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## INVESTORS SERVICE

### **Rating Action: Moody's changes the outlooks of WEPCO, Wisconsin Gas, WPSC to negative; Affirms ratings of WEC and other subsidiaries**

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Global Credit Research - 29 Jun 2016

New York, June 29, 2016 -- Moody's Investors Service ("Moody's") affirmed the ratings of Wisconsin Gas LLC (A1 senior unsecured), Wisconsin Public Service Corporation (WPSC, A1 senior unsecured), Wisconsin Electric Power Company (WEPCO, A1 Issuer Rating) as well as Elm Road Generating Station Supercritical (ERGSS; A1 senior unsecured), and changed their outlooks to negative from stable.

Moody's affirmed the ratings of WEC Energy Group, Inc. (WEC), Wisconsin Energy Capital Corporation (WECC) and Integrys Holding, Inc (Integrys), including their A3 senior unsecured ratings, with a stable outlook. Moody's also affirmed the ratings of the two local gas distribution company (LDC) subsidiaries operating in Illinois, namely Peoples Gas Light and Coke Company (PGL) and North Shore Gas Company (NSG) including their A2 Issuer ratings. The rating outlooks of WEC, WECC, Integrys, PGL and NSG remain stable.

#### RATINGS RATIONALE

The negative outlook on WEPCO, WPSC and Wisconsin Gas is largely driven by Moody's expectation that, despite the anticipated moderation in their capital expenditures going forward, particularly for WPSC and Wisconsin Gas, key credit metrics of the three utilities will remain more commensurate with the mid-range of the A-scoring range for this factor for standard business risk in the Regulated Electric and Gas Utilities rating methodology scorecard grid. Specifically, the 3-year cash flow from operation (CFO) pre-W/C to debt ratio and retained cash flow (RCF) to debt ratio recorded by WPSC and WEPCO (even after adjustments related to the Power the Future leases) will remain below 28% and 23%, respectively. The negative rating outlook of Wisconsin Gas is premised on the expectation that the LDC will be able to report CFO pre-W/C to debt and RCF to debt ratios in the low to mid 20% and below 18% ranges, respectively. These credit metrics are in line with the low-to-mid-range of the A-scoring range for this factor for low business risk organizations in the same methodology scorecard grid.

The A1 rating and negative outlook of ERGSS reflect the credit profile of WEPCO given that ERGSS' notes are supported by WEPCO's lease payment obligations under the Power the Future lease arrangements because these payments are the sole source of cash flow to service ERGSS' senior notes.

The A1 senior unsecured ratings and negative rating outlooks of WPSC, WEPCO and Wisconsin Gas factor in that the vast majority of their operations are regulated, the constructive relationship with their regulators including the Public Service Commission of Wisconsin (PSCW), and the overall credit supportive regulatory frameworks under which they operate, particularly in Wisconsin where there has been a long track-record of consistency as well as predictable regulatory decisions with very limited, if any, instances of political interference. Additional features supporting our opinion include the ability of Wisconsin utilities to file general rate cases on a biennial basis based on forward-looking test periods. Moreover, rates are currently based on key regulatory parameters that compare well with those for other US utilities, particularly those underlying WEPCO's lease payments for the Power the Future electricity generation assets.

However, the negative rating outlooks of WEPCO, Wisconsin Gas and WPSC also considers Moody's view that these utilities' recovery of their cash costs are subject to less automatic mechanisms, reducing the timeliness recovery compared to many other US jurisdictions. For example, for the recovery of fuel and power related costs which are subject to a 2% tolerance band compared to a monthly benchmark with recovery/credits of under-/collected amounts subject to PSCW's additional review. For its part, Wisconsin Gas' cash flows visibility does not benefit from decoupling and/or Weather Normalization Adjustment mechanisms nor do its rates include surcharges related to the recovery of infrastructure related investments while these types of mechanisms are currently prevalent among the majority of LDCs operating in the US.

Moody's acknowledges that these utilities have pursued changes in their rate designs through increases in the fixed charge component embedded in their rates; however, the portion of the fixed costs subject to recovery via the volumetric portion of their margins is still significant, particularly in the case of WEPCO and Wisconsin Gas. Moody's also observes that unlike other jurisdictions with highly credit supportive regulatory recovery

mechanisms, Wisconsin utilities currently only start recording cash returns on and of their multi-year projects once the project begins operations and is added to rate base through a general rate case. Moreover, the utilities' cash flows do not benefit from any rider mechanism that allows for a timely cash recovery of costs in between rate cases should they differ significantly from the forecasted costs used when setting rates. For example, in the absence of transmission riders WEPCO's balance of regulated assets have been increasing significantly to reflect the deferred recovery of the transmission costs in the wake of the material investments pursued by American Transmission Company (A1 stable) in recent years. That said, Moody's acknowledges that credits to customers, for example in connection with over-collected amounts, are also not subject to automatic mechanisms. The three utilities apply the resulting regulatory liabilities to reduce the balance of their recorded regulatory assets (when allowed) and/or to somewhat manage the impact on their customers' bills of the allowed rate increases; however, the latter also diminishes the utilities' recorded operating cash flows. Thus, contributing to the utilities recording key credit metrics that are more in line with the mid-range of the A-rating category.

#### WEC and Integrys

The affirmation of the A3 unsecured as well as the stable outlooks of WEC, WECC, and Integrys factor in structural subordination of the holding-companies debt and the more diversified source of cash flows following the completion of the Integrys acquisition in June 2015. In contrast to Moody's initial expectations we do not anticipate that WEC will be able to record positive free cash flows over the medium term; however, the issuers' A3 ratings and stable outlooks capture our expectation that the group's consolidated key credit metrics will compare well with other A3-rated holding parent companies of regulated utilities in the US. Moody's assumes that the group will continue pursuing prudent financial policies including a target dividend payout ratio ranging between 65% and 70%. Importantly, the A3 ratings and stable outlooks also assume that the outstanding indebtedness at the holding companies will progressively decline as a percentage of the consolidated debt from the current significant 30% (when combining WEC and Integrys' debt) to around 25% over the next 18 months. Moody's expects this will result from a combination of repayments of outstanding holding company indebtedness as it becomes due along with the expectation that the group's new indebtedness going forward will largely occur at the utility subsidiary level to finance their capital requirements.

#### PGL and NSG

The affirmation of the A2 issuer ratings and stable outlook of PGL and NSG reflect Moody's expectation of ongoing regulatory credit supportiveness and prudent financial policies (including limited dividend distributions) as these two utilities execute on their capex programs. The stable outlooks assume their credit metrics will become better positioned within the A-rating category according to the Regulated Electric and Gas Utilities Methodology. Specifically, that PGL's RCF to debt remains above 17% on a sustainable basis. In the case of NSG, the stable outlook reflects an expectation that it will be able to record 3-year CFO pre-W/C to debt and 3-year RCF to debt in excess of 19% and 15%, respectively.

#### WHAT CAN CHANGE THE RATING -- DOWN

A downgrade of the ratings of WSPC, WEPCO and/or Wisconsin Gas is likely if their key credit metrics remain weak for the A1-rating category. Specifically, if the 3-year CFO pre-W/C to debt and 3-year RCF to debt recorded by WSPC and WEPCO (even after adjustments related to the Power the Future leases) remains below 28% and 23%, respectively. As for Wisconsin Gas if its 3-year average CFO pre-W/C to debt and RCF to debt remains below the mid 20% and 18% ranges, respectively.

The ratings of WEC and Integrys could be downgraded if we perceive a deterioration in the credit supportiveness of the regulatory environments under which their utility subsidiaries operate and/or if there is a further increase in the holding company indebtedness. Moreover, a downgrade is likely to be triggered if the group fails to report consolidated metrics that we consider commensurate with the A-rating category. Specifically, if their CFO pre-W/C to debt falls below 20% on a sustained basis.

The ratings of PGL and NSG could come under pressure upon a deterioration in the credit supportiveness of the regulatory framework and/or heightened political interference that results in unanticipated additional capex requirements and/or challenges to the LDCs' ability to recover operating costs and/or capex on a timely basis. A more aggressive dividend policy than currently anticipated would also likely create negative pressure on the rating or outlook, particularly if these circumstances negatively affected the financial performance of PGL and NSG. Specifically, if PGL's 3-year ratio of RCF to debt fell below 17% for an extended period, and NSG's 3-year CFO pre-W/C to debt declined below 20%, on a sustained basis.

Outlook Actions:

..Issuer: Elm Road Generating Station Supercritical

....Outlook, Changed To Negative From Stable

..Issuer: Integrys Holding, Inc.

....Outlook, Remains Stable

..Issuer: North Shore Gas Company

....Outlook, Remains Stable

..Issuer: Peoples Gas Light and Coke Company

....Outlook, Remains Stable

..Issuer: WEC Energy Group, Inc.

....Outlook, Remains Stable

..Issuer: Wisconsin Electric Power Company

....Outlook, Changed To Negative From Stable

..Issuer: Wisconsin Energy Capital Corporation

....Outlook, Remains Stable

..Issuer: Wisconsin Gas LLC

....Outlook, Changed To Negative From Stable

..Issuer: Wisconsin Public Service Corporation

....Outlook, Changed To Negative From Stable

Affirmations:

..Issuer: Elm Road Generating Station Supercritical

....Senior Unsecured Regular Bond/Debenture, Affirmed A1

..Issuer: Illinois Development Finance Authority

....Senior Secured Revenue Bonds, Affirmed Aa3

....Underlying Senior Secured Revenue Bonds, Affirmed Aa3

..Issuer: Illinois Finance Authority

....Senior Secured Revenue Bonds, Affirmed Aa3

....Underlying Senior Secured Revenue Bonds, Affirmed Aa3

..Issuer: Integrys Energy Group, Inc.

....Junior Subordinated Regular Bond/Debenture, Affirmed Baa1

....Senior Unsecured Regular Bond/Debenture, Affirmed A3

..Issuer: Integrys Holding, Inc.

.... Issuer Rating, Affirmed A3

....Senior Unsecured Commercial Paper, Affirmed P-2

..Issuer: North Shore Gas Company  
.... Issuer Rating, Affirmed A2  
....Senior Secured Medium-Term Note Program, Affirmed (P)Aa3  
..Issuer: Oak Creek (City of) WI  
....Revenue Bonds, Affirmed A1  
....Revenue Bonds, Affirmed P-1  
..Issuer: Peoples Gas Light and Coke Company  
.... Commercial Paper, Affirmed P-1  
.... Issuer Rating, Affirmed A2  
....Senior Secured First Mortgage Bonds, Affirmed Aa3  
....Senior Secured Medium-Term Note Program, Affirmed (P)Aa3  
..Issuer: WEC Energy Group, Inc.  
.... Issuer Rating, Affirmed A3  
....Junior Subordinated Regular Bond/Debenture, Affirmed Baa1  
....Senior Unsecured Shelf, Affirmed (P)A3  
....Junior Subordinated Shelf, Affirmed (P)Baa1  
....Senior Unsecured Commercial Paper, Affirmed P-2  
....Senior Unsecured Regular Bond/Debenture, Affirmed A3  
..Issuer: Wisconsin Electric Power Company  
.... Commercial Paper, Affirmed P-1  
.... Issuer Rating, Affirmed A1  
....Pref. Stock Preferred Stock, Affirmed A3  
....Senior Unsecured Regular Bond/Debenture, Affirmed A1  
....Senior Unsecured Shelf, Affirmed (P)A1  
..Issuer: Wisconsin Energy Capital Corporation  
....Senior Unsecured Medium-Term Note Program, Affirmed (P)A3  
....Senior Unsecured Regular Bond/Debenture, Affirmed A3  
..Issuer: Wisconsin Gas LLC  
.... Commercial Paper, Affirmed P-1  
....Senior Unsecured Regular Bond/Debenture, Affirmed A1  
..Issuer: Wisconsin Public Service Corporation  
.... Issuer Rating, Affirmed A1  
....Pref. Stock Shelf, Affirmed (P)A3

...Senior Secured First Mortgage Bonds, Affirmed A1  
...Senior Secured Regular Bond/Debenture, Affirmed A1  
...Senior Secured Shelf, Affirmed (P)Aa2  
...Senior Unsecured Commercial Paper, Affirmed P-1  
...Senior Unsecured Regular Bond/Debenture, Affirmed A1

Headquartered in Milwaukee, Wisconsin Energy Corporation (WEC) is a diversified energy holding company that conducts operations in an energy segment and, to a much lesser extent, a non-energy segment that primarily invests in real estate. It holds directly or indirectly via the holding company Integrys Holding, Inc (A3 stable) ownership-stakes in several subsidiaries. These include Wisconsin Electric Power Company (WEPCO; A1 negative), Wisconsin Public Service Corporation (WPS, A1 negative), Wisconsin Gas LLC (Wisconsin Gas; A1 negative), Peoples Gas, Light and Coke Company (PGL, A2 stable), North Shore Gas Company (NSG, A2 stable), Minnesota Energy Resources Corporation (unrated), and Michigan Gas Utilities Corporation (unrated). Elm Road Generating Station Supercritical, LLC (ERGSS; A1 negative) holds WEC's approximately 83% undivided ownership interests in Unit 1 and Unit 2 at the Elm Road Generating Station consisting of two 615 MW supercritical pulverized units at the Oak Creek coal electric generating station. These were part of WEC's Power The Future strategy to design, build and finance four units aggregating 2,320MW. In addition to the Oak Creek Unit 1 and 2, the PTF facilities also included two 545MW combined cycle natural gas units located at the Port Washington Generating Station (PWGS Unit 1 and 2). All four PTF facilities have been leased to WEPCO.

The principal methodology used in these ratings was Regulated Electric and Gas Utilities published in December 2013. Please see the Ratings Methodologies page on [www.moodys.com](http://www.moodys.com) for a copy of this methodology.

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