INTEGRYS ENERGY GROUP, INC.
Form 10-Q
August 08, 2007

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

FORM 10-Q

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

For the quarterly period ended June 30, 2007

OR

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

For the transition period from __________ to __________

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [x] No [ ]

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

Large Accelerated filer [X] Accelerated filer [ ] Non-accelerated filer [ ]

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

Yes [ ] No [x]

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

Common stock, $1 par value,
75,995,281 shares outstanding at
August 1, 2007

INTEGRYS ENERGY GROUP, INC.
FORM 10-Q FOR THE QUARTER ENDED JUNE 30, 2007

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Commonly Used Acronyms

ATC	American Transmission Company LLC
DOE	United States Department of Energy
DPC	Dairyland Power Cooperative
EPA	United States Environmental Protection Agency
ESOP	Employee Stock Ownership Plan
FASB	Financial Accounting Standards Board
FERC	Federal Energy Regulatory Commission
LIFO	Last-in, first-out
ICC	Illinois Commerce Commission
ICE	Intercontinental Exchange
MERC	Minnesota Energy Resources Corporation
MGUC	Michigan Gas Utilities Corporation
MISO	Midwest Independent Transmission System Operator
MPSC	Michigan Public Service Commission
MPUC	Minnesota Public Utility Commission
NSG	North Shore Gas Company
NYMEX	New York Mercantile Exchange
PEC	Peoples Energy Corporation
PEP	Peoples Energy Production Company
PGL	The Peoples Gas Light and Coke Company
PSCW	Public Service Commission of Wisconsin
SEC	Securities and Exchange Commission
SFAS	Statement of Financial Accounting Standards
UPPCO	Upper Peninsula Power Company
WDNR	Wisconsin Department of Natural Resources
WPSC	Wisconsin Public Service Corporation

Forward-Looking Statements

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

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

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

Forward-looking statements involve a number of risks and uncertainties. There are many factors that could cause actual results to differ materially from those expressed or implied in this report. Some risk factors that could cause results different from any forward-looking statement include those described in Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2006 and as such may be amended or supplemented in Part II, Item 1A of this report. Other factors include:

- Unexpected costs and/or unexpected liabilities related to the PEC merger, or the effects of purchase accounting that may be different from our expectations;
- The successful combination of the operations of Integrys Energy Group and PEC;
- Integrys Energy Group may be unable to achieve the forecasted synergies in connection with the PEC merger or it may take longer or cost more than expected to achieve these synergies;
- The credit ratings of Integrys Energy Group or its subsidiaries could change in the future;
- Resolution of pending and future rate cases and negotiations (including the recovery of deferred costs) and other regulatory decisions impacting Integrys Energy Group's regulated businesses;
- The impact of recent and future federal and state regulatory changes, including legislative and regulatory initiatives regarding deregulation and restructuring of the electric and natural gas utility industries, changes in environmental, tax and other laws and regulations to which Integrys Energy Group and its subsidiaries are subject, as well as changes in application of existing laws and regulations;
- Current and future litigation, regulatory investigations, proceedings or inquiries, including but not limited to, manufactured gas plant site cleanup, pending EPA investigations of WPSC generation facilities and the appeal of the decision in the contested case proceeding regarding the Weston 4 air permit;
- Resolution of audits or other tax disputes with the Internal Revenue Service and various state, local and Canadian revenue agencies;
- The effects, extent and timing of additional competition or regulation in the markets in which our subsidiaries operate;
- The impact of fluctuations in commodity prices, interest rates and customer demand;
- Available sources and costs of fuels and purchased power;

Investment performance of employee benefit plan assets;
Advances in technology;
Effects of and changes in political, legal and economic conditions and developments in the United States and Canada;
Potential business strategies, including mergers and acquisitions or dispositions of assets or businesses, which cannot be assured to be completed (such as construction of the Weston 4 power plant; additional investment in ATC related to construction of the Wausau, Wisconsin, to Duluth, Minnesota, transmission line; and the sale of PEP);
The direct or indirect effects of terrorist incidents, natural disasters or responses to such events;

Financial market conditions and the results of financing efforts, including credit ratings, and risks associated with commodity prices (particularly natural gas and electricity), interest rates and counter-party credit;

Weather and other natural phenomena, in particular the effect of weather on natural gas and electricity sales;

The effect of accounting pronouncements issued periodically by standard-setting bodies; and

Other factors discussed elsewhere herein and in other reports filed by the registrants from time to time with the SEC.

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

PART 1. FINANCIAL INFORMATION

Item 1. Financial Statements

INTEGRYS ENERGY GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

(Millions, except per share data)	Three Months Ended June 30 2007	Three Months Ended June 30 2006	Six Months Ended June 30 2007	Six Months Ended June 30 2006
Nonregulated revenue	**$ 1,649.9**	$ 1,125.8	**$ 3,426.7**	$ 2,682.4
Utility revenue	**711.8**	349.5	**1,681.6**	788.6
Total revenues	**2,361.7**	1,475.3	**5,108.3**	3,471.0
Nonregulated cost of fuel, natural gas, and purchased power	**1,650.9**	1,072.0	**3,314.6**	2,543.6
Utility cost of fuel, natural gas, and purchased power	**420.2**	171.4	**1,072.0**	440.5
Operating and maintenance expense	**251.9**	120.4	**438.6**	238.5
Depreciation and amortization expense	**50.6**	29.3	**90.8**	56.5
Taxes other than income taxes	**22.0**	14.6	**43.1**	29.2
Operating income (loss)	**(33.9)**	67.6	**149.2**	162.7
Miscellaneous income	**21.6**	14.5	**33.9**	23.2
Interest expense	**(42.6)**	(22.4)	**(79.0)**	(40.7)
Minority interest	**-**	1.2	**0.1**	2.4
Other expense	**(21.0)**	(6.7)	**(45.0)**	(15.1)
Income (loss) before taxes	**(54.9)**	60.9	**104.2**	147.6
Provision (benefit) for income taxes	**(15.3)**	19.0	**26.6**	46.4
Income (loss) from continuing operations	**(39.6)**	41.9	**77.6**	101.2
Discontinued operations, net of tax	**24.0**	(6.2)	**47.0**	(4.6)
Income (loss) before preferred stock dividends of subsidiary	**(15.6)**	35.7	**124.6**	96.6
Preferred stock dividends of subsidiary	**0.8**	0.8	**1.6**	1.6
Income (loss) available for common shareholders	**$ (16.4)**	$ 34.9	**$ 123.0**	$ 95.0
Average shares of common stock				
Basic	**76.0**	42.2	**66.8**	41.2
Diluted	**76.0**	42.2	**67.1**	41.3
Earnings (loss) per common share -- basic				
Income (loss) from continuing operations	**$ (0.53)**	$ 0.97	**$ 1.14**	$ 2.42
Discontinued operations, net of tax	**$ 0.31**	$ (0.14)	**$ 0.70**	$ (0.11)
Earnings (loss) per common share -- basic	**$ (0.22)**	$ 0.83	**$ 1.84**	$ 2.31

Earnings (loss) per common share -- diluted								
Income (loss) from continuing operations	**$**	**(0.53)**	$	0.97	**$**	**1.13**	$	2.41
Discontinued operations, net of tax	**$**	**0.31**	$	(0.14)	**$**	**0.70**	$	(0.11)
Earnings (loss) per common share -- diluted	**$**	**(0.22)**	$	0.83	**$**	**1.83**	$	2.30
Dividends per common share declared	**$**	**0.660**	$	0.565	**$**	**1.243**	$	1.130

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

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INTEGRYS ENERGY GROUP, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS (Unaudited) (Millions)	**June 30 2007**	December 31 2006
Assets		
Cash and cash equivalents	**$ 31.7**	$ 23.2
Restricted cash	**-**	22.0
Accounts receivable - net of reserves of $69.9 and $17.0, respectively	**1,190.2**	1,037.3
Accrued unbilled revenues	**208.8**	184.8
Inventories	**651.7**	456.3
Current assets from risk management activities	**898.5**	1,068.6
Deferred income taxes	**13.2**	-
Assets held for sale	**828.4**	6.1
Other current assets	**129.2**	129.1
Current assets	**3,951.7**	2,927.4
Property, plant, and equipment, net of accumulated depreciation of $2,584.0 and $1,427.8, respectively	**4,325.0**	2,534.8
Regulatory assets	**1,241.2**	417.8
Long-term assets from risk management activities	**419.5**	308.2
Goodwill	**946.8**	303.9
Pension assets	**89.4**	-
Other	**406.8**	369.6
Total assets	**$ 11,380.4**	$ 6,861.7
Liabilities and Shareholders' Equity		
Short-term debt	**$ 865.6**	$ 722.8
Current portion of long-term debt	**54.9**	26.5
Accounts payable	**1,154.0**	949.4
Current liabilities from risk management activities	**899.8**	1,001.7
Deferred income taxes	**-**	3.1
Liabilities held for sale	**46.3**	-
Other current liabilities	**434.6**	202.9
Current liabilities	**3,455.2**	2,906.4
Long-term debt	**2,142.7**	1,287.2
Deferred income taxes	**536.6**	97.6
Deferred investment tax credits	**38.9**	13.6
Regulatory liabilities	**304.3**	301.7
Environmental remediation liabilities	**637.3**	95.8
Pension and postretirement benefit obligations	**384.6**	188.6
Long-term liabilities from risk management activities	**367.9**	264.7
Asset retirement obligations	**136.7**	10.1
Other	**153.1**	111.3
Long-term liabilities	**4,702.1**	2,370.6

Commitments and contingencies				
Preferred stock of subsidiary with no mandatory redemption		**51.1**		51.1
Common stock equity		**3,172.0**		1,533.6
Total liabilities and shareholders' equity	**$**	**11,380.4**	$	6,861.7

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

INTEGRYS ENERGY GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

(Millions)	Six Months Ended June 30 2007	2006
Operating Activities		
Net income before preferred stock dividends of subsidiary	**$ 124.6**	$ 96.6
Adjustments to reconcile net income to net cash provided by operating activities		
Discontinued operations, net of tax	**(47.0)**	4.6
Depreciation and amortization	**90.8**	56.5
Recovery of Kewaunee outage expenses	**5.1**	6.3
Refund of non-qualified decommissioning trust	**(27.3)**	(30.0)
Recoveries and refunds of other regulatory assets and liabilities	**17.9**	13.0
Unrealized gains on nonregulated energy contracts	**(6.7)**	(33.0)
Pension and postretirement expense	**35.4**	25.7
Pension and postretirement funding	**(4.4)**	(2.7)
Deferred income taxes and investment tax credit	**18.2**	8.0
Gains due to settlement of contracts pursuant to the merger with PEC	**(4.0)**	-
Gain on the sale of interest in Guardian Pipeline, LLC	**-**	(6.2)
Gain on the sale of WPS ESI Gas Storage. LLC	**-**	(9.0)
Gain on the sale of partial interest in synthetic fuel operation	**(1.4)**	(3.5)
Equity income, net of dividends	**1.6**	5.8
Other	**(2.6)**	15.4
Changes in working capital		
Receivables, net	**548.5**	375.6
Inventories	**(57.2)**	(168.1)
Other current assets	**62.6**	3.0
Accounts payable	**(249.0)**	(384.7)
Other current liabilities	**(154.5)**	(1.1)
Net cash provided by (used for) operating activities	**350.6**	(27.8)
Investing Activities		
Capital expenditures	**(155.0)**	(153.6)
Proceeds from the sale of property, plant and equipment	**2.3**	2.4
Purchase of equity investments and other acquisitions	**(34.9)**	(41.5)
Proceeds on the sale of interest in Guardian Pipeline, LLC	**-**	38.5
Proceeds on the sale of WPS ESI Gas Storage, LLC	**-**	19.9
Cash paid for transaction costs pursuant to the merger with PEC	**(13.8)**	-
Acquisition of natural gas operations in Michigan and Minnesota, net of liabilities assumed	**1.7**	(317.9)
Restricted cash for repayment of long-term debt	**22.0**	-
Restricted cash for acquisition	**-**	(333.3)
Transmission interconnection	**(23.9)**	(1.8)
Other	**6.4**	2.1
Net cash used for investing activities	**(195.2)**	(785.2)

Financing Activities				
Short-term debt, net		**(66.3)**		738.0
Gas loans, net		**(7.5)**		(43.1)
Repayment of long-term debt		**(25.0)**		(1.4)
Payment of dividends				
Preferred stock		**(1.6)**		(1.6)
Common stock		**(76.9)**		(46.7)
Issuance of common stock		**25.2**		151.9
Other		**2.1**		0.3
Net cash provided by (used for) financing activities		**(150.0)**		797.4
Change in cash and cash equivalents - continuing operations		**5.4**		(15.6)
Change in cash and cash equivalents - discontinued operations				
Net cash provided by operating activities		**40.1**		23.1
Net cash provided by (used for) investing activities		**(37.0)**		(17.7)
Change in cash and cash equivalents		**8.5**		(10.2)
Cash and cash equivalents at beginning of period		**23.2**		27.7
Cash and cash equivalents at end of period	**$**	**31.7**	$	17.5

The accompanying condensed notes are an integral part of these statements

INTEGRYS ENERGY GROUP, INC AND SUBSIDIARIES
CONDENSED NOTES TO FINANCIAL STATEMENTS
June 30, 2007

NOTE 1--FINANCIAL INFORMATION

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

These financial statements on Form 10-Q have not been audited. Management believes that these financial statements include all adjustments (which unless otherwise noted include only normal recurring adjustments) necessary for a fair presentation of the financial results for each period shown. We have condensed or omitted certain financial information and note disclosures normally included in our annual audited financial statements. These condensed financial statements should be read along with the audited financial statements and notes included in our Annual Report on Form 10-K for the year ended December 31, 2006. In addition, certain items from the prior periods have been reclassified to conform to the current year presentation. Significant reclassifications are as follows:

Reclassifications

Condensed Consolidated Balance Sheet

Customers electing a budget payment plan had a credit balance of $49.2 million at December 31, 2006. Since this balance is subject to change based upon the amount of future billings, this balance was reclassified from accounts payable to other current liabilities.

Condensed Consolidated Statements of Income

For the three and six months ended June 30, 2006, $4.1 million and $7.8 million, respectively, of software and intangible asset amortization expense was reclassified from operating and maintenance expense to depreciation and amortization expense to conform to the three and six months ended June 30, 2007 presentation.

Condensed Consolidated Statement of Cash Flows

The reclassifications discussed above related to the Condensed Consolidated Balance Sheets and Condensed Consolidated Statements of Income were also reflected as reclassifications in the Condensed Consolidated Statements of Cash Flows for the six months ended June 30, 2006. These reclassifications had no impact on total operating, investing, or financing activities.

Dispositions

WPS Niagara Generation, LLC's (Niagara's) results of operations and cash flows were reclassified as discontinued operations for the three and six months ended June 30, 2006. The sale of Niagara was completed in January 2007. Refer to Note 4, "*Discontinued Operations*," for more information.

Sunbury Generation, LLC's (Sunbury's) results of operations and cash flows for the three and six months ended June 30, 2006 were reclassified as discontinued operations. The sale of Sunbury was completed in July 2006. Refer to Note 4, "*Discontinued Operations*," for more information.

Mergers and Acquisitions

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

The assets and liabilities, results of operations, and cash flows of MGUC and MERC were included in Integrys Energy Group's Condensed Consolidated Financial Statements effective April 1 and July 1, 2006, respectively. See Note 5, "*Acquisitions and Sales of Assets*," for more information.

NOTE 2--CASH AND CASH EQUIVALENTS

We consider short-term investments with an original maturity of three months or less to be cash equivalents.

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

	Six Months Ended June 30	
(Millions)	**2007**	2006
Cash paid for interest	**$ 56.8**	$ 35.7
Cash paid for income taxes	**$ 18.9**	$ 20.5

Under Integrys Energy Group's cash management policy, accounting overdraft cash balances of $30.4 million and $6.1 million at June 30, 2007, and December 31, 2006, respectively, were reclassified to accounts payable.

Significant non-cash transactions were as follows:

	Six Months Ended June 30	
(Millions)	**2007**	2006
Weston 4 construction costs funded through accounts payable	**$ 29.3**	$ 39.3
Equity issued for net assets acquired in PEC merger	**1,556.3**	-
Realized gain on settlement of contracts due to PEC merger	**4.0**	-
Merger transaction costs funded through other current liabilities	**0.3**	-
Purchase price adjustments related to MGUC funded through accounts payable	**-**	26.0

NOTE 3--RISK MANAGEMENT ACTIVITIES

As part of our regular operations, Integrys Energy Group enters into contracts, including options, swaps, futures, forwards, and other contractual commitments, to manage market risks such as changes in commodity prices and interest rates.

Integrys Energy Group accounts for its derivative contracts in accordance with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended and interpreted. SFAS No. 133 establishes accounting and financial reporting standards for derivative instruments and requires, in part, that we recognize certain derivative instruments on the balance sheet as assets or liabilities at their fair value. Subsequent changes in fair value of the derivatives are recorded currently in earnings unless certain hedge accounting criteria are met. If the derivatives qualify for regulatory deferral subject to the provisions of SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation," the derivatives are marked to fair value pursuant to SFAS No. 133 and are offset with a corresponding regulatory asset or liability.

Integrys Energy Group classifies mark-to-market gains and losses on derivative instruments not qualifying for hedge accounting or regulatory deferral as a component of revenues.

The following table shows Integrys Energy Group's assets and liabilities from risk management activities as of June 30, 2007, and December 31, 2006:

	Assets		Liabilities	
(Millions)	**June 30, 2007**	December 31, 2006	**June 30, 2007**	December 31, 2006
Utility Segments				
Commodity contracts	**$ 6.2**	$ 5.9	**$ 45.9**	$ 12.1
Financial transmission rights	**26.0**	14.3	**8.6**	2.0
Cash flow hedges – commoditycontracts	**-**	-	**0.5**	-
Nonregulated Segments				
Commodity and foreign currency contracts	**1,244.4**	1,237.7	**1,178.2**	1,195.4
Fair value hedges				
Commodity contracts	**5.8**	11.0	**0.2**	0.3
Interest rate swaps	**-**	-	**2.0**	-
Cash flow hedges				
Commodity contracts	**35.6**	107.9	**30.1**	53.3
Interest rate swaps	**-**	-	**2.2**	3.3
Total	**$ 1,318.0**	$ 1,376.8	**$ 1,267.7**	$ 1,266.4
Balance Sheet Presentation				
Current	**$ 898.5**	$ 1,068.6	**$ 899.8**	$ 1,001.7
Long-term	**419.5**	308.2	**367.9**	264.7
Total	**$ 1,318.0**	$ 1,376.8	**$ 1,267.7**	$ 1,266.4

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

Utility Segments

The derivatives listed in the above table as "Commodity contracts" include a limited number of electric and natural gas purchase contracts as well as financial derivative contracts (NYMEX futures and options) used by both the electric and natural gas utility segments to mitigate the market price volatility of natural gas. The electric utility segment also uses financial instruments to manage transmission congestion costs, which are shown in the above table as "Financial transmission rights."

Derivative instruments at the utilities are entered into in accordance with the terms of the risk management policies approved by Integrys Energy Group's Board of Directors and, if applicable, by the respective regulatory bodies. Changes in the fair value of non-hedge derivative instruments are recognized as regulatory assets or liabilities as our regulators have allowed deferral of the mark-to-market effects of derivative instruments at the utilities. Thus, management believes any gains or losses resulting from the eventual settlement of these derivative instruments will be collected from or refunded to customers.

Additionally, PGL uses derivatives to hedge changes in the price of natural gas used to support operations. These instruments are designated as cash flow hedges, which allow for the effective portion of the unrealized change in value during the life of the hedge to be recorded in comprehensive income, net of taxes. Commodity contracts that are designated as cash flow hedges extend through September 2008. Cash flow hedge ineffectiveness recorded in operating and maintenance expense on the Condensed Consolidated Statements of Income related to commodity contracts was insignificant for the three and six months ended June 30, 2007. When testing for effectiveness, no portion of the derivative instruments was excluded. Amounts recorded in other comprehensive income related to these cash flow hedges will be recognized in earnings as the hedged transactions occur or if it becomes probable that the hedged transaction will not occur. The amount to be recognized in earnings over the next 12 months as the hedged transactions occur is insignificant.

Nonregulated Segments

The derivatives in the nonregulated segments not designated as hedges under generally accepted accounting principles are primarily commodity contracts used to manage price risk associated with natural gas and electric energy purchase and sale activities, and foreign currency contracts used to manage foreign currency exposure related to Integrys Energy Services' Canadian operations. In addition, Integrys Energy Services entered into interest rate swaps associated with long-term storage contracts as well as a series of derivative contracts (options) covering a specified number of barrels of oil in order to manage exposure to the risk of an increase in oil prices that could result in a phase-out of Section 29/45K federal tax credits from Integrys Energy Services' investment in a synthetic fuel production facility for 2007. See Note 12, "*Commitments and Contingencies*," for more information. Changes in the fair value of non-hedge derivatives are recognized currently in earnings.

Our nonregulated segments also enter into commodity derivative contracts that are designated as either fair value or cash flow hedges. Fair value hedges are used to mitigate the risk of changes in the price of natural gas held in storage. The changes in the fair value of these hedges are recognized currently in earnings, as are the changes in fair value of the hedged items. Fair value hedge ineffectiveness recorded in nonregulated revenue on the Condensed Consolidated Statements of Income was not significant for the three months ended June 30, 2007, and 2006. Fair value hedge ineffectiveness recorded in nonregulated revenue on the Condensed Consolidated Statements of Income was not significant for the six months ended June 30, 2007, and was a pre-tax gain of $2.6 million for the six months ended June 30, 2006. Changes in the difference between the spot and forward prices of natural gas were excluded from the assessment of hedge effectiveness and reported directly in nonregulated revenue. The amount excluded was a pre-tax gain of $2.1 million during the three months ended June 30, 2007, and was not significant during the three months ended June 30, 2006. The amount excluded was a pre-tax gain of $3.1 million during the six months ended June 30, 2007, and was not significant during the six months ended June 30, 2006.

Commodity contracts that are designated as cash flow hedges extend through February 2011, and are used to mitigate the risk of cash flow variability associated with the future purchases and sales of natural gas, oil, and electricity. To the extent they are effective, the changes in the values of these contracts are included in other comprehensive income, net of taxes. Cash flow hedge ineffectiveness recorded in nonregulated revenue on the Condensed Consolidated Statements of Income related to commodity contracts was not significant for the three months ended June 30, 2007, and was a pre-tax gain of $2.8 million for the three months ended June 30, 2006. Cash flow hedge ineffectiveness recorded in nonregulated revenue on the Condensed Consolidated Statements of Income related to commodity contracts was a pre-tax loss of $5.9 million for the six months ended June 30, 2007, and a pre-tax gain of $4.1 million for the six months ended June 30, 2006. When testing for effectiveness, no portion of the derivative instruments was excluded. Amounts recorded in other comprehensive income related to these cash flow hedges will be recognized in earnings when the hedged transactions occur, which is typically as the related contracts are settled, or if it is probable that the hedged transaction will not occur. During the three and six months ended June 30, 2007, and 2006, the amounts reclassified from other comprehensive income into earnings as a result of the discontinuance of cash flow hedge accounting for certain hedge transactions were not significant. In the next 12 months, subject to changes in market prices of natural gas and electricity, we expect that a pre-tax gain of $14.8 million will be recognized in earnings as the hedged transactions occur. We expect this amount to be substantially offset by settlement of the related nonderivative contracts that are being hedged.

As a result of the merger with PEC, Integrys Energy Group assumed a fixed to floating interest rate swap. This swap is designated as a fair value hedge and is used to hedge the changes in fair value of $50.0 million of PEC Series A 6.9% notes due January 15, 2011, from movements in interest rates. The changes in the fair value of this hedge are recognized currently in earnings, as are the changes in fair value of the hedged notes. Fair value hedge ineffectiveness recorded in nonregulated revenue on the Condensed Consolidated Statements of Income was not significant for the three and six months ending June 30, 2007. When testing for effectiveness, no portion of the derivative instruments was excluded.

In the second quarter of 2005, two interest rate swaps were designated as cash flow hedges to fix the interest rate on an unsecured term loan at Integrys Energy Group. Since the designation of these contracts as cash flow hedges, the changes in the fair value of the effective portion of these swaps are included in other comprehensive income, net of taxes, while changes related to the ineffective portion are recorded in earnings. During the three and six months ended June 30, 2007, and 2006, cash flow hedge ineffectiveness recorded in earnings related to these swaps was not significant. Amounts recorded in other comprehensive income related to these swaps will be recognized as a component of interest expense when the interest expense on the related debt is recognized in earnings. The amount to be reclassified as interest expense over the next 12 months is insignificant. Integrys Energy Group did not exclude any component of the derivative instruments' change in fair value from the assessment of hedge effectiveness.

In 2006, Integrys Energy Group entered into two forward-starting interest rate swaps with ten-year terms to hedge a portion of the interest rate risk associated with the planned issuance of $200.0 million of fixed-rate, long-term debt securities. Because both swaps qualified for cash flow hedge treatment, changes in the fair value of the swaps were recorded in other comprehensive income, net of taxes. Both swaps were settled in 2006, and in December 2006, Integrys Energy Group issued $300.0 million of junior subordinated notes. Amounts remaining in accumulated other comprehensive income for the forward-starting swaps are being reclassified to interest expense over a ten-year period beginning in December 2006 to correspond with the first ten years of interest on the related debt. The amount to be reclassified to interest expense over the next 12 months is not significant.

NOTE 4--DISCONTINUED OPERATIONS

PEP

In February 2007, Integrys Energy Group announced its plans to divest of PEP. SFAS No. 141 "Business Combinations," states that assets acquired in a business combination that will be sold should be recognized at fair value less costs to sell in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 requires that long-lived assets classified as held for sale be measured at the lower of their carrying amount or fair value, less costs to sell, and to cease depreciation, depletion, and amortization. At the date of the merger, the assets and liabilities of PEP were classified as held for sale and results of operations and related cash flows occurring subsequent to the merger were reported as discontinued operations. Integrys Energy Group is working with a financial advisor on this transaction and anticipates the divesture to be completed by December 31, 2007.

At June 30, 2007, the assets and liabilities associated with PEP that will be transferred in the sale have been classified as held for sale. No adjustments to write down the PEP assets to fair value less costs to sell were required during the time period subsequent to the merger through June 30, 2007. The major classes of assets and liabilities held for sale at June 30, 2007, for PEP are as follows:

(Millions)		**2007**
Accounts receivable	**$**	**41.3**
Other current assets		**3.5**
Property, plant, and equipment, net		**783.6**
Total assets held for sale	**$**	**828.4**
Accounts payable	**$**	**35.2**
Other current liabilities		**5.4**
Asset retirement obligations		**5.7**
Liabilities held for sale	**$**	**46.3**

A summary of the components of discontinued operations recorded in the Condensed Consolidated Statements of Income related to PEP for the three months ended June 30 was as follows:

(Millions)		**2007**
Nonregulated revenue	**$**	**52.6**
Operating and maintenance expense		**12.0**
Taxes other than income		**2.2**
Income before taxes		**38.4**
Income tax provision		**14.4**
Discontinued operations, net of tax	**$**	**24.0**

A summary of the components of discontinued operations recorded in the Condensed Consolidated Statements of Income related to PEP for the time period subsequent to the merger through June 30, 2007, were as follows:

(Millions)		**2007**
Nonregulated revenue	**$**	**70.8**
Operating and maintenance expense		**16.0**
Taxes other than income		**3.7**
Income before taxes		**51.1**
Income tax provision		**18.9**
Discontinued operations, net of tax	**$**	**32.2**

It has been Integrys Energy Group's policy to not allocate interest to discontinued operations unless the asset group being sold has external debt obligations. For the period ended June 30, 2007, PEP did not have any external debt obligations.

WPS Niagara Generation, LLC

In January 2007, Integrys Energy Services completed the sale of WPS Niagara Generation, LLC, which owned a 50-megawatt merchant generation facility located near Niagara Falls, New York, for approximately $31 million, subject to post closing adjustments. The pre-tax gain recorded in 2007 was $24.6 million, $14.8 million after-tax, and was included as a component of discontinued operations. This facility was a merchant facility and sold power on a wholesale basis when market conditions were economically favorable.

The major classes of assets held for sale at December 31, 2006, for Niagara were as follows:

(Millions)		December 31, 2006
Inventories	$	0.4
Property, plant, and equipment, net		4.6
Other assets		1.1
Total assets held for sale	$	6.1

A summary of the components of discontinued operations recorded in the Condensed Consolidated Statements of Income related to Niagara for the three months ended June 30 were as follows:

(Millions)	2006
Nonregulated revenue	$ 3.7
Nonregulated cost of fuel, natural gas, and purchased power	2.4
Operating and maintenance expense	2.1
Depreciation and amortization expense	0.1
Taxes other than income	0.1
Other income	0.2
Loss before taxes	(0.8)
Income tax benefit	(0.2)
Discontinued operations, net of tax	$ (0.6)

A summary of the components of discontinued operations recorded in the Condensed Consolidated Statements of Income related to Niagara for the six months ended June 30 were as follows:

(Millions)	**2007**	2006
Nonregulated revenue	**$ 1.5**	$ 9.1
Nonregulated cost of fuel, natural gas, and purchased power	**1.0**	6.1
Operating and maintenance expense	**0.5**	3.1
Gain on Niagara sale	**24.6**	-