.9**	$34.7	**$128.4**	$(145.5)
Cash flow hedges, net of tax *	**20.1**	25.3	**7.7**	(5.4)
Foreign currency translation, net of tax	**(0.7)**	1.8	**0.1**	1.3
Amortization of unrecognized pension and other postretirement benefit costs, net of tax	**-**	-	**0.5**	(0.2)
Unrealized loss on available-for-sale securities, net of tax	**-**	0.1	**-**	0.1
Total comprehensive income (loss)	**$98.3**	$61.9	**$136.7**	$(149.7)

* For the three months ended June 30, 2010, and 2009, the tax was $13.0 million and $15.6 million, respectively. The tax was $7.3 million for the six months ended June 30, 2010, and the tax benefit was $4.6 million for the six months ended June 30, 2009.

The following table shows the changes to Integrys Energy Group's accumulated other comprehensive loss from December 31, 2009, to June 30, 2010.

(Millions)	**Six Months Ended June 30, 2010**
December 31, 2009 balance	$(44.0)
Cash flow hedges	7.7
Foreign currency translation	0.1
Amortization of unrecognized pension and other postretirement benefit costs	0.5
June 30, 2010 balance	**$(35.7)**

NOTE 18--COMMON EQUITY

Integrys Energy Group's reconciliation of shares outstanding was as follows:

	June 30, 2010		**December 31, 2009**	
	Shares	**Average Cost**	**Shares**	**Average Cost**
Common stock issued	**77,194,573**		76,418,843	
Less:				
Deferred compensation rabbi trust	**379,062**	**$42.76** (1)	402,839	$42.58 (1)
Restricted stock	**16,915**	**$54.76** (2)	35,861	$55.33 (2)
Total shares outstanding	**76,798,596**		75,980,143	

(1) Based on Integrys Energy Group's stock price on the day the shares entered the deferred compensation rabbi trust. Shares paid out of the trust are valued at the average cost of shares in the trust.

(2) Based on the grant date fair value of the restricted stock.

Beginning February 11, 2010, Integrys Energy Group issued new shares of common stock to meet the requirements of its Stock Investment Plan and certain stock-based employee benefit and compensation plans. From January 1, 2010 to February 11, 2010, and during 2009, Integrys Energy Group purchased shares of its common stock on the open market to meet the requirements of these plans.

Integrys Energy Group had the following changes to issued common stock during the six months ended June 30, 2010:

Integrys Energy Group's common shares	
Common stock at December 31, 2009	76,418,843
Shares issued	
Stock Investment Plan	380,993
Stock-based compensation	407,648
Restricted stock shares retired	(12,911)
Common stock at June 30, 2010	**77,194,573**

Earnings (Loss) Per Share

Basic earnings (loss) per share is computed by dividing net income (loss) attributed to common shareholders by the weighted average number of common shares outstanding during the period. Diluted earnings (loss) per share is computed by dividing net income (loss) attributed to common shareholders by the weighted average number of common shares outstanding during the period, adjusted for the exercise and/or conversion of all potentially dilutive securities. Such dilutive items include in-the-money stock options, performance stock rights, and restricted stock. The calculation of diluted earnings per share for the three months ended June 30, 2010, and 2009, excluded 2.1 million and 3.2 million, respectively, out-of-the-money stock options that had an anti-dilutive effect. The calculation of diluted earnings per share for the six months ended June 30, 2010, excluded 1.9 million out-of-the-money stock options that had an anti-dilutive effect. The effects of an insignificant number of in-the-money securities were not included in the computation for the six months ended June 30, 2009, because there was a net loss, which would cause the impact to be anti-dilutive. The calculation also excluded 3.2 million out-of-the-money stock options for the six months ended June 30, 2009. The following table reconciles the computation of basic and diluted earnings (loss) per share:

	Three Months Ended June 30		**Six Months Ended June 30**	
(Millions, except per share amounts)	**2010**	**2009**	**2010**	**2009**
Numerator:				
Net income (loss) from continuing operations	**$79.4**	$35.0	**$129.6**	$(144.5)
Discontinued operations, net of tax	**-**	0.3	**0.1**	0.3
Preferred stock dividends of subsidiary	**(0.8)**	(0.8)	**(1.6)**	(1.6)
Noncontrolling interest in subsidiaries	**0.3**	0.2	**0.3**	0.3
Net income (loss) attributed to common shareholders	**$78.9**	$34.7	**$128.4**	$(145.5)
Denominator:				
Average shares of common stock – basic	**77.4**	76.8	**77.2**	76.7
Effect of dilutive securities				
Stock-based compensation	**0.5**	-	**0.4**	-
Average shares of common stock – diluted	**77.9**	76.8	**77.6**	76.7
Earnings (loss) per common share				
Basic	**$1.02**	$0.45	**$1.66**	$(1.90)
Diluted	**1.01**	0.45	**1.65**	(1.90)

NOTE 19--VARIABLE INTEREST ENTITIES

Effective January 1, 2010, Integrys Energy Group implemented SFAS No. 167, "Amendments to FASB Interpretation No. 46 (R)" (now incorporated as part of the Consolidation Topic of the FASB ASC). Integrys Energy Group has variable interests in two entities through power purchase agreements relating to the cost of fuel. In these cases, Integrys Energy Group has considered which interest holder has the power to direct the activities that most significantly impact the economics of the variable interest entity; this interest holder is considered the primary beneficiary of the entity and is required to consolidate the entity. For a variety of reasons, including the length of the remaining term of the contracts compared with the remaining lives of the plants and the fact that Integrys Energy Group does not have the power to direct the operations of the facilities, Integrys Energy Group has determined it is not the primary beneficiary of these variable interest entities.

At June 30, 2010, the assets and liabilities on the Condensed Consolidated Balance Sheets that related to the involvement with these variable interest entities pertained to working capital accounts and represented the amounts owed by Integrys Energy Group for current deliveries of power. Integrys Energy Group has not provided or guaranteed any debt or equity support, liquidity arrangements, performance guarantees, or other commitments associated with these contracts. There is no significant potential exposure to loss as a result of its involvement with the variable interest entities.

In 2008, Integrys Energy Group's subsidiary, Integrys Energy Services, contributed certain assets to LGS Renewables I, L.C. (LGS) in exchange for a 50% interest in the entity. Simultaneously, Integrys Energy Services entered into a loan agreement with LGS to finance the development and construction of a pipeline project to provide landfill gas to a customer. Integrys Energy Group determined at the time that the entity is a variable interest entity and that Integrys Energy Services is the primary beneficiary of the entity. Integrys Energy Group updated its conclusion upon implementation of the new standard and continued to conclude that Integrys Energy Services is the primary beneficiary. Therefore, Integrys Energy Group's condensed consolidated financial statements include the results of LGS.

At June 30, 2010, Integrys Energy Group's variable interests in LGS included its equity investment and outstanding loans of $24.7 million. Integrys Energy Group's maximum exposure to loss as a result of this partnership is equal to advances under the loan agreement. Its equity investment is insignificant.

The carrying amounts and classifications of the LGS assets and liabilities included in Integrys Energy Group's condensed consolidated financial statements were:

(Millions)	**June 30, 2010**	December 31, 2009
Current assets	**$ 1.4**	$ 0.8
Property, plant and equipment	**16.5**	17.1
Other long-term assets	**4.9**	4.8
Total assets	**$22.8**	$22.7
Current portion of notes payable to affiliates	**$24.7**	$ 2.0
Other current liabilities	**0.7**	0.5
Long-term notes payable to affiliates	**-**	22.2
Total equity	**(2.6)**	(2.0)
Total liabilities and equity	**$22.8**	$22.7

In July 2010, Integrys Energy Services purchased LGS Development, L.P.'s 50% ownership interest in LGS and became the sole owner.

NOTE 20--FAIR VALUE

Fair Value Measurements

Integrys Energy Group identified additional classes of risk management assets and liabilities as a result of the implementation of FASB Accounting Standards Update (ASU) 2010-06, "Fair Value Measurements and Disclosures (Topic 820), Improving Disclosures about Fair Value Measurements." As required, this ASU was only applied to disclosures beginning with the quarter ended March 31, 2010, and, therefore, prior periods do not reflect the expanded disclosure requirements.

The following tables show Integrys Energy Group's assets and liabilities that were accounted for at fair value on a recurring basis, categorized by level within the fair value hierarchy.

(Millions)	June 30, 2010 Level 1	Level 2	Level 3	Total
Assets				
Risk Management Assets				
Utility Segments				
Financial transmission rights	$ -	$ -	$ 9.2	$ 9.2
Natural gas contracts	1.6	2.5	-	4.1
Petroleum product contracts	0.4	-	-	0.4
Nonregulated Segments				
Natural gas contracts	54.7	124.9	38.6	218.2
Electric contracts	36.2	178.5	54.9	269.6
Interest rate swaps	-	1.9	-	1.9
Foreign exchange contracts	0.4	0.9	-	1.3
Total Risk Management Assets	$ 93.3	$308.7	$102.7	$504.7
Other Assets	$ 0.1	$ -	$ -	$ 0.1
Liabilities				
Risk Management Liabilities				
Utility Segments				
Financial transmission rights	$ -	$ -	$ 1.6	$ 1.6
Natural gas contracts	2.0	29.6	-	31.6
Nonregulated Segments				
Natural gas contracts	58.5	143.8	5.6	207.9
Electric contracts	48.0	227.2	91.0	366.2
Interest rate swaps	-	4.3	-	4.3
Foreign exchange contracts	1.0	0.3	-	1.3
Total Risk Management Liabilities	$109.5	$405.2	$ 98.2	$612.9
Long-term debt hedged by fair value hedge	$ -	$ 51.9	$ -	$ 51.9

(Millions)	December 31, 2009 Level 1	Level 2	Level 3	Total
Assets				
Risk management assets	$284.9	$439.6	$1,593.0	$2,317.5
Other	0.1	-	-	0.1
Liabilities				
Risk management liabilities	336.4	582.2	1,471.6	2,390.2
Long-term debt hedged by fair value hedge	-	52.6	-	52.6

Integrys Energy Group determined the fair values above using a market based approach that incorporates observable market inputs where available, and internally developed inputs where observable market data is not readily available. For the unobservable inputs, consideration is given to the assumptions that market participants would use in valuing the asset or liability. These factors include not only the credit standing of the counterparties involved, but also the impact of Integrys Energy Group's nonperformance risk on its liabilities.

The risk management assets and liabilities listed in the tables include options, swaps, futures, physical commodity contracts, and other instruments used to manage market risks related to changes in commodity prices and interest rates. For more information on Integrys Energy Group's derivative instruments, see Note 3, "*Risk Management Activities.*"

When possible, Integrys Energy Group bases the valuations of its risk management assets and liabilities on quoted prices for identical assets in active markets. These valuations are classified in Level 1. The valuations of certain contracts include inputs related to market price risk (commodity or interest rate), price volatility (for option contracts), price correlation (for cross commodity contracts), credit risk, and time value. These inputs are available through multiple sources, including brokers and over-the-counter and online exchanges. Transactions valued using these inputs are classified in Level 2.

Certain derivatives are categorized in Level 3 due to the significance of unobservable or internally-developed inputs. The primary reasons for a Level 3 classification are as follows:

- While price curves may have been based on observable information, significant assumptions may have been made regarding seasonal or monthly shaping and locational basis differentials.
- Certain transactions were valued using price curves that extended beyond the quoted period. Assumptions were made to extrapolate prices from the last quoted period through the end of the transaction term, primarily through use of historically settled data or using correlations to other locations.

Integrys Energy Group recognizes transfers between the levels of the fair value hierarchy at the value as of the end of the reporting period.

The following table shows net risk management assets (liabilities) transferred between the levels of the fair value hierarchy during the three and six months ended June 30, 2010. All the transfers that occurred during the period related to electric contracts in the nonregulated segment.

	Three Months Ended June 30, 2010			Six Months Ended June 30, 2010		
(Millions)	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
Transfers into Level 1 from	N/A	$ 0.1	$ (3.1)	N/A	$(9.8)	$(17.4)
Transfers into Level 2 from	$ -	N/A	$(16.4)	$ -	N/A	$ 6.8
Transfers into Level 3 from	$ -	$(0.4)	N/A	$ -	$(4.8)	N/A

Derivatives are transferred in or out of Level 3 primarily due to changes in the source of data used to construct price curves as a result of changes in market liquidity.

The following tables set forth a reconciliation of changes in the fair value of items categorized as Level 3 measurements:

Three Months Ended June 30, 2010	Nonregulated Segments		Utility Segments	
(Millions)	Natural gas	Electric	Financial transmission rights	Total
Balance at the beginning of the period	$36.8	$(132.3)	$1.5	$(94.0)
Net realized and unrealized gains included in earnings	5.2	35.9	3.7	44.8
Net unrealized gains recorded as regulatory assets or liabilities	-	-	3.5	3.5
Net unrealized gains included in other comprehensive loss	-	10.0	-	10.0
Net purchases and settlements	(9.0)	31.2	(1.1)	21.1
Net transfers into Level 3	-	(0.4)	-	(0.4)
Net transfers out of Level 3	-	19.5	-	19.5
Balance at the end of the period	**$33.0**	**$ (36.1)**	**$7.6**	**$ 4.5**
Net unrealized gains included in earnings related to instruments still held at the end of the period	**$ 5.2**	**$ 35.9**	**$ -**	**$41.1**

Six Months Ended June 30, 2010	Nonregulated Segments		Utility Segments	
(Millions)	Natural gas	Electric	Financial transmission rights	Total
Balance at the beginning of the period	$31.4	$ 86.5	$3.5	$121.4
Net realized and unrealized gains (losses) included in earnings	22.4	(58.9)	3.5	(33.0)
Net unrealized gains recorded as regulatory assets or liabilities	-	-	2.1	2.1
Net unrealized losses included in other comprehensive loss	-	(3.2)	-	(3.2)
Net purchases and settlements	(20.8)	(66.3)	(1.5)	(88.6)
Net transfers into Level 3	-	(4.8)	-	(4.8)
Net transfers out of Level 3	-	10.6	-	10.6
Balance at the end of the period	$33.0	$(36.1)	$7.6	$ 4.5
Net unrealized gains (losses) included in earnings related to instruments still held at the end of the period	$22.4	$(58.9)	$ -	$ (36.5)

(Millions)	Three Months Ended June 30, 2009	Six Months Ended June 30, 2009
Balance at the beginning of the period	$131.6	$182.0
Net realized and unrealized losses included in earnings	(113.7)	(40.5)
Net unrealized gains recorded as regulatory assets or liabilities	6.1	6.0
Net unrealized gains (losses) included in other comprehensive loss	9.3	(8.7)
Net purchases and settlements	30.9	12.9
Net transfers in/out of Level 3	(106.8)	(194.3)
Balance at the end of the period	$ (42.6)	$ (42.6)
Net unrealized losses included in earnings related to instruments still held at the end of the period	$(113.5)	$ (37.9)

Unrealized gains and losses included in earnings related to Integrys Energy Services' risk management assets and liabilities are recorded through nonregulated revenue on the Condensed Consolidated Statements of Income. Realized gains and losses on these same instruments are recorded in nonregulated revenue or nonregulated cost of fuel, natural gas, and purchased power, depending on the nature of the instrument. Unrealized gains and losses on Level 3 derivatives at the utilities are deferred as regulatory assets or liabilities. Therefore, these fair value measurements have no impact on earnings. Realized gains and losses on these instruments flow through utility cost of fuel, natural gas, and purchased power on the Condensed Consolidated Statements of Income.

Fair Value of Financial Instruments

The following table shows the financial instruments included on the Condensed Consolidated Balance Sheets of Integrys Energy Group that are not recorded at fair value.

	June 30, 2010		December 31, 2009	
(Millions)	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Long-term debt	**$2,392.6**	**$2,526.2**	$2,511.2	$2,543.6
Preferred stock	**51.1**	**50.0**	51.1	44.3

The fair values of long-term debt instruments are estimated based on the quoted market price for the same or similar issues, or on the current rates offered to Integrys Energy Group for debt of the same remaining maturity, without considering the effect of third-party credit enhancements. The fair values of preferred stock are estimated based on quoted market prices when available, or by using a perpetual dividend discount model.

Due to the short-term nature of cash and cash equivalents, accounts receivable, accounts payable, notes payable, and outstanding commercial paper, the carrying amount approximates fair value.

NOTE 21--MISCELLANEOUS INCOME

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

	Three Months Ended June 30		Six Months Ended June 30	
(Millions)	**2010**	2009	**2010**	2009
Equity earnings on investments	**$19.8**	$18.7	**$39.5**	$37.1
Interest and dividend income	**1.1**	2.2	**2.1**	2.6
Equity portion of AFUDC	**0.4**	1.2	**0.9**	2.8
Key executive life insurance	**2.0**	1.2	**2.0**	1.2
Other	**1.1**	(2.7)	**0.3**	(2.0)
Total miscellaneous income	**$24.4**	$20.6	**$44.8**	$41.7

NOTE 22--REGULATORY ENVIRONMENT

Wisconsin

2011 Rate Case

On April 1, 2010, WPS filed an application with the PSCW to increase retail electric and natural gas rates $64.2 million (6.9%) and $5.0 million (1.2%), respectively, with rates effective January 1, 2011. The filing includes a request for an 11.25% return on common equity and a common equity ratio of 53.62% in WPS's regulatory capital structure. The proposed retail electric and natural gas rate increases for 2011 are being driven by decreased sales due primarily to the ongoing economic recession and increased energy efficiency efforts by customers, the amortization in 2011 of the 2009 deferred amounts under WPS's electric Revenue Stabilization Mechanism, and increased payments to the Wisconsin Focus on Energy program.

2010 Rates

On December 22, 2009, the PSCW issued a final written order for WPS authorizing an electric rate increase of $18.2 million, offset by an $18.2 million refund of 2009 and 2008 fuel costs, and a retail natural gas rate increase of $13.5 million, effective January 1, 2010. Based on an order issued on April 1, 2010, the remaining $10.0 million of the total 2008 and 2009 fuel cost over-collections, plus interest of $1.3 million, were refunded to customers in April and May 2010.

The PSCW issued another rate order on April 1, 2010, making fuel cost over-collections for 2010 subject to refund as of that date. As of June 30, 2010, the balance of the 2010 fuel cost over-collections to be refunded to customers in 2011 was $4.2 million, which has been recorded as a short-term regulatory liability. Fuel cost over/under-recovery impacts for 2008, 2009, and 2010 related to the Weston 4 power plant exfoliation issue remain open and will be addressed as part of the current 2011 rate case.

2009 Rates

On December 30, 2008, the PSCW issued a final written order for WPS authorizing no change in retail electric rates from the fuel surcharge adjusted rates authorized effective July 4, 2008, and a $3.0 million decrease in retail natural gas rates. The PSCW also approved a decoupling mechanism as a four-year pilot program. The mechanism allows WPS to defer and recover or refund in future rate proceedings all or a portion of the differences between the actual and authorized margin per customer impact of variations in volumes. The annual deferral or refund is limited to $14.0 million for electric service and $8.0 million for natural gas service. The mechanism does not adjust for changes in volume resulting from changes in customer count and also does not cover large commercial and industrial customers.

Michigan

2011 UPPCO Rate Case

On June 30, 2010, UPPCO filed an application with the MPSC to increase retail electric rates $15.4 million (16.8%), with rates effective January 1, 2011. The filing includes a request for an 11.25% return on common equity and a common equity ratio of 54.86% in UPPCO's regulatory capital structure. The proposed retail electric rate increase for 2011 is primarily being driven by increased capital investments associated with FERC-required replacements and upgrades of hydroelectric facilities, reduced wholesale and retail sales, and increased meter reading costs.

2010 UPPCO Rates

On December 16, 2009, the MPSC issued a final written order authorizing UPPCO a retail electric rate increase of $6.5 million, effective January 1, 2010. The new rates reflect a 10.90% return on common equity and a common equity ratio of 54.83% in UPPCO's regulatory capital structure. The order included approval of a decoupling mechanism, as well as an uncollectibles expense tracking mechanism, which allows for the deferral and subsequent recovery or refund of 80% of the difference between actual write-offs (net of recoveries) and bad debt expense included in utility rates, both effective January 1, 2010.

2010 MGU Rates

On December 16, 2009, the MPSC issued a final written order authorizing MGU a retail natural gas rate increase of $3.5 million, effective January 1, 2010. The filing included a 10.75% return on common equity and a common equity ratio of 50.26% in MGU's regulatory capital structure. The order included approval of an uncollectibles expense tracking mechanism, which allows for the deferral and subsequent recovery or refund of 80% of the difference between actual write-offs (net of recoveries) and bad debt expense included in utility rates, effective January 1, 2010. On July 1, 2010, the MPSC granted an order approving a decoupling mechanism for MGU as a pilot program, effective September 1, 2010. MGU's approved decoupling mechanism adjusts for the impact on revenues of changes in weather-normalized use per customer for residential and small commercial customers. On July 29, 2010, MGU filed with the MPSC a petition for rehearing requesting, among other items, an effective date for decoupling of January 1, 2010, consistent with the effective date of final rates under the MPSC's December 16, 2009 order.

2009 MGU Rates

On January 13, 2009, the MPSC issued a final written order for MGU approving a settlement agreement authorizing an annual retail natural gas rate increase of $6.0 million, effective January 14, 2009. The new rates reflected a 10.45% return on common equity and a common equity ratio of 50.01% in MGU's regulatory capital structure.

Illinois

2010 Rates

On January 21, 2010, the ICC issued a final order authorizing a retail natural gas rate increase of $69.8 million for PGL and $13.9 million for NSG, effective January 28, 2010. The rates for PGL reflect a 10.23% return on common equity and a common equity ratio of 56% in its regulatory capital structure. The rates for NSG reflect a 10.33% return on common equity and a common equity ratio of 56% in its regulatory capital structure. The ICC approved a rider mechanism to recover the costs, above an annual baseline, of an accelerated natural gas main replacement program by PGL through a special charge on customers' bills, known as Rider ICR. In February 2010, prior to the ICC granting rehearing on this issue, PGL filed Rider ICR with a $51.85 million annual baseline. On rehearing, PGL proposed a baseline of

$45.28 million with an annual escalation factor. No party filed testimony opposing the proposal. On June 2, 2010, the ICC issued its rehearing order approving PGL's proposed baseline. Recovery of costs for the accelerated gas main replacement program will begin in 2011 with the first Rider ICR charges being effective April 1, 2011. The rate order also approved the recovery of net dismantling costs of property, plant, and equipment over the life of the asset rather than when incurred. PGL and NSG, as well as Chicago, the AG, and the Citizens Utility Board, filed requests for rehearing in February 2010, all addressing Rider ICR. On March 10, 2010, the ICC voted to grant rehearing on the Rider ICR annual baseline determination and denied all other rehearing requests, including requests about other aspects of Rider ICR. The AG, the Citizens Utility Board, PGL, and NSG filed appeals with the Illinois appellate court. On June 17, 2010, the AG filed a motion to stay the effectiveness of Rider ICR or, alternatively, to make the rider's effectiveness subject to refund. PGL opposed this motion and a decision on the motion is still pending.

Recent Illinois Legislation

In July 2009, Illinois Senate Bill (SB) 1918 was signed into law. SB 1918 contains a provision that allows PGL and NSG to file a rider to recover (or refund) the incremental difference between the rate case authorized uncollectible expense and the actual uncollectible expense reported to the ICC each year. PGL and NSG filed their respective riders with the ICC in September 2009, and began recording the effects of this provision at that time. The ICC approved the rider in February 2010. SB 1918 also requires a percentage of income payment plan for low-income utility customers that PGL and NSG are offering as a transition program in 2010 and 2011, with a permanent program to begin no later than September 1, 2011. Additionally, SB 1918 requires an on-bill financing program that PGL and NSG filed in February 2010, with a requested June 2011 effective date, that the ICC approved in June 2010. The on-bill financing program will allow certain residential customers of PGL and NSG to borrow funds from a third party lender to purchase energy efficiency measures and pay back the borrowed funds over time through a charge on their utility bill. PGL and NSG must file an EEP to meet specified energy efficiency standards no later than October 1, 2010, with the first program year beginning June 2011.

2008 Rates

On February 5, 2008, the ICC issued a final order authorizing a retail natural gas rate increase of $71.2 million for PGL and a retail natural gas rate decrease of $0.2 million for NSG, effective February 14, 2008. The rates for PGL reflected a 10.19% return on common equity and a common equity ratio of 56% in its regulatory capital structure. The rates for NSG reflected a 9.99% return on common equity and a common equity ratio of 56% in its regulatory capital structure. The order included approval of a decoupling mechanism, effective March 1, 2008, as a four-year pilot program, which allows PGL and NSG to adjust rates going forward to recover or refund the difference between the actual and authorized margin impact of variations in volumes. Legislation was introduced, but not enacted, at the Illinois state legislature to roll back decoupling. Integrys Energy Group actively supports the ICC's decision to approve this rate setting mechanism. The order also approved an EEP, which allows PGL and NSG to recover up to $6.4 million and $1.1 million per year, respectively, of energy efficiency costs. This EEP is separate from, and will be replaced by, the SB 1918 required EEP.

On March 26, 2008, the ICC denied PGL's and NSG's request for rehearing of their rate orders, and all but one such request from interveners, which only affected PGL. The ICC approved a stipulation resolving the rehearing issue. Following the stipulation approval, PGL and NSG and four other parties filed appeals with the Illinois appellate court. Issues on appeal include the decoupling mechanism.

Minnesota

2010 Rates

On December 4, 2009, the MPUC approved a final written order authorizing MERC a retail natural gas rate increase of $15.4 million, effective January 1, 2010. The new rates reflect a 10.21% return on common equity and a common equity ratio of 48.77% in its regulatory capital structure. Since the final approved rate increase was lower than the interim rate increase that went into effect in October 2008, refunds of $5.5 million were made to customers in March 2010.

Federal

Through a series of orders issued by the FERC, Regional Through and Out Rates for transmission service between the MISO and the PJM Interconnection were eliminated effective December 1, 2004. To compensate transmission owners for the revenue they will no longer receive due to this rate elimination, the FERC ordered a transitional pricing mechanism called the Seams Elimination Charge Adjustment (SECA) be put into place. Load-serving entities paid these SECA charges during a 16-month transition period from December 1, 2004, through March 31, 2006.

For the 16-month transitional period, Integrys Energy Services received billings of $19.2 million (pre-tax) for these charges. Integrys Energy Services initially expensed $14.7 million of the $19.2 million, as it was considered probable that Integrys Energy Services' total exposure would be reduced by at least $4.5 million due to inconsistencies between the FERC's SECA order and the transmission owners' compliance filings. Subsequent to receiving the billings, Integrys Energy Services reached settlement agreements with three of its vendors for a combined $1.6 million, which reduced the $4.5 million original receivable balance to approximately $3 million.

In August 2006, the administrative law judge hearing the case issued an Initial Decision that was in substantial agreement with all of Integrys Energy Services' positions, and on May 21, 2010, the FERC issued its Final Order on the Initial Decision. In the Final Order, the FERC ruled favorably for Integrys Energy Services on two issues, which are anticipated to result in additional refunds of approximately $2 million, but reversed the rulings of the Initial Decision on nearly every other substantive issue. As a result of this ruling, Integrys Energy Services expensed, as a component of margin, an additional approximately $1 million in the second quarter of 2010, as only approximately $2 million of the approximate $3 million receivable balance remained probable of collection from counterparties. Integrys Energy Services and numerous other parties filed for rehearing of the FERC's Final Order. A number of related orders will be considered for judicial review. Any refunds to Integrys Energy Services will include interest for the period from payment to refund.

NOTE 23--SEGMENTS OF BUSINESS

At June 30, 2010, Integrys Energy Group reported five segments, which are described below.

- The natural gas utility segment includes the regulated natural gas utility operations of WPS, MGU, MERC, PGL, and NSG.
- The electric utility segment includes the regulated electric utility operations of WPS and UPPCO.
- The electric transmission investment segment includes Integrys Energy Group's approximate 34% ownership interest in ATC. ATC is a federally regulated electric transmission company operating in Wisconsin, Michigan, Minnesota, and Illinois.
- Integrys Energy Services is a diversified nonregulated natural gas and electric power supply and services company serving retail customers (residential, commercial, and industrial).
- The holding company and other segment includes the operations of the Integrys Energy Group holding company and the PEC holding company, along with any nonutility activities at WPS, MGU, MERC, UPPCO, PGL, NSG, and IBS. Equity earnings from Integrys Energy Group's investment in WRPC are also included in the holding company and other segment.

The tables below present information for the respective periods pertaining to Integrys Energy Group's reportable segments:

	Regulated Operations				Nonutility and Nonregulated Operations			
(Millions)	Natural Gas Utility	Electric Utility	Electric Transmission Investment	Total Regulated Operations	Integrys Energy Services	Holding Company and Other	Reconciling Eliminations	Integrys Energy Group Consolidated
Three Months Ended June 30, 2010								
External revenues	$296.8	$314.0	$ -	$610.8	$401.0	$ 3.0	$ -	$1,014.8
Intersegment revenues	0.1	6.9	-	7.0	0.2	-	(7.2)	-
Restructuring (income) expense	(0.1)	(0.1)	-	(0.2)	6.7	-	-	6.5
Net gain on Integrys Energy Services' dispositions related to strategy change	-	-	-	-	(25.0)	-	-	(25.0)
Depreciation and amortization expense	32.6	24.6	-	57.2	4.5	6.2	-	67.9
Miscellaneous income (expense)	0.3	0.3	19.2	19.8	2.4	12.8	(10.6)	24.4
Interest expense (income)	12.8	10.7	-	23.5	1.4	22.3	(10.6)	36.6
Provision (benefit) for income taxes	(1.2)	13.8	7.7	20.3	27.8	(3.6)	-	44.5
Preferred stock dividends of subsidiary	(0.1)	(0.7)	-	(0.8)	-	-	-	(0.8)
Net income (loss) attributed to common shareholders	(1.7)	26.2	11.5	36.0	45.6	(2.7)	-	78.9

	Regulated Operations				Nonutility and Nonregulated Operations			
(Millions)	Natural Gas Utility	Electric Utility	Electric Transmission Investment	Total Regulated Operations	Integrys Energy Services	Holding Company and Other	Reconciling Eliminations	Integrys Energy Group Consolidated
Three Months Ended June 30, 2009								
External revenues	$308.7	$303.9	$ -	$612.6	$812.0	$ 3.0	$ -	$1,427.6
Intersegment revenues	0.1	10.4	-	10.5	0.5	-	(11.0)	-
Restructuring expense	-	-	-	-	19.1	-	-	19.1
Depreciation and amortization expense	26.6	22.6	-	49.2	4.7	3.7	-	57.6
Miscellaneous income (expense)	0.6	1.3	18.4	20.3	1.1	10.3	(11.1)	20.6
Interest expense (income)	12.6	10.5	-	23.1	2.6	25.4	(11.1)	40.0
Provision (benefit) for income taxes	(2.3)	12.1	7.4	17.2	8.1	(6.8)	-	18.5
Net income (loss) from continuing operations	(4.0)	23.6	11.0	30.6	10.9	(6.5)	-	35.0
Discontinued operations	-	-	-	-	0.3	-	-	0.3
Preferred stock dividends of subsidiary	(0.1)	(0.7)	-	(0.8)	-	-	-	(0.8)
Net income (loss) attributed to common shareholders	(4.1)	22.9	11.0	29.8	11.4	(6.5)	-	34.7

(Millions)	Natural Gas Utility	Electric Utility	Electric Transmission Investment	Total Regulated Operations	Integrys Energy Services	Holding Company and Other	Reconciling Eliminations	Integrys Energy Group Consolidated
	Regulated Operations				Nonutility and Nonregulated Operations			
Six Months Ended June 30, 2010								
External revenues	$1,223.3	$644.1	$ -	$1,867.4	$1,044.8	$ 6.0	$ -	$2,918.2
Intersegment revenues	0.3	11.7	-	12.0	1.0	-	(13.0)	-
Restructuring (income) expense	(0.1)	(0.1)	-	(0.2)	9.2	0.2	-	9.2
Net loss on Integrys Energy Services' dispositions related to strategy change	-	-	-	-	14.8	-	-	14.8
Depreciation and amortization expense	63.3	49.0	-	112.3	9.2	10.6	-	132.1
Miscellaneous income (expense)	0.8	0.5	38.7	40.0	2.9	23.3	(21.4)	44.8
Interest expense (income)	25.9	21.5	-	47.4	4.8	45.2	(21.4)	76.0
Provision (benefit) for income taxes	55.4	31.9	15.6	102.9	(1.1)	(7.2)	-	94.6
Net income (loss) from continuing operations	68.3	53.6	23.1	145.0	(3.3)	(12.1)	-	129.6
Discontinued operations	-	-	-	-	0.1	-	-	0.1
Preferred stock dividends of subsidiary	(0.3)	(1.3)	-	(1.6)	-	-	-	(1.6)
Net income (loss) attributed to common shareholders	68.0	52.3	23.1	143.4	(2.9)	(12.1)	-	128.4

(Millions)	Natural Gas Utility	Electric Utility	Electric Transmission Investment	Total Regulated Operations	Integrys Energy Services	Holding Company and Other	Reconciling Eliminations	Integrys Energy Group Consolidated
	Regulated Operations				Nonutility and Nonregulated Operations			
Six Months Ended June 30, 2009								
External revenues	$1,405.3	$621.8	$ -	$2,027.1	$2,595.5	$ 5.8	$ -	$4,628.4
Intersegment revenues	0.3	22.2	-	22.5	1.1	-	(23.6)	-
Goodwill impairment loss	291.1	-	-	291.1	-	-	-	291.1
Restructuring expense	-	-	-	-	19.1	-	-	19.1
Depreciation and amortization expense	52.4	45.0	-	97.4	9.8	7.3	-	114.5
Miscellaneous income (expense)	1.8	2.2	36.4	40.4	2.0	24.0	(24.7)	41.7
Interest expense (income)	26.2	21.0	-	47.2	5.7	54.5	(24.7)	82.7
Provision (benefit) for income taxes	1.7	26.4	14.6	42.7	(6.4)	(5.0)	-	31.3
Net income (loss) from continuing operations	(176.9)	51.3	21.8	(103.8)	(18.3)	(22.4)	-	(144.5)
Discontinued operations	-	-	-	-	0.3	-	-	0.3
Preferred stock dividends of subsidiary	(0.3)	(1.3)	-	(1.6)	-	-	-	(1.6)
Net income (loss) attributed to common shareholders	(177.2)	50.0	21.8	(105.4)	(17.7)	(22.4)	-	(145.5)

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

The following discussion should be read in conjunction with the accompanying condensed consolidated financial statements and related notes and Integrys Energy Group's Annual Report on Form 10-K for the year ended December 31, 2009.

SUMMARY

Integrys Energy Group is a diversified energy holding company with regulated electric and natural gas utility operations (serving customers in Illinois, Michigan, Minnesota, and Wisconsin), nonregulated energy operations, and an approximate 34% equity ownership interest in ATC (a federally regulated electric transmission company operating in Wisconsin, Michigan, Minnesota, and Illinois).

RESULTS OF OPERATIONS

(Millions, except per share amounts)	Three Months Ended June 30 2010	Three Months Ended June 30 2009	Change in 2010 Over 2009	Six Months Ended June 30 2010	Six Months Ended June 30 2009	Change in 2010 Over 2009
Natural gas utility operations	**$ (1.7)**	$ (4.1)	(58.5)%	**$ 68.0**	$ (177.2)	N/A
Electric utility operations	**26.2**	22.9	14.4 %	**52.3**	50.0	4.6 %
Electric transmission investment	**11.5**	11.0	4.5 %	**23.1**	21.8	6.0 %
Integrys Energy Services' operations	**45.6**	11.4	300.0 %	**(2.9)**	(17.7)	(83.6)%
Holding company and other operations	**(2.7)**	(6.5)	(58.5)%	**(12.1)**	(22.4)	(46.0)%
Net income (loss) attributed to common shareholders	**$78.9**	$34.7	127.4 %	**$128.4**	$(145.5)	N/A
Basic earnings (loss) per share	**$1.02**	$0.45	126.7 %	**$1.66**	$(1.90)	N/A
Diluted earnings (loss) per share	**$1.01**	$0.45	124.4 %	**$1.65**	$(1.90)	N/A
Average shares of common stock						
Basic	**77.4**	76.8	0.8 %	**77.2**	76.7	0.7 %
Diluted	**77.9**	76.8	1.4 %	**77.6**	76.7	1.2 %

Summary of Financial Results – Second Quarter 2010 Compared with Second Quarter 2009

Integrys Energy Group recognized net income attributed to common shareholders of $78.9 million ($1.01 diluted earnings per share) for the quarter ended June 30, 2010, compared with net income attributed to common shareholders of $34.7 million ($0.45 diluted earnings per share) for the quarter ended June 30, 2009. Significant factors impacting the $44.2 million increase in earnings were as follows (and are discussed in more detail thereafter):

- Financial results at the regulated natural gas utility segment improved $2.4 million, driven by a $13.2 million after-tax increase in earnings from rates implemented at certain regulated natural gas utilities in the first quarter of 2010. This was partially offset by a $6.6 million after-tax decrease in earnings related to lower quarter-over-quarter volumes and a $3.6 million after-tax increase in depreciation and amortization expense primarily related to a change in recovery method under a recent rate order.

- Earnings at the regulated electric utility segment increased $3.3 million, driven by a $6.2 million after-tax increase in margins, primarily related to lower fuel and purchased power costs incurred in the second quarter of 2010 compared with fuel and purchased power cost recovery rates set in 2009, as well as retail rate increases at WPS and UPPCO. The increase in margins was partially offset by a $2.5 million after-tax increase in operating expenses, primarily related to increases in electric transmission expense and customer assistance expense.

- Earnings at the electric transmission investment segment increased $0.5 million, due to an increase in income from Integrys Energy Group's ownership interest in ATC.
- Earnings at Integrys Energy Services increased $34.2 million, driven by an $18.5 million after-tax decrease in operating and maintenance expenses, a $15.2 million after-tax gain from the sale of Integrys Energy Services of Texas, LP (which primarily resulted from mark-to-market timing differences that have historically caused earnings volatility at Integrys Energy Services), and a $7.9 million after-tax decrease in restructuring expenses. These increases in earnings were partially offset by a $10.6 million after-tax decrease in margins, primarily driven by Integrys Energy Services' strategy change.
- The net loss at the holding company and other segment decreased $3.8 million, driven by a $1.9 million after-tax decrease in external interest expense, and a $1.7 million decrease in legal expenses.

Summary of Financial Results – Six Months 2010 Compared with Six Months 2009

Integrys Energy Group recognized net income attributed to common shareholders of $128.4 million ($1.65 diluted earnings per share) for the six months ended June 30, 2010, compared with a net loss attributed to common shareholders of $145.5 million ($1.90 net loss per share) for the six months ended June 30, 2009. Significant factors impacting the $273.9 million increase in earnings were as follows (and are discussed in more detail thereafter):

- Earnings at the regulated natural gas utility segment increased $245.2 million, driven by the positive period-over-period impact on earnings of a $248.8 million after-tax non-cash goodwill impairment loss recorded in the first quarter of 2009. Earnings also benefited $28.2 million after-tax from rate increases implemented at certain regulated natural gas utilities in the first quarter of 2010 and a $4.5 million after-tax decrease in bad debt expense. These positive impacts were partially offset by a $13.2 million after-tax decrease in earnings related to lower period-over-period volumes, a $6.5 million non-cash increase in provision for income taxes related to the 2010 federal health care legislation, and higher operating expenses. Higher operating expenses included a $6.5 million after-tax increase in depreciation and amortization expense related to a change in recovery method under a recent rate order, a $5.6 million after-tax increase in employee benefit costs, and a $3.2 million after-tax increase related to energy efficiency initiatives.
- Earnings at the regulated electric utility segment increased $2.3 million, driven by a $13.5 million after-tax increase in margins, primarily related to lower fuel and purchased power costs incurred in the second quarter of 2010 compared with fuel and purchased power cost recovery rates set in 2009, as well as retail rate increases at WPS and UPPCO. The increase in margins was partially offset by a $7.5 million after-tax increase in operating expenses, primarily related to increases in electric transmission expense and customer assistance expense. In addition, federal health care legislation enacted in March 2010 resulted in a $4.5 million non-cash increase to the provision for income taxes at the electric utility segment.
- Earnings at the electric transmission investment segment increased $1.3 million, due to an increase in income from Integrys Energy Group's ownership interest in ATC.
- The net loss at Integrys Energy Services decreased $14.8 million, driven by a $29.8 million after-tax decrease in operating and maintenance expenses and a $6.4 million after-tax decrease in restructuring expenses. These decreases in net loss were partially offset by a $16.5 million after-tax decrease in margins, primarily driven by Integrys Energy Services' strategy change, and an $8.9 million net after-tax loss on dispositions, which primarily resulted from mark-to-market timing differences that have historically caused earnings volatility at Integrys Energy Services.

- The net loss at the holding company and other segment decreased $10.3 million, driven by a $4.0 million after-tax decrease in external interest expense, the period-over-period positive impact of lower tax benefits recognized in the first quarter of 2009 due to the implementation of a February 2009 tax law change in Wisconsin, and a $3.0 million decrease in legal expenses.

Utility Operations

For the three and six months ended June 30, 2010, and 2009, utility operations included the regulated natural gas utility segment, consisting of the regulated natural gas operations of PGL, WPS, MERC, MGU, and NSG, and the regulated electric segment, consisting of the regulated electric operations of WPS and UPPCO.

Regulated Natural Gas Utility Segment Operations

(Millions, except heating degree days)	Three Months Ended June 30 2010	Three Months Ended June 30 2009	Change in 2010 Over 2009	Six Months Ended June 30 2010	Six Months Ended June 30 2009	Change in 2010 Over 2009
Revenues	**$296.9**	$308.8	(3.9)%	**$1,223.6**	$1,405.6	(12.9)%
Purchased natural gas costs	**121.0**	142.4	(15.0)%	**728.4**	918.7	(20.7)%
Margins	**175.9**	166.4	5.7 %	**495.2**	486.9	1.7 %
Operating and maintenance expense	**125.6**	126.8	(0.9)%	**266.1**	277.9	(4.2)%
Goodwill impairment loss *	**-**	-	-	**-**	291.1	(100.0)%
Depreciation and amortization expense	**32.6**	26.6	22.6 %	**63.3**	52.4	20.8 %
Taxes other than income taxes	**8.0**	7.3	9.6 %	**17.0**	16.3	4.3 %
Operating income (loss)	**9.7**	5.7	70.2 %	**148.8**	(150.8)	N/A
Miscellaneous income	**0.3**	0.6	(50.0)%	**0.8**	1.8	(55.6)%
Interest expense	**(12.8)**	(12.6)	1.6 %	**(25.9)**	(26.2)	(1.1)%
Other expense	**(12.5)**	(12.0)	4.2 %	**(25.1)**	(24.4)	2.9 %
Income (loss) before taxes	**$(2.8)**	$(6.3)	(55.6)%	**$ 123.7**	$ (175.2)	N/A
Throughput in therms						
Residential	**162.9**	216.7	(24.8)%	**899.4**	1,012.6	(11.2)%
Commercial and industrial	**48.7**	64.1	(24.0)%	**273.2**	317.4	(13.9)%
Interruptible	**5.6**	6.1	(8.2)%	**21.7**	24.1	(10.0)%
Interdepartmental	**2.0**	2.3	(13.0)%	**5.3**	4.4	20.5 %
Transport	**311.9**	296.1	5.3 %	**913.3**	909.5	0.4 %
Total sales in therms	**531.1**	585.3	(9.3)%	**2,112.9**	2,268.0	(6.8)%
Weather						
Average heating degree days	**580**	852	(31.9)%	**3,862**	4,439	(13.0)%

* See Note 8, "*Goodwill and Other Intangible Assets*," for more information.

Second Quarter 2010 Compared with Second Quarter 2009

Regulated natural gas utility segment revenues decreased $11.9 million quarter-over-quarter, driven by:

- An approximate $55 million decrease in revenues as a result of lower natural gas throughput volumes, related to:

  - An approximate $31 million decrease driven by lower weather normalized volumes. Residential customer volumes decreased, resulting from customer conservation, efficiency efforts, and general economic conditions. Commercial and industrial customer volumes also decreased, resulting from reduced demand related to changes in customers' business operations attributed to general economic conditions.

  - An approximate $30 million decrease as a result of warmer quarter-over-quarter weather, evidenced by the 31.9% decrease in average heating degree days.

  - Partially offsetting these decreases was an approximate $6 million net positive quarter-over-quarter impact of decoupling mechanisms for residential, small commercial and industrial, and transportation customers, primarily at PGL and NSG. Under decoupling, PGL, NSG, and WPS are allowed to defer the difference between the actual and rate case authorized delivery charge components of margin from certain customers and adjust future rates in accordance with rules applicable to each jurisdiction.

- The decrease in revenues was partially offset by:

  - The approximate $22 million positive impact of natural gas distribution rate orders at the regulated natural gas utilities. See Note 22, "*Regulatory Environment*," for more information on these rate orders.

    - PGL and NSG received final rate orders from the ICC for retail natural gas distribution rate increases that were effective January 28, 2010, which had an approximate $19 million positive impact on revenues.

    - WPS received a final rate order from the PSCW for a retail natural gas distribution rate increase that was effective January 1, 2010, which had an approximate $2 million positive impact on revenues.

    - MGU received a final rate order from the MPSC for a retail natural gas distribution rate increase that was effective January 1, 2010, which had an approximate $1 million positive impact on revenues.

  - An approximate $21 million increase in revenues as a result of an approximate 11% increase in the average per-unit cost of natural gas sold by the regulated natural gas utilities during the quarter ended June 30, 2010, compared with the same quarter in 2009. For all of Integrys Energy Group's regulated natural gas utilities, prudently incurred natural gas commodity costs are passed directly through to customers in current rates.

<u>Margins</u>

Regulated natural gas utility segment margins increased $9.5 million quarter-over-quarter, driven by:

- The approximate $22 million positive impact of rate orders at the regulated natural gas utilities.

- The increase in margins was partially offset by an approximate $11 million decrease in margins resulting from the 9.3% decrease in natural gas throughput volumes attributed to warmer quarter-over-quarter weather, customer conservation and efficiency efforts, and the negative impact from general economic conditions. This decrease in margins includes an approximate $6 million net positive impact from decoupling mechanisms in place, primarily at PGL and NSG. WPS's natural gas utility also has a decoupling mechanism which includes an annual $8.0 million cap for the deferral of any excess or shortfall from the rate case authorized margin for certain classes of customers. This cap was reached prior to the end of the first quarter of 2010 but was not reached during 2009, which resulted in WPS realizing approximately $6 million less margins quarter-over-quarter driven by lower sales volumes with no offsetting decoupling to mitigate these lower volumes.

Operating Income (Loss)

Operating income at the regulated natural gas utility segment increased $4.0 million quarter-over-quarter, driven by the positive impact of the $9.5 million increase in the natural gas utility margins, partially offset by a $5.5 million increase in operating expenses quarter-over-quarter. The $5.5 million quarter-over-quarter increase in operating expenses was driven by an increase in depreciation and amortization expense, primarily related to the ICC's rate order for PGL and NSG, effective January 28, 2010, which allows up front recovery in rates for net dismantling costs by including them as a component of depreciation rates applied to natural gas distribution assets.

Six Months 2010 Compared with Six Months 2009

Regulated natural gas utility segment revenues decreased $182.0 million period-over-period, driven by:

- An approximate $124 million decrease in revenues as a result of lower natural gas throughput volumes, related to:
  - An approximate $87 million decrease as a result of warmer period-over-period weather during the heating season, evidenced by the 13.0% decrease in average heating degree days.
  - An approximate $49 million decrease driven by lower weather normalized volumes. Residential customer volumes decreased, resulting from customer conservation, efficiency efforts, and general economic conditions. Commercial and industrial customer volumes also decreased, resulting from reduced demand related to changes in customers' business operations attributed to general economic conditions.
  - Partially offsetting these decreases was an approximate $12 million positive period-over-period impact of decoupling mechanisms for residential, small commercial and industrial, and transportation customers at PGL, WPS, and NSG.
- An approximate $89 million decrease as a result of an approximate 10% decrease in the average per-unit cost of natural gas sold by the regulated natural gas utilities during the six months ended June 30, 2010, compared with the same period in 2009. For all of Integrys Energy Group's regulated natural gas utilities, prudently incurred natural gas commodity costs are passed directly through to customers in current rates.
- An approximate $20 million decrease from lower recovery of environmental cleanup expenditures related to former manufactured gas plant sites, partially offset by a $3 million increase in revenues related to recoveries received under the PGL and NSG bad debt rider, which was approved in February 2010. Recoveries in 2010 under the bad debt rider represent billings to customers of the net excess of actual 2008 and 2009 bad debt expense over bad debt expense reflected in utility rates during those same periods. See Note 22, "*Regulatory Environment*," for more information on the PGL and NSG bad debt rider.

- The decrease in revenues was partially offset by the approximate $47 million positive impact of natural gas distribution rate orders at the regulated natural gas utilities.

  - PGL and NSG received final rate orders from the ICC for retail natural gas distribution rate increases that were effective January 28, 2010, which had an approximate $37 million positive impact on revenues.

  - WPS received a final rate order from the PSCW for a retail natural gas distribution rate increase that was effective January 1, 2010, which had an approximate $8 million positive impact on revenues.

  - MGU received a final rate order from the MPSC for a retail natural gas distribution rate increase that was effective January 1, 2010, which had an approximate $2 million positive impact on revenues.

Margins

Regulated natural gas utility segment margins increased $8.3 million period-over-period, driven by:

- The approximate $47 million positive impact of rate orders at the regulated natural gas utilities.

- The increase in margins was partially offset by:

  - An approximate $22 million decrease in margins resulting from the 6.8% decrease in natural gas throughput volumes attributed to warmer period-over-period weather, customer conservation and efficiency efforts, and the negative impact from general economic conditions. This decrease in margins includes an approximate $12 million positive impact from decoupling mechanisms in place at PGL, NSG, and WPS. The decoupling mechanism for WPS's natural gas utility includes an annual $8.0 million cap for the deferral of any excess or shortfall from the rate case authorized margin. This cap was reached prior to the end of the first quarter of 2010 but was not reached during 2009, which resulted in WPS realizing approximately $7 million less margins period-over-period driven by lower sales volumes with no offsetting decoupling to mitigate these lower volumes.

  - An approximate $20 million decrease in margins from lower recovery of environmental cleanup expenditures related to former manufactured gas plant sites, partially offset by a $3 million increase in margins related to recoveries received under the PGL and NSG bad debt rider, which was approved in February 2010. Recoveries in 2010 under the bad debt rider represent billings to customers of the net excess of actual 2008 and 2009 bad debt expense over bad debt expense reflected in utility rates during those same periods. The net $17 million decrease in margins relating to these two items was offset by a decrease in operating and maintenance expense from the amortization of the related regulatory assets and, therefore, had no impact on earnings.

Operating Income (Loss)

Operating income at the regulated natural gas utility segment increased $299.6 million, from an operating loss of $150.8 million during the six months ended June 30, 2009, to operating income of $148.8 million during the same period of 2010. This increase was primarily driven by the positive period-over-period impact of a $291.1 million non-cash goodwill impairment loss that was recorded in the first quarter of 2009, the $8.3 million increase in the regulated natural gas utility margins, and a $0.2 million decrease in other operating expenses. See Note 8, "*Goodwill and Other Intangible Assets*," for information related to the goodwill impairment loss recorded in 2009.

The $0.2 million period-over-period decrease in other operating expenses primarily related to:

- An approximate $20 million decrease in amortization of the regulatory asset related to environmental cleanup expenditures of manufactured gas plant sites, partially offset by amortization of approximately $3 million of the regulatory asset related to the PGL and NSG bad debt rider. The net $17 million decrease in operating and maintenance expense related to these two items was recovered from customers in rates and, therefore, had no impact on earnings.

- A $7.5 million net decrease in bad debt expense, primarily related to the impact lower volumes and lower energy prices had on overall accounts receivable balances in addition to a decrease in the number of past due accounts. This decrease reflects the current year net unfavorable impact of the bad debt riders for PGL, NSG, and MGU as it relates to 2010 activity.

- A $2.0 million decrease in labor costs driven by the reduction in workforce and company-wide furloughs as a result of previously announced cost management efforts.

- These decreases were partially offset by:

  - A $10.9 million increase in depreciation and amortization expense, primarily related to the ICC's rate order for PGL and NSG, effective January 28, 2010, which allows up front recovery in rates for net dismantling costs by including them as a component of depreciation rates applied to natural gas distribution assets.

  - A $9.3 million increase in employee benefit costs, partially related to an increase in pension and post-retirement medical expenses, driven by the amortization of negative investment returns from 2008.

  - A $5.3 million increase in operating expenses related to energy conservation programs and enhanced efficiency initiatives.

Regulated Electric Utility Segment Operations

(Millions, except heating degree days)	Three Months Ended June 30 2010	2009	Change in 2010 Over 2009	Six Months Ended June 30 2010	2009	Change in 2010 Over 2009
Revenues	**$320.9**	$314.3	2.1 %	**$655.8**	$644.0	1.8 %
Fuel and purchased power costs	**136.6**	140.3	(2.6)%	**277.0**	287.7	(3.7)%
Margins	**184.3**	174.0	5.9 %	**378.8**	356.3	6.3 %
Operating and maintenance expense	**97.8**	95.1	2.8 %	**200.3**	191.4	4.6 %
Depreciation and amortization expense	**24.6**	22.6	8.8 %	**49.0**	45.0	8.9 %
Taxes other than income taxes	**10.8**	11.4	(5.3)%	**23.0**	23.4	(1.7)%
Operating income	**51.1**	44.9	13.8 %	**106.5**	96.5	10.4 %
Miscellaneous income	**0.3**	1.3	(76.9)%	**0.5**	2.2	(77.3)%
Interest expense	**(10.7)**	(10.5)	1.9 %	**(21.5)**	(21.0)	2.4 %
Other expense	**(10.4)**	(9.2)	13.0 %	**(21.0)**	(18.8)	11.7 %
Income before taxes	**$ 40.7**	$ 35.7	14.0 %	**$ 85.5**	$ 77.7	10.0 %
Sales in kilowatt-hours						
Residential	**684.1**	666.6	2.6 %	**1,476.9**	1,509.7	(2.2)%
Commercial and industrial	**2,119.0**	1,976.0	7.2 %	**4,146.0**	3,974.9	4.3 %
Wholesale	**1,248.1**	1,207.2	3.4 %	**2,459.8**	2,342.6	5.0 %
Other	**8.0**	8.1	(1.2)%	**19.2**	19.6	(2.0)%
Total sales in kilowatt-hours	**4,059.2**	3,857.9	5.2 %	**8,101.9**	7,846.8	3.3 %
Weather						
WPS:						
Heating degree days	**744**	1,065	(30.1)%	**4,188**	5,036	(16.8)%
Cooling degree days	**138**	111	24.3 %	**138**	111	24.3 %
UPPCO:						
Heating degree days	**1,110**	1,542	(28.0)%	**4,702**	5,791	(18.8)%
Cooling degree days	**57**	39	46.2 %	**57**	39	46.2 %

Second Quarter 2010 Compared with Second Quarter 2009

Revenues

Regulated electric utility segment revenues increased $6.6 million quarter-over-quarter, driven by:

- An approximate $4 million increase primarily due to a 13.1% increase in sales volumes to large commercial and industrial customers at WPS related to changes in business operations, which Integrys Energy Group attributes mainly to improving general economic conditions in WPS's service territory.
- An approximate $4 million increase related to retail electric rate increases at both WPS and UPPCO, effective January 1, 2010.

Margins

Regulated electric utility segment margins increased $10.3 million quarter-over-quarter, driven by:

- An approximate $8 million increase related to lower fuel and purchased power costs incurred in the second quarter of 2010 compared with fuel and purchased power cost recovery rates set in 2009.

- An approximate $4 million increase related to retail electric rate increases at both WPS and UPPCO, effective January 1, 2010.

Operating Income

Operating income at the regulated electric utility segment increased $6.2 million quarter-over-quarter, driven by the $10.3 million increase in electric margins, partially offset by a $4.1 million increase in operating expenses.

The increase in operating expenses was the result of:

- A $3.9 million increase in electric transmission expense.

- A $3.1 million increase in customer assistance expense related to payments made to the Focus on Energy program, which helps residents and businesses install cost-effective, energy efficient, and renewable energy products.

- A $2.0 million increase in depreciation and amortization expense at WPS, primarily related to the Crane Creek Wind Farm being placed in service for accounting purposes in December 2009.

- These increases in regulated electric utility operating expenses were partially offset by:

  - A $2.1 million decrease in labor costs, driven by the reduction in workforce and company-wide furloughs instituted for 2010 as a result of previously announced cost management efforts.

  - A $1.8 million decrease in electric maintenance expense at WPS, primarily related to a greater number of planned outages at the generation plants during the second quarter of 2009, compared with the second quarter of 2010.

Other Expense

Other expense at the regulated electric utilities increased $1.2 million, driven by a $1.2 million decrease in AFUDC related to the Crane Creek Wind Farm.

Six Months 2010 Compared with Six Months 2009

Revenues

Regulated electric utility segment revenues increased $11.8 million period-over-period, driven by:

- An approximate $9 million increase in opportunity sales, made possible by a combination of an increase in available capacity at WPS (which resulted from lower residential, small commercial and industrial, and contracted wholesale sales) and the availability of low-cost energy from Weston 4.

- An approximate $7 million increase related to retail electric rate increases at both WPS and UPPCO, effective January 1, 2010.

- An approximate $7 million increase primarily due to a 10.0% increase in sales volumes to large commercial and industrial customers at WPS related to changes in business operations, which Integrys Energy Group attributes mainly to improving general economic conditions in WPS's service territory.

- These increases in regulated electric utility segment revenues were partially offset by:

- An approximate $10 million decrease in revenues from wholesale customers due to a decrease in contracted sales volumes and fuel costs. The decrease in fuel costs caused a decrease in per-unit revenues because commodity costs are passed directly through to these customers in rates.

- An approximate $3 million decrease in revenues, net of decoupling, due to a 1.8% decrease in sales volumes to residential customers at WPS primarily related to customer conservation and efficiency efforts, along with warmer period-over-period weather during the heating season as evidenced by the decrease in heating degree days. In the second quarter of 2010 and 2009, WPS reached the annual $14.0 million electric decoupling cap.

Margins

Regulated electric utility segment margins increased $22.5 million period-over-period, driven by:

- An approximate $16 million increase related to lower fuel and purchased power costs incurred in the first six months of 2010 compared with fuel and purchased power cost recovery rates set in 2009.

- An approximate $7 million increase related to retail electric rate increases at both WPS and UPPCO, effective January 1, 2010.

Operating Income

Operating income at the regulated electric utility segment increased $10.0 million period-over-period, driven by the $22.5 million increase in electric margins, partially offset by a $12.5 million increase in operating expenses.

The increase in operating expenses was the result of:

- A $7.5 million increase in electric transmission expense.

- A $6.1 million increase in customer assistance expense related to payments made to the Focus on Energy program, which helps residents and businesses install cost-effective, energy efficient, and renewable energy products.

- A $4.1 million increase in employee benefit costs, primarily related to an increase in pension and other postretirement benefit expenses, driven by the amortization of negative investment returns from 2008.

- A $3.9 million increase in depreciation and amortization expense at WPS, primarily related to the Crane Creek Wind Farm being placed in service for accounting purposes in December 2009.

- These increases in regulated electric utility operating expenses were partially offset by:

  - A $4.8 million decrease in electric maintenance expense at WPS, primarily related to a greater number of planned outages at its generation plants during the six months ended June 30, 2009, compared with the same period in 2010.

  - A $3.5 million decrease in labor costs, driven by the reduction in workforce and company-wide furloughs instituted for 2010 as a result of previously announced cost management efforts.

Other Expense

Other expense at the regulated electric utilities increased $2.2 million, driven by a $2.2 million decrease in AFUDC related to the Crane Creek Wind Farm.

Electric Transmission Investment Segment Operations

Second Quarter 2010 Compared with Second Quarter 2009

Miscellaneous Income

Miscellaneous income at the electric transmission investment segment increased $0.8 million during the second quarter of 2010 compared with the same quarter in 2009, due to an increase in income from Integrys Energy Group's approximate 34% ownership interest in ATC. The increase in income was driven by returns earned by ATC on investments in transmission equipment for improved reliability.

Six Months 2010 Compared with Six Months 2009

Miscellaneous Income

Miscellaneous income at the electric transmission investment segment increased $2.3 million during the six months ended June 30, 2010, compared with the same period in 2009, due to an increase in income from Integrys Energy Group's approximate 34% ownership interest in ATC. The increase in income was driven by returns earned by ATC on investments in transmission equipment for improved reliability.

Integrys Energy Services' Operations

Integrys Energy Services is a diversified nonregulated retail energy supply and services company serving residential, commercial, and industrial customers.

Integrys Energy Services Segment Results of Operations

(Millions, except natural gas sales volumes)	Three Months Ended June 30 2010	Three Months Ended June 30 2009	Change in 2010 over 2009	Six Months Ended June 30 2010	Six Months Ended June 30 2009	Change in 2010 over 2009
Revenues	**$401.2**	$812.5	(50.6)%	**$1,045.8**	$2,596.6	(59.7)%
Cost of fuel, natural gas, and purchased power	**314.3**	708.0	(55.6)%	**952.5**	2,475.8	(61.5)%
Margins	**86.9**	104.5	(16.8)%	**93.3**	120.8	(22.8)%
Margin Detail						
Realized retail electric margins	**22.5** [(1)]	22.8	(1.3)%	**39.9** [(1)]	46.4	(14.0)%
Realized wholesale electric margins	**(2.5)** [(2)]	22.9	N/A	**(1.6)** [(2)]	27.0	N/A
Fair value adjustments	**47.5**	23.3	103.9 %	**4.4**	(35.8)	N/A
Other	**8.2**	8.6	(4.7)%	**16.3**	16.9	(3.6)%
Electric and other margins	**75.7**	77.6	(2.4)%	**59.0**	54.5	8.3 %
Realized retail natural gas margins	**3.6**	7.8	(53.8)%	**32.8**	47.3	(30.7)%
Realized wholesale natural gas margins	**(2.4)**	(1.5)	60.0 %	**(4.0)**	25.2	N/A
Lower-of-cost-or-market inventory adjustments	**1.4**	46.0	(97.0)%	**6.0**	65.0	(90.8)%
Fair value adjustments	**8.6**	(25.4)	N/A	**(0.5)**	(71.2)	(99.3)%
Natural gas margins	**11.2**	26.9	(58.4)%	**34.3**	66.3	(48.3)%
Operating and maintenance expense	**28.0**	58.9	(52.5)%	**58.8**	108.5	(45.8)%
Restructuring expense	**6.7**	19.1	(64.9)%	**9.2**	19.1	(51.8)%
Net (gain) loss on Integrys Energy Services' dispositions related to strategy change	**(25.0)**	-	N/A	**14.8**	-	N/A
Depreciation and amortization	**4.5**	4.7	(4.3)%	**9.2**	9.8	(6.1)%
Taxes other than income taxes	**0.6**	1.3	(53.8)%	**3.8**	4.4	(13.6)%
Operating income (loss)	**72.1**	20.5	251.7 %	**(2.5)**	(21.0)	(88.1)%
Miscellaneous income	**2.4**	1.1	118.2 %	**2.9**	2.0	45.0 %
Interest expense	**(1.4)**	(2.6)	(46.2)%	**(4.8)**	(5.7)	(15.8)%
Other income (expense)	**1.0**	(1.5)	N/A	**(1.9)**	(3.7)	(48.6)%
Income (loss) before taxes	**$ 73.1**	$ 19.0	284.7 %	**$ (4.4)**	$ (24.7)	(82.2)%
Physical volumes (includes only transactions settled physically for the periods shown)						
Retail electric sales volumes in kwh	**3,189.8**	3,719.3	(14.2)%	**6,343.1**	7,716.6	(17.8)%
Wholesale electric sales volumes in kwh	**344.2**	1,135.0	(69.7)%	**821.3**	2,170.9	(62.2)%
Retail natural gas sales volumes in bcf	**23.8**	54.6	(56.4)%	**74.2**	151.9	(51.2)%
Wholesale natural gas sales volumes in bcf	**3.8**	100.8	(96.2)%	**25.7**	261.7	(90.2)%

kwh – kilowatt-hours
bcf – billion cubic feet

(1) Amounts include negative margin of $1.4 million related to the settlement of supply contracts in connection with Integrys Energy Services' strategy change.

(2) Amounts include negative margin of $3.8 million related to the settlement of supply contracts in connection with Integrys Energy Services' strategy change.

Second Quarter 2010 Compared with Second Quarter 2009

Revenues

Revenues decreased $411.3 million quarter-over-quarter, as a result of Integrys Energy Group's decision to reposition Integrys Energy Services to focus on selected retail markets in the United States and investments in energy assets with renewable attributes. See Note 5, "*Dispositions*," for a discussion of the dispositions completed in connection with Integrys Energy Services' strategy change.

Margins

Integrys Energy Services uses derivative and nonderivative financial instruments to economically hedge risks associated with physical transactions. Because many of the derivative instruments utilized in these transactions may not qualify, or are not designated, as hedges under GAAP derivative accounting rules, fluctuations in the fair value of these instruments due to changing commodity prices are recorded as unrealized gains or losses within margins. Nonderivative instruments have no impact on margins until settlement.

Integrys Energy Services' margins decreased $17.6 million quarter-over-quarter. The significant items contributing to the change in margins were as follows:

Electric and Other Margins

Realized wholesale electric margins

Wholesale transactions and structured origination activity were significantly scaled back in conjunction with Integrys Energy Services' sale of substantially all of its United States wholesale electric marketing and trading business. See Note 5, "*Dispositions*," for more information on Integrys Energy Services' sale of its United States wholesale electric marketing and trading business.

Retail and wholesale electric fair value adjustments

This non-cash activity resulted from the application of GAAP derivative accounting rules to Integrys Energy Services' portfolio of electric customer supply contracts, requiring that these derivative instruments be adjusted to fair market value.

Natural Gas Margins

Realized retail natural gas margins

The quarter-over-quarter decrease in realized retail natural gas margins was primarily related to the sale of Integrys Energy Services' Canadian retail natural gas portfolio in September 2009.

Realized wholesale natural gas margins

Wholesale transactions were significantly scaled back in conjunction with Integrys Energy Services' sale of substantially all of its wholesale natural gas business. See Note 5, "*Dispositions*," for more information on Integrys Energy Services' sale of its wholesale natural gas business.

Lower-of-cost-or-market inventory adjustments

Integrys Energy Services' physical natural gas inventory is valued at lower-of-cost-or-market. When the market price of natural gas is lower than the carrying value of the inventory, write-downs are recorded within margins to reflect inventory at the end of the period at its net realizable value. The lower-of-cost-or-market inventory write-downs are offset by higher margins in future periods as the inventory that was written down is sold. The quarter-over-quarter decrease in margins from lower-of-cost-or-market inventory adjustments was driven by a lower volume of inventory withdrawn from storage in the second quarter of 2010 for which inventory write-downs had previously been recorded.

Fair value adjustments

Fair value adjustments required under derivative accounting rules primarily relate to financial instruments used to economically hedge risks associated with natural gas storage and transportation activity.

Operating Income

Integrys Energy Services' operating income increased $51.6 million quarter-over-quarter, driven by a $30.9 million decrease in operating and maintenance expense, a net gain on dispositions of $25.0 million driven by the $25.3 million gain on the sale of Integrys Energy Services of Texas, LP in June 2010 (which primarily resulted from mark-to-market timing differences that have historically caused earnings volatility at Integrys Energy Services), and a $12.4 million decrease in restructuring expenses, partially offset by the $17.6 million decrease in margins discussed above.

The decrease in operating and maintenance expense was driven by:

- A $13.7 million decrease in employee payroll and benefit related expenses primarily due to the reduction in workforce associated with Integrys Energy Services' strategy change.
- The $9.0 million positive quarter-over-quarter impact of a fee incurred in the second quarter of 2009 related to an agreement with a counterparty that enabled Integrys Energy Services to reduce collateral support requirements.
- A $4.0 million decrease in bad debt expense driven by the second quarter of 2009 default of a large retail natural gas customer, as well as a general decrease in reserves resulting from reduced business activity.
- The $1.7 million positive quarter-over-quarter impact of a loss recorded in the second quarter of 2009 on the sale and leaseback of a solar equipment project.

See Note 5, "*Dispositions*," for a discussion of the dispositions completed in connection with Integrys Energy Services' strategy change.

Six Months 2010 Compared with Six Months 2009

Revenues

Revenues decreased $1,550.8 million during the six months ended June 30, 2010, compared with the same period in 2009, as a result of Integrys Energy Group's decision to reposition Integrys Energy Services to focus on selected retail markets in the United States and investments in energy assets with renewable attributes. See Note 5, "*Dispositions*," for a discussion of the dispositions completed in connection with Integrys Energy Services' strategy change.

Margins

Integrys Energy Services uses derivative and nonderivative financial instruments to economically hedge risks associated with physical transactions. Because many of the derivative instruments utilized in these transactions may not qualify, or are not designated, as hedges under GAAP derivative accounting rules, fluctuations in the fair value of these instruments due to changing commodity prices are recorded as unrealized gains or losses within margins. Nonderivative instruments have no impact on margins until settlement.

Integrys Energy Services' margins decreased $27.5 million during the six months ended June 30, 2010, compared with the same period in 2009. The significant items contributing to the change in margins were as follows:

Electric and Other Margins

Realized retail electric margins

Realized retail electric margins decreased $6.5 million during the six months ended June 30, 2010, compared with the same period in 2009, driven by:

- A $2.9 million decrease in the Mid Atlantic market, driven by lower than anticipated sales to full requirements customers as a result of the economic conditions in this market. Also contributing to the decrease in margins in this market were higher period-over-period capacity costs (Integrys Energy Services must purchase capacity from the market operator to serve its customers).

- A $1.9 million decrease in the Texas market. The decrease was due to Integrys Energy Services' scaled back new business activity in this market in the second half of 2009, resulting from the decision to exit this market. The sale of Integrys Energy Services of Texas, LP was completed in June 2010. See Note 5, "*Dispositions*," for a discussion of this sale.

- A $1.5 million decrease in the Illinois market, primarily driven by reduced marketing efforts in 2009 before the decision was made to continue business activity in this market, as well as lower customer demand as a result of the economic conditions in this market. Partially offsetting these decreases was a change in pricing strategy that resulted in higher per unit margins due to a refocus of marketing efforts to higher margin customers.

<u>Realized wholesale electric margins</u>

Wholesale transactions and structured origination activity were significantly scaled back in conjunction with Integrys Energy Services' sale of substantially all of its United States wholesale electric marketing and trading business. See Note 5, "*Dispositions*," for more information on Integrys Energy Services' sale of its United States wholesale electric marketing and trading business.

<u>Retail and wholesale electric fair value adjustments</u>

This non-cash activity resulted from the application of GAAP derivative accounting rules to Integrys Energy Services' portfolio of electric customer supply contracts, requiring that these derivative instruments be adjusted to fair market value.

Natural Gas Margins

<u>Realized retail natural gas margins</u>

Realized retail natural gas margins decreased $14.5 million during the six months ended June 30, 2010, compared with the same period in 2009, driven by:

- An $8.6 million decrease in the Illinois market, driven by the period-over-period negative impact of the withdrawal of a significant amount of natural gas from storage in the first half of 2009, resulting in higher realized gains during that period.

- A $5.2 million decrease due to the sale of Integrys Energy Services' Canadian retail natural gas portfolio in September 2009.

<u>Realized wholesale natural gas margins</u>

Wholesale transactions were significantly scaled back in conjunction with Integrys Energy Services' sale of substantially all of its wholesale natural gas business. See Note 5, "*Dispositions*," for more information on Integrys Energy Services' sale of its wholesale natural gas business.

<u>Lower-of-cost-or-market inventory adjustments</u>

Integrys Energy Services' physical natural gas inventory is valued at lower-of-cost-or-market. When the market price of natural gas is lower than the carrying value of the inventory, write-downs are recorded within margins to reflect inventory at the end of the period at its net realizable value. The lower-of-cost-or-market inventory write-downs are offset by higher margins in future periods as the inventory that was written down is sold. The period-over-period decrease in margins from lower-of-cost-or-market inventory adjustments was driven by a lower volume of inventory withdrawn from storage in the first half of 2010 for which inventory write-downs had previously been recorded.

Fair value adjustments

Fair value adjustments required under derivative accounting rules primarily relate to financial instruments used to economically hedge risks associated with natural gas storage and transportation activity.

Operating Income (Loss)

Integrys Energy Services' operating loss decreased $18.5 million period-over-period, driven by a $49.7 million decrease in operating and maintenance expense and a $9.9 million decrease in restructuring expense, partially offset by the $27.5 million decrease in margins discussed above, and net losses of $14.8 million related to dispositions completed in connection with Integrys Energy Services' strategy change, which primarily resulted from mark-to-market timing differences that have historically caused earnings volatility at Integrys Energy Services.

The decrease in operating and maintenance expense was driven by:

- A $22.3 million decrease in employee payroll and benefit related expenses primarily due to the reduction in workforce associated with Integrys Energy Services' strategy change.
- The $9.0 million positive period-over-period impact of a fee incurred in the second quarter of 2009 related to an agreement with a counterparty that enabled Integrys Energy Services to reduce collateral support requirements.
- An $8.6 million period-over-period decrease in bad debt expense driven by the 2010 recovery of a receivable fully reserved during the first quarter of 2009, the default of a large retail natural gas customer in the second quarter of 2009, and a general decrease in reserves resulting from reduced business activity.
- A $4.9 million decrease in broker commissions, contractor expenses, and various other fees, resulting from reduced business activity.
- The $1.7 million positive period-over-period impact of a loss recorded on the sale and leaseback of a solar equipment project in the second quarter of 2009.

See Note 5, "*Dispositions,*" for a discussion of the dispositions completed in connection with Integrys Energy Services' strategy change.

Holding Company and Other Segment Operations

(Millions)	Three Months Ended June 30 2010	Three Months Ended June 30 2009	Change in 2010 over 2009	Six Months Ended June 30 2010	Six Months Ended June 30 2009	Change in 2010 over 2009
Operating income	**$ 3.2**	$ 1.8	77.8%	**$ 2.6**	$ 3.1	(16.1)%
Other expense	**(9.5)**	(15.1)	(37.1)%	**(21.9)**	(30.5)	(28.2)%
Loss before taxes	**$(6.3)**	$(13.3)	(52.6)%	**$(19.3)**	$(27.4)	(29.6)%

Second Quarter 2010 Compared with Second Quarter 2009

<u>Other Expense</u>

Other expense at the holding company and other segment decreased $5.6 million during the second quarter of 2010 compared with the same quarter in 2009, driven by a $3.1 million decrease in external interest expense. Also contributing to the decrease in other expense was a decrease in legal expenses.

Six Months 2010 Compared with Six Months 2009

<u>Other Expense</u>

Other expense at the holding company and other segment decreased $8.6 million during the six months ended June 30, 2010 compared with the same period in 2009, driven by a $6.7 million decrease in external interest expense. Also contributing to the decrease in other expense was a decrease in legal expenses.

Provision for Income Taxes

	Three Months Ended June 30		Six Months Ended June 30	
	2010	**2009**	**2010**	**2009**
Effective Tax Rate	**35.9%**	34.6%	**42.2%**	(27.7)%

Second Quarter 2010 Compared with Second Quarter 2009

The increase in the effective tax rate for the quarter ended June 30, 2010, compared with the same quarter in 2009, was driven by the effect of comparable quarter-over-quarter book to tax return differences in relation to higher net income in 2010.

Six Months 2010 Compared with Six Months 2009

The increase in the effective tax rate for the six months ended June 30, 2010, compared with the same period in 2009, was primarily related to the tax treatment of Integrys Energy Group's $291.1 million non-cash pre-tax goodwill impairment loss recorded in 2009. Although Integrys Energy Group had a $113.2 million loss before income taxes for the six months ended June 30, 2009, it still recorded a $31.3 million provision for income taxes because $186.2 million of the total pre-tax goodwill impairment loss was not deductible for income tax purposes.

Also contributing to the increase in the period-over-period effective tax rate was the elimination of the deductibility of prescription drug payments to retirees, to the extent those payments will be offset by the receipt of the Medicare Part D subsidy, as mandated in the 2010 federal health care legislation. See "*Liquidity and Capital Resources, Other Future Considerations – Federal Health Care Reform*" for more information. As a result of the legislation, Integrys Energy Group expensed $11.8 million of non-cash deferred income tax benefits during the first quarter of 2010, which were previously recognized as a reduction in provision for income taxes. The 2010 effective tax rate has also been adjusted to reflect an additional non-cash provision for income taxes of $1.9 million related to current year expected retiree benefits.