BSQUARE CORP /WA
Form 10-K
February 16, 2007

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

Form 10-K

(Mark One)

þ	**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** **For the fiscal year ended December 31, 2006**
	or
o	**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 000-27687
BSQUARE CORPORATION
(Exact name of registrant as specified in its charter)

Washington	**91-1650880**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*

110 110th Avenue NE, Suite 200, Bellevue, Washington 98004
(Address of principal executive offices)

(425) 519-5900
(Registrant s telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	**Name of Each Exchange on Which Registered**
Common Stock, no par value	The NASDAQ Stock Market LLC (NASDAQ Global Market)

Securities registered pursuant to Section 12(g) of the Act:
None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act. Yes o No þ

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 þ No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

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. (Check one):
Large accelerated filer o Accelerated filer o Non-accelerated filer þ

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2). Yes o No þ

The aggregate market value of common stock held by non-affiliates of the registrant as of June 30, 2006 was approximately $13,367,000 based on the closing price of $2.217 per share of the registrant s common stock as listed on the NASDAQ Global Market.

The number of shares of common stock outstanding as of January 31, 2007: 9,618,291

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive proxy statement to be delivered to shareholders in connection with the annual meeting of shareholders to be held on June 6, 2007 are incorporated by reference into Part III of this Form 10-K.

BSQUARE CORPORATION

FORM 10-K

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PART I

Item 1. *Business.*

FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K and the documents incorporated herein by reference contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 based on current expectations, estimates and projections about our industry and our management s beliefs and assumptions. When used in this Form 10-K and elsewhere, the words believes, plans, estimates, intends, anticipates, seeks and expects and similar expressions are intended to identify forward-lookin statements. These forward-looking statements include, but are not limited to, statements about our plans, objectives, expectations and intentions and other statements that are not historical facts. These forward-looking statements are not guarantees of future performance and are subject to certain risks and uncertainties that are difficult to predict. Accordingly, actual results may differ materially from those anticipated or expressed in such statements as a result of a variety of factors, including those set forth under Item 1A, Risk Factors. Such forward-looking statements include, but are not limited to, statements with respect to the following:

The development of the smart device market and our ability to address its opportunities and challenges;

The adoption of Windows CE, Windows XP Embedded, Pocket PC and Smartphone as operating systems of choice for many smart device hardware and software applications vendors;

Our business plan and our strategy for implementing our plan;

Our ability to expand our strategic relationships with hardware and software vendors;

Our ability to maintain our relationship with Microsoft Corporation (Microsoft);

Our ability to address challenges and opportunities in the international marketplace;

Our ability to develop our technology and expand our proprietary software and service offerings; and

Our anticipated working capital needs and capital expenditure requirements, including our ability to meet our anticipated cash needs.

Readers are cautioned not to place undue reliance on the forward-looking statements, which speak only as of the date made. Except as required by law, we undertake no obligation to update any forward-looking statement, whether as a result of new information, future events or otherwise. Readers, however, should carefully review the factors set forth in this and other reports or documents that we file from time to time with the Securities and Exchange Commission (SEC).

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BUSINESS

Overview

As used in this Annual Report on Form 10-K, we, us and our refer to BSQUARE Corporation. We provide software and engineering service offerings to the smart device marketplace. A smart device is a dedicated purpose computing device that typically has the ability to display information, runs an operating system (e.g., Microsoft® Windows® CE 6.0) and may be connected to a network via a wired or wireless connection. Examples of smart devices that we target include set-top boxes, home gateways, point-of-sale terminals, kiosks, voting machines, gaming platforms, personal digital assistants (PDAs), personal media players and smartphones. We primarily focus on smart devices that utilize embedded versions of the Microsoft Windows family of operating systems, specifically Windows CE, Windows XP Embedded and Windows Mobile™.

We have been providing software and engineering services to the smart device marketplace since our inception. Our customers include world class original equipment manufacturers (OEMs), original design manufacturers (ODMs), silicon vendors, peripheral vendors, and enterprises that develop, market and distribute smart devices. The software and engineering services we provide our customers are utilized and deployed throughout various phases of our customers device life cycle, including design, development, customization, quality assurance and deployment.

Until mid-2004, we were also in the business of manufacturing and distributing our own proprietary hardware device, called the Power Handheld, which was sold to telecommunication carriers. During the second quarter of 2004, we decided to discontinue this hardware business and end the manufacturing of the device. The hardware business segment is reported as a discontinued operation in our financial results.

We were incorporated in the State of Washington in July 1994. Our principal office is located at 110 110th Avenue NE, Suite 200, Bellevue, Washington 98004, and our telephone number is (425) 519-5900.

Industry Background

The increasing need for connectivity among both business and consumer users is driving demand for easy-to-use, cost-effective and customizable methods of electronic communication. Although the personal computer (PC) has been the traditional means of electronically connecting suppliers, partners and customers, the benefits of smart devices have led to their rapid adoption as a new class of powerful technology.

Smart devices are particularly attractive to businesses and consumers because they are often less expensive than desktop and laptop computers; have adaptable configurations, including size, weight and shape; and are able to support a variety of customized applications and user interfaces that can be designed for specific tasks. These devices also are typically compatible with existing business information systems.

The smart device industry is characterized by a wide variety of hardware configurations and end-user applications, often designed to address a specific vertical market. To accommodate these diverse characteristics in a cost-effective manner, OEMs and ODMs require operating systems that can be integrated with a diverse set of smart devices and can support an expanding range of industry-specific functionality, content and applications. The Microsoft Windows family of embedded operating systems specifically Windows CE, Windows Mobile and Windows XP Embedded helps satisfy these requirements because it leverages the existing industry-wide base of Microsoft Windows developers and technology standards, can be customized to operate across a variety of smart devices and integrate with existing information systems, offers Internet connectivity, and reduces systems requirements compared to traditional PC operating systems.

The smart device marketplace is being influenced by the following factors:

- Growing demand by business professionals and high-end consumers for converged mobile devices that combine telephony, data (such as email and internet browsing), multimedia and location awareness is driving new sophisticated smart device designs by our OEM customers;

- The ubiquity of cellular and WLAN wireless networks is driving rapid adoption of smart devices that leverage broadband and high-speed wireless data networks, including Internet Protocol (IP) set-top boxes,

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- voice-over-IP (VoIP) phones, residential gateways, and home networking solutions linking smart devices with PCs;

- The baseline expectation for device functionality continues to grow. Users of smart devices expect to be able to access email and the Internet and synchronize their devices with corporate data sources. Microsoft operating systems are already well positioned to leverage this trend with built-in synchronization capabilities, access to Exchange email servers, and similar functionality;

- Security is becoming an increasingly important concern as devices are able to access networks and store sensitive information locally such as email, spreadsheets and other documents. Users are demanding that these types of information be protected in the same ways they are protected on the desktop; and

- Higher bandwidth networks coupled with the larger displays and increased processing power found on new devices means that more multi-media content will be available to devices increasing demand for digital rights management, content management and related technologies.

Software and Service Solutions for Smart Device Makers

Our customers include world class OEMs and ODMs, device component suppliers such as silicon vendors and peripheral vendors and enterprises with customized device needs such as retailers and field service organizations. Representative customer relationships in 2006 included:

- A large North American OEM continued to engage us to assist in the development and testing of mobile office phones;

- Palm, Inc. continued to engage us to provide engineering services for its series of Windows Mobile Smartphone devices;

- A silicon vendor engaged us to develop drivers for several of its silicon solutions and to include its components on our proprietary hardware reference designs;

- A silicon vendor engaged us to assist in the development of a series of board support packages (BSPs) in support of various processors;

- Several large Asian OEMs engaged us to assist in the development of new lines of Windows Mobile-based handheld devices;

- A large North American silicon vendor engaged us to assist in developing several Windows Mobile BSPs in support of its new line of processors focused on the handset market; and

- Over 75 OEMs and silicon vendors including Symbol Technologies, Hewlett-Packard Company (HP), ASUStek Computer, Hand Held Products and Lite-On Technology Corporation licensed our SDIO Now! technology in 2006 for integration into their smart devices.

We offer a range of software products to our customers for the development and deployment of smart devices, including both those of third parties and our own proprietary software products, along with our engineering service offerings. Our goal is to increase the breadth and depth of our software and engineering service offerings to smart device customers to enhance our position as an overall solutions provider.

Third-Party Software Products

We have multiple license and distribution agreements with third-party software vendors. Our ability to resell these third-party software products, whether stand-alone or in conjunction with our own proprietary software and engineering service offerings, provides our customers with a significant source for their smart device project needs. Our third-party software offerings include the following:

We are a Microsoft authorized Value-Added Provider (VAP) of Windows Embedded operating systems (OS) and toolkits for Windows CE, Windows XP/NT Embedded, Windows XP Professional with Embedded Restrictions, Windows Server with Embedded Restrictions, Windows XP Embedded for Point of Sale and Microsoft Classic operating systems with Embedded restrictions, including DOS and Windows 98/2000/

ME/NT. The majority of our software revenue in 2006 was earned through the resale of Microsoft Embedded operating systems; and

We sub-license and resell other third-party software such as the Esmertec Jeode Java Virtual Machine (JVM) under our JEM-CE™ brand name and Datalight Inc. s FlashFX and Reliance products.

Proprietary Software Products

Our proprietary software offerings include:

SDIO Hx   SDIO (Secure Digital Input Output) is an industry standard format that allows very small form-factor peripheral and memory cards to be used with smart devices. Our SDIO solutions have become the industry standard software development kit used by OEMs, ODMs and peripheral vendors who are creating SDIO solutions for smart devices running Microsoft Windows CE and Windows Mobile operating systems. There are currently over 100 licensees of our SDIO technology.

In response to customer demand and the changing technology landscape affecting secure digital (SD) technology, we released SDIO Now! 2.2 in the first quarter of 2006. Differentiated from other competitive offerings, this product included features requested by licensees such as support for larger SD memory cards, increased performance and a cost-effective solution for adding any combination of two MultiMediaCards (MMC), SD cards or SDIO cards to converged devices.

In the second quarter of 2006, we extended our SDIO product line with the introduction of our SDIO Hx architecture, which significantly increases the data throughput performance for handheld devices. OEMs can now economically add high performance Wi-Fi capabilities to smartphones and other embedded devices by using an internal SDIO Wi-Fi card while adding a second external expansion slot for high-density memory cards or other SDIO peripherals. The demand for this cost-effective high performance Wi-Fi/memory solution has made it a highly desirable feature on the next generation of handheld devices.

Microsoft has incorporated our SDIO Now! v2.0 technology into its CE 5.0 and Windows Mobile 5.0 operating systems. While the SDIO Hx versions of software have functionality and performance enhancements not found in the SDIO Now! v2.0, there can be no assurance that the inclusion of the SDIO Now! v2.0 software in the base Microsoft operating system will not have a detrimental effect on sales of the SDIO Hx software in the future.

Media+ Portable Media Player   Media+ is a digital media-management and player software solution based on Microsoft® Windows® CE 5.0 that enables OEMs to quickly enter the growing market for PMP players, a new product category that enables consumers to enjoy movies and video clips, view family photos, and listen to music on a single mobile device.

Our DevkitIDP line of Marvell XScale® Technology-based development platforms accelerate time to market for OEMs building Windows CE 5.0, Windows CE 6.0 and Windows Mobile 5.0 embedded devices. We currently ship DevkitIDP 255, acquired from Vibren Technologies, Inc. (Vibren) in August 2005. The DevkitIDP 255 is based on the Marvel PXA255 Embedded Processor. In 2006, we launched the DevkitIDP 270 based on a new generation Marvell PXA270 embedded processor, as well as DevKitIDP 320 based on the new Marvell 320 PROCESSORS.. We intend on introducing additional development platforms in the future which may be based on other silicon vendors processor families. Our DevkitIDP products uniquely offer a wide variety of peripheral chips and multiple expansion slots, which provides developers valuable flexibility in the early stages of development when device functionality is being validated. The DevkitIDP product layout is optimized so developers can quickly access hardware test points which shortens debug time.

Our SchemaBSP tool, acquired from Vibren, reduces customer development efforts. SchemaBSP offers a revolutionary three-step process that, when used in conjunction with Microsoft Platform Builder, reduces Windows CE board bring up time by up to 40%. Once an BSP is created with SchemaBSP, the architecture of the tool enables code reuse across multiple product lines, easy BSP updates when new hardware features are added to a design, and quick migration to new OS versions of Windows CE.

Universal serial bus (USB) interfaces.

Software revenue for the last three fiscal years was as follows (in thousands):

	Year Ended December 31,		
	2006	2005	2004
Software revenue:			
Third-party software	$ 30,317	$ 28,561	$ 25,663
BSQUARE proprietary software	2,617	2,649	2,701
Total software revenue	$ 32,934	$ 31,210	$ 28,364
Software revenue as a percentage of total revenue	66%	73%	73%
Third-party software revenue as a percentage of total software revenue	92%	92%	90%

The resale of Microsoft Embedded operating systems and related products accounts for substantially all of our third-party software revenue.

Engineering Service Offerings

We provide Windows Embedded and Windows Mobile smart device makers with consulting and professional engineering services including:

- Device solution strategy consulting;
- Software and hardware design and development services;
- Platform development systems integration;
- Application, middleware and multimedia software development;
- Quality assurance and testing services;
- Hardware design, prototype and product development services;
- Customer technical support; and
- Platform development and quality assurance training.

Customers utilize our engineering service offerings because our deep experience with Windows Embedded operating systems typically results in shorter development cycles and reduced time to market, lower overall costs to complete projects, and product robustness and features the customer may have been unable to achieve through other means.

Revenue from professional engineering services for the last three fiscal years was as follows (in thousands):

	Year Ended December 31,		
	2006	2005	2004
Total service revenue	$ 16,881	$ 11,713	$ 10,556
Service revenue as a percentage of total revenue	34%	27%	27%

Strategy

Our strategy is to continue to enhance our position as a leading provider of smart device software. To advance this strategy, we intend to focus on the following areas:

Enhance our proprietary software product portfolio to generate additional revenue, particularly higher margin revenue, through which will have the added benefit of increasing opportunities to sell additional engineering services and third-party software products to our customers. During 2006, we increased our level of research and development in conjunction with the SDIO Hx version releases mentioned previously as well as through the development of our DevKitIDP references designs. We are continuing to execute and

evolve our product strategy and expect to continue to invest in new product development initiatives during 2007;

Provide our North American customers of Windows Embedded operating systems with additional product offerings as they become available from Microsoft. For example, in 2006, Microsoft made available to its authorized distributors the Window Embedded Point CE 6.0 operating system, which is targeted at the general device market;

Expand our engineering service offerings by adding new packaged engineering services, engineering capabilities, training and custom consulting offerings; for example, we were funded by Microsoft to develop the Windows CE 6.0 training curriculum and plan to deliver the first training course to customers early in 2007;

Leverage the significant number of customers gained through our resale of Microsoft Embedded operating systems by selling these customers additional software and service offerings. In each quarter, we typically sell Microsoft Embedded operating systems to over 400 unique customers. Today, more of these customers purchase service or software offerings other than the core Microsoft Embedded operating systems than in the past; and

Increase the percentage of sales derived from our international customers, particularly by focusing on growing sales in the Asia-Pacific region.

A key element of our strategy is the expansion of our proprietary products that we license to our smart device customers. We believe that the continuing complexity and demands of device development will require our customers to seek out partners that are able to provide more complete device software solutions that can be quickly customized and brought to market.

Relationship with Microsoft and Impact on our Smart Device Solutions Business

We have a long-standing relationship with Microsoft and this relationship is critical to the continuing success of our business. Our credentials as a Microsoft partner include:

We are one of Microsoft s largest distributors of embedded operating systems worldwide;

We are a Windows Embedded Gold-level Systems Integrator;

We were the Microsoft Systems Integrator of the Year for 2006;

We are a developer and provider of Microsoft Official Curriculum Training for Windows CE and Windows XP Embedded;

We are a leading systems integrator for Microsoft s Windows Mobile for Smartphone and Pocket PC-based device development projects;

We are a Preferred Provider of Visual Tools to Microsoft;

We are a Gold-level member of Microsoft s Third-Party Tools Provider Program;

We are an authorized Microsoft Windows CE for Automotive Solutions Integrator; and

We have been engaged by Microsoft on various service engagements.

We work closely with Microsoft executives, developers, and product managers. We leverage these relationships in a variety of ways, including:

We gain early access to new Microsoft embedded software and other technologies;

We are able to leverage co-marketing resources from Microsoft, including market development funds, to support our own marketing and sales efforts;

We participate in Microsoft-sponsored trade shows, seminars, and other events;

We receive sales leads from Microsoft that enable us to sell our smart device software and service solutions;

We receive certain rebates based upon certain predefined objectives and our Microsoft Embedded operating systems sales volume; and

We participate in Windows Embedded and Windows Mobile design reviews, enabling early access to product roadmap information wherein we provide important technical and customer feedback.

See Item 1A, Risk Factors, for more information regarding our relationship with Microsoft.

Customers

Customers of our smart device software and engineering service offerings include leading OEMs, ODMs, enterprises, silicon vendors and peripheral vendors seeking to leverage the benefits of Windows Embedded operating systems to develop high-quality, full-featured smart devices that meet the requirements of numerous end-markets. Representative customers include Digipos Systems Inc., Electronics for Imaging, Inc., Lockheed Martin, Micros Systems, Inc., Microsoft Corporation, PalmOne, Inc. and Solectron.

Sales and Marketing

We market our smart device software and engineering services to OEMs, ODMs, enterprises, silicon vendors and peripheral vendors predominantly through our direct sales force located in the United States, Taipei, Taiwan and Tokyo, Japan. We do not make significant use of resellers, channel partners, representative agents or other indirect channels.

Key elements of our sales and marketing strategy include direct marketing, advertising, event marketing, public relations, customer and strategic alliance partner co-marketing programs and a comprehensive website. We rely significantly on lead referral and other marketing support programs from strategic partners, particularly Microsoft.

Research and Development

Our research and development organization is responsible for the design, development and release of our reference design and software products. Members of our research and development staff work closely with our sales and marketing departments, as well as with our customers and potential customers, to better understand market needs and requirements. We perform our research and development primarily utilizing our engineering staff located in Bellevue, Washington and Akron, Ohio.

Competition

The market for Windows-based embedded software and services is extremely competitive. We face competition from the following**:**

Our current and potential customers internal research and development departments, which may seek to develop their own proprietary products and solutions that compete with our proprietary software products and engineering services;

North American engineering service firms such as Intrinsyc, Vanteon and Teleca;

Off-shore development companies such as WiPro, particularly those focused on the North American marketplace

ODMs, particularly those in Taiwan who are adding software development capabilities to their offerings;

Contract manufacturers who are adding software development capabilities to their offerings; and

Microsoft Embedded operating system distributors such as Arrow and Avnet. Larger customers of Microsoft Embedded operating systems are typically knowledgeable of the competing distributors in the North American market and, consequently, will often put large orders out to bid amongst the distributors, which can create margin pressure and make it difficult to maintain long-term relationships with these customers. The gross profit

margin on sales of Microsoft Embedded Windows licenses is relatively low, historically about 14% on average. There can be no assurance that gross profit on future sales will not decline given these competitive pressures.

As we develop new products, particularly products focused on specific industries, we may begin competing with companies with which we have not previously competed. It is also possible that new competitors will enter the market or that our competitors will form alliances, including alliances with Microsoft, that may enable them to rapidly increase their market share. Microsoft has not agreed to any exclusive arrangement with us, nor has it agreed not to compete with us. Microsoft may decide to bring more of the core embedded development services and expertise that we provide in-house, possibly resulting in reduced product and service revenue opportunities for us. The barrier to entering the market as a provider of Windows-based smart device software and services is low. In addition, Microsoft has created marketing programs to encourage systems integrators to work on Windows Embedded operating system products and services. These systems integrators are given substantially the same access by Microsoft to the Windows technology as we are. New competitors may have lower overhead than we do and may be able to undercut our pricing. We expect that competition will increase as other established and emerging companies enter the Windows-based smart device market, and as new products and technologies are introduced.

International Operations

During 2006, our international operations consisted principally of subsidiaries and operations in Taipei, Taiwan and Vancouver, British Columbia, Canada. Because our OEM Distribution Agreement with Microsoft restricts our resale of Microsoft Embedded operating systems to North America, including Mexico, our foreign operations have traditionally focused on the sale of our own proprietary software products, particularly SDIO Now!, and engineering services. In the fourth quarter of 2005, we re-established a direct sales presence in Tokyo, Japan. We intend to continue to rebuild our ability to sell our products and services in Japan during 2007 and also plan on broadening our sales presence throughout the Asia-Pacific marketplace. We formalized and expanded our partnership with an engineering services firm in Hydrabad, India during 2006 although there are no commitments in terms of the utilization of those resources.

See Item 1A, Risk Factors, and Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations, for more information regarding our international operations.

Personnel

As of December 31, 2006, we had 170 employees, including 109 employees in professional engineering services, 12 employees in research and product development, and 49 employees in sales, marketing and administrative services. Of these employees, 138 are located in the United States, 11 are located in Canada and 21 are located in Taiwan. In addition, from time to time, we employ temporary employees, consultants and contractors. As of December 31, 2006, we employed 41 contractors compared to 31 at December 31, 2005.

The following highlights the number of employees by area:

	December 31,		
	2006	**2005**	**2004**
Professional Engineering Services	109	68	59
Research and Product Development	12	9	7
Sales, Marketing and Administrative	49	47	48

Total	170	124	114

As conditions necessitate, periodically professional engineering service employees will perform research and development engineering and visa versa.

Intellectual Property and Other Proprietary Rights

Our intellectual property is critical to our success. In general, we attempt to protect our intellectual property rights through patent, copyright, trademark and trade secret laws and contractual arrangements. There can, however, be no assurance that our efforts will be effective to prevent the misappropriation of our intellectual property, or to

prevent the development and design by others of products or technologies similar to, or competitive with those developed by us.

Additionally, because a significant portion of our revenue relates to the resale of third-party software products, we are also reliant on our partners, particularly Microsoft, to appropriately protect their own intellectual property.

We currently have a number of pending U.S. and international patent applications. We have 19 issued patents worldwide and a number of registered trademarks. We will continue to pursue appropriate protections for our intellectual property.

See Item 1A, Risk Factors, for more information regarding our intellectual property and other proprietary rights.

Available Information

We are a reporting company and file annual, quarterly and current reports and other information with the SEC. You may read and copy any materials we file with the SEC at the SEC s Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. You also may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains reports, proxy and information statements, and other information we file electronically with the SEC at http://www.sec.gov.

Our Internet website can be found at *www.bsquare.com.* We make available free of charge through our investor relations section, under SEC Filings, all our filings, including our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K and amendments to those reports filed pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as soon as reasonably practicable after such material is filed with, or furnished to, the SEC.

Directors and Executive Officers

The following table sets forth certain information with respect to our directors and executive officers as of January 31, 2007.

Name	Age	Positions
Donald B. Bibeault	65	Chairman of the Board
Brian T. Crowley	46	President and Chief Executive Officer, Director
Elwood D. Howse, Jr.	67	Director
Elliott H. Jurgensen, Jr.	62	Director
Scot E. Land	53	Director
William D. Savoy	42	Director
Kendra A. VanderMeulen	55	Director
Carey E. Butler	52	Vice President, Professional Engineering Services
Scott C. Mahan	42	Vice President, Finance; Chief Financial Officer; Secretary and Treasurer
Larry C. Stapleton	44	Vice President, North American Sales

Donald B. Bibeault has been our Chairman of the Board since July 2003. His term of office as a director expires at the 2008 Annual Meeting of Shareholders. Mr. Bibeault is currently President of Bibeault & Associates, Inc. a turnaround-consulting firm, a position he has held since 1975. During that period, Mr. Bibeault has served as

chairman, chief executive officer, or chief operating officer of numerous corporations, including Pacific States Steel, PLM International, Best Pipe and Steel, Inc., Ironstone Group, Inc., American National Petroleum, Inc., Tyler-Dawson Supply and Iron Oak Supply Corporation. He has also served as special turnaround advisor to the CEOs of Silicon Graphics Inc., Varity Corporation, Bank of America amongst others. In 2005, Dr. Bibeault was given the first ever Lifetime Achievement Award by the Association of Certified Turnaround Professionals (ACTP). He has been a member of the Board of Overseers of Columbia Business School, a trustee of Golden Gate University, a member of the University of Rhode Island Business Advisory Board, and the Board of Visitors of Golden Gate

University Law School. Mr. Bibeault received a B.S. in electrical engineering from the University of Rhode Island, a M.B.A. from Columbia University and a Ph.D from Golden Gate University. He is also a recipient of a Doctor of Laws degree (honoris causa) from Golden Gate University Law School.

Brian T. Crowley has been our President and Chief Executive Officer since July 2003. His term of office as a director expires at the 2008 Annual Meeting of Shareholders. From April 2002 to July 2003, Mr. Crowley served as our Vice President, Product Development. From December 1999 to November 2001, Mr. Crowley held various positions at DataChannel, a market leader in enterprise portals, including Vice President of Engineering and Vice President of Marketing. From April 1999 to December 1999, Mr. Crowley was Vice President, Operations of Consortio, a software company. From December 1997 to April 1999, Mr. Crowley was Director of Development at Sequel Technology, a network solutions provider. From 1986 to December 1997, Mr. Crowley held various positions at Applied Microsystems Corporation, including Vice President and General Manager of the Motorola products and quality assurance divisions. Mr. Crowley also serves as a director of the WSA (formerly Washington Software Association). Mr. Crowley holds a B.S. in Electrical Engineering from Arizona State University.

Elwood D. Howse, Jr. has been a director of BSQUARE since November 2002. His current term of office as a director expires at the 2009 Annual Meeting of Shareholders. Mr. Howse was formerly President of Cable & Howse Ventures, a Northwest venture capital management firm formed in 1977. Mr. Howse also participated in the founding of Cable, Howse and Ragen, investment banking and stock brokerage firm, today owned by Wells Fargo and known as Ragen MacKenzie. Mr. Howse has served as corporate director and advisor to various public, private and non-profit enterprises. He served on the board of the National Venture Capital Association and is past President of the Stanford Business School Alumni Association. He currently serves on the boards of directors of Formotus, Inc., OrthoLogic Corporation, Perlego Systems Inc., PowerTech Group, Inc. and not-for profits Junior Achievement Worldwide and Junior Achievement of Washington. He has served on a number of other corporate boards in the past. Mr. Howse received both a B.S. in engineering and a M.B.A. from Stanford University and served in the U.S. Navy submarine force.

Elliott H. Jurgensen, Jr. has been a director of BSQUARE since January 2003. His term of office as a director expires at this year s Annual Meeting of Shareholders. Mr. Jurgensen retired from KPMG LLP in 2003 after 32 years, including 23 years as an audit partner. During his career he held a number of leadership roles, including Managing Partner of the Bellevue, Washington office of KPMG from 1982 to 1991, and Managing Partner of the Seattle, Washington office of KPMG from 1993 to 2002. He is also a director of McCormick & Schmick s Seafood Restaurants, Inc., Isilon Systems, Inc. and ASC Management, Inc. Mr. Jurgensen has a B.S. in accounting from San Jose State University.

Scot E. Land has been a director of BSQUARE since February 1998. His term of office as a director expires at this year s Annual Meeting of Shareholders. Mr. Land is currently Executive Director, Program on Technology Commercialization, University of Washington. Prior to joining the faculty of the UW, Mr. Land was a managing director of Cascadia Capital LLC. Mr. Land was a founder and managing director of Encompass Ventures from September 1997 to July 2005, Mr. Land was a Senior Technology Analyst and Strategic Planning Consultant with Microsoft from June 1995 to September 1997, and a technology research analyst and investment banker for First Marathon Securities, a Canadian investment bank, from September 1993 to April 1995. From October 1988 to February 1993, Mr. Land was the President and Chief Executive Officer of InVision Technologies, (a wholly owned subsidiary of GE) founded by Mr. Land in October 1988, that designs and manufacturers high-speed computer-aided topography systems for automatic explosives detection for aviation security. Prior to founding InVision Technologies, Mr. Land served as a principal in the international consulting practice of Ernst & Young LLP, a public accounting firm, from April 1984 to October 1988. Mr. Land serves as a director of several privately held companies.

William D. Savoy has been a director of BSQUARE since May 2004. His current term of office as a director expires at the 2009 Annual Meeting of Shareholders. Mr. Savoy currently consults with The Muckleshoot Indian Tribe on investment-related matters, strategic planning and economic development. Mr. Savoy served as a consultant for Vulcan Inc., an investment entity that manages the personal financial activities of Paul Allen, from September 2003 to December 2005. Vulcan Inc. resulted from the consolidation in 2000 of Vulcan Ventures Inc., a venture capital fund, and Vulcan Northwest. Mr. Savoy served in various capacities at Vulcan Inc. and its

predecessors from 1988 to September 2003, most recently as the president of the portfolio and asset management division, managing Vulcan s commercial real estate, hedge fund, treasury and other financial activities, and as the president of both Vulcan Northwest and Vulcan Ventures. Mr. Savoy served as the president and chief executive officer of Layered, Inc., a software company, from June 1989 until its sale in June 1990 and as its chief financial officer from August 1988 to June 1989. He is also a director of Drugstore.com, where he is a member of the audit committee and chairman of the compensation committee. Mr. Savoy received a B.S. in computer science, accounting and finance from Atlantic Union College.

Kendra VanderMeulen has been a director at BSQUARE since March 2005. Her term of office as a director expires at this year s Annual Meeting of Shareholders. Ms. VanderMeulen recently served as executive vice president, Mobile at InfoSpace, and is an active board member or advisor to a variety of companies in the wireless Internet arena, including Perlego Systems, Inc., and Inrix, Inc. Ms. VanderMeulen joined AT&T Wireless (formerly McCaw Cellular Communications, now Cingular) in 1994 to lead the formation of the wireless data division. Prior to McCaw, Ms. VanderMeulen served as COO and president of the Communications Systems Group of Cincinnati Bell Information Systems (now Convergys). She also held a variety of business and technical management positions at AT&T in the fields of software development, voice processing, and signaling systems. Ms. VanderMeulen received a BS degree in mathematics from Marietta College and a MS degree in computer science from Ohio State University. She is the recipient of the 1999 Catherine B. Cleary award as the outstanding woman leader of AT&T.

Carey E. Butler has been our Vice President, Professional Engineering Services since November 2003 and directs development teams located in Washington State and Taiwan. From 2002 to 2003, Ms. Butler served as Western Region Area Manager at Information Builders, a business intelligence software and services company. From 2000 to 2001, Ms. Butler was Vice President at Aris Corporation, a professional services company, and from 1996 to 2000 was Partner at BDO Seidman, LLP, a public accounting and management consulting firm. From 1990 to 1996, Ms. Butler was Principal of Performance Computing, Inc., a technology consulting company, subsequently sold to BDO Seidman. From 1982 to 1990, Ms. Butler was Vice President of Operations, Sales and Marketing of Mytec, Inc., a value-added reseller of turnkey financial systems. Ms. Butler holds a B.A. in Business, Quantitative Methods (Computer Science) from University of Washington.

Scott C. Mahan has been our Vice President, Finance, Chief Financial Officer, Secretary and Treasurer since January 2004. From October 2003 to December 2003, Mr. Mahan served as a consultant to BSQUARE. From February 2003 to July 2003, Mr. Mahan served as the Interim CFO and Head of Business & Corporate Development at Cranium, Inc., a games manufacturer. From March 2002 to November 2002, Mr. Mahan served as Chief Operating Officer at Xylo, Inc., a company that provides human resource technology and services to Fortune 1000 companies, and from June 1998 to December 2001 as CFO and Vice President, Administration at Qpass, Inc, a provider of billing serves to wireless carriers. From September 1996 to May 1998, Mr. Mahan served as Director of Finance at Sequel Technology Corporation, a company that delivered licensed software for the network traffic monitoring market. From August 1994 to August 1996, Mr. Mahan was Controller of Spry, Inc., an Internet software company and Internet service provider. Prior to that, Mr. Mahan was the Assistant Corporate Controller at Paccar Inc. from August 1993 to July 1994 and was an Audit Manager at Ernst & Young LLP in Seattle where he was employed from July 1987 to August 1993. Mr. Mahan holds a B.S. in Management from Tulane University.

Larry C. Stapleton has been our Vice President of North America Sales since March 2005. Mr. Stapleton is responsible for sales of professional engineering services, products and distribution. Prior to joining BSQUARE, Mr. Stapleton served as Vice President of Global Business Development at Terabeam from November 1999 to April 2004, where he was responsible for developing telecom carrier business for broadband wireless access equipment in Asia and managing employees and VAR partnerships in Singapore, Malaysia, Japan, China, Philippines, and South Korea. Prior to that, Mr. Stapleton served as Terabeam s Vice President, Product Development, responsible for developing all of Terabeam s optical telecommunications equipment. From November 1997 to November 1999,

Mr. Stapleton was Vice President of Sales and Marketing for SelfCHARGE, a contract product design and manufacturing (ODM) startup developing products for the medical, consumer and industrial markets. Before that he was Senior Director of Client Services at Teague from April 1992 to November 1997, generating designs for AT&T, Microsoft, John Deere, and many other Fortune 500 companies. He also has held a variety of product development, marketing, and engineering positions with several Fortune 100 companies. His degrees include an M.B.A. from University of Washington and a B.S., Mechanical Engineering, from San Jose State University.

Item 1A. *Risk Factors.*

The following risk factors and other information included in this Annual Report on Form 10-K should be carefully considered. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us, or that we currently deem immaterial, may also impair our business operations. If any of the following risks occur, our business, financial condition, operating results and cash flows could be materially adversely affected.

Microsoft-Related Risk Factors

Due to the market that we serve and, in particular, our focus on devices utilizing Microsoft s Embedded operating systems as well as the fact that a significant portion of our revenue is derived from the resale of Microsoft Embedded operating systems, Microsoft has a significant direct and indirect influence on our business. The following represent several Microsoft-related risk factors which may negatively impact our business and operating results.

If we do not maintain our OEM Distribution Agreement with Microsoft, our revenue would decrease and our business would be adversely affected.

We have an OEM Distribution Agreement (ODA) with Microsoft, which enables us to resell Microsoft Windows Embedded operating systems to our customers in the United States, Canada, the Caribbean (excluding Cuba) and Mexico. Software sales under this agreement constitute a significant portion of our revenue. If the ODA was terminated, our software revenue and resulting gross profit would decrease significantly and our operating results would be negative impacted. Moreover, if the ODA with Microsoft is renewed on less favorable terms, our revenue could decrease, our gross profit from these transactions, which is low relative to our gross profit from sales of our proprietary software products, could further decline and/or our operating expenses could increase. Microsoft offers us, and our competitors, largely volume-based rebates under the ODA and its related programs which have the effect of increasing our software gross profit. If Microsoft were to reduce, or eliminate, these rebate programs, which can contribute 2-3% of our total gross profit percentage from sales of Microsoft Embedded operating systems on a quarterly basis, our gross profit and operating results would be negatively impacted. Microsoft informed us in the fourth quarter of 2006 that they are restructuring the rebate program beginning in the first quarter of 2007. We expect this restructuring to have a negative impact on our gross profit but are not yet able to quantify the impact. The ODA is renewable annually, and there is no automatic renewal provision in the agreement. The ODA was last renewed in October 2006 and will expire on June 30, 2007, unless terminated earlier under the provisions of the ODA.

Microsoft has audited our records under our OEM Distribution Agreement in the past and will do so again in the future, and any negative audit results could result in additional charges and/or the termination of the ODA.

There are provisions in the ODA that require us to maintain certain internal records and processes for royalty auditing and other reasons. Non-compliance with these and other requirements could result in the termination of the ODA. We underwent an audit under the ODA with Microsoft covering a period of five years which concluded in the second quarter of 2004. Microsoft determined that we had correctly reported royalties during the audit period but that we could not account for all license inventory that we had received from Microsoft s authorized replicators. While we disagreed with many of the audit findings, we ultimately chose to settle the dispute. Total settlement costs of $310,000 were recognized in the second quarter of 2004, which included audit costs of $140,000. In addition, we were notified during the fourth quarter of 2006 that Microsoft will be conducting another audit, which is currently scheduled to begin in March 2007. It is possible that future audits could result in additional charges.

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If we do not maintain our favorable relationship with Microsoft, we will have difficulty marketing and selling our software and services and may not receive developer releases of Windows Embedded operating systems and Windows Mobile targeted platforms. As a result, our revenue and operating results could suffer.

We maintain a strategic marketing relationship with Microsoft. In the event that our relationship with Microsoft were to deteriorate, our efforts to market and sell our software and services to OEMs and others could be adversely affected and our business could be harmed. Microsoft has significant influence over the development plans and buying decisions of OEMs and others utilizing Windows Embedded operating systems and Windows Mobile targeted platforms for smart devices and these targeted platforms are a significant focus for us. Microsoft provides customers referrals to us. Moreover, Microsoft controls the marketing campaigns related to its operating systems. Microsoft s marketing activities, including trade shows, direct mail campaigns and print advertising, are important to the continued promotion and market acceptance of Windows Embedded operating systems and Windows Mobile targeted platforms and, consequently, to our sale of Windows-based embedded software and services. We must maintain a favorable relationship with Microsoft to continue to participate in joint marketing activities with them, which includes participating in partner pavilions at trade shows, listing our services on Microsoft s website, and receiving customer referrals. In the event that we are unable to continue our joint marketing efforts with Microsoft, or fail to receive referrals from them, we would be required to devote significant additional resources and incur additional expenses to market software products and services directly to potential customers. In addition, we depend on Microsoft for developer releases of new versions of, and upgrades to, Windows Embedded and Windows Mobile software in order to facilitate timely development and delivery of our own software and services. If we are unable to maintain our favorable relationship with Microsoft, our revenue could decline and/or our costs could increase thereby negatively impacting our operating results.

Unexpected delays or announcement of delays by Microsoft of Windows Embedded operating systems and Windows Mobile targeted platforms product releases could adversely affect our revenue and operating results.

Unexpected delays or announcement of delays in Microsoft s delivery schedule for new versions of its Windows Embedded operating systems and Windows Mobile targeted platforms could cause us to delay our product introductions or impede our ability to sell our products and services and/or to complete customer projects on a timely basis. These delays, or announcements of delays by Microsoft, could also cause our customers to delay or cancel their project development activities or product introductions, which could have a negative impact on our revenue and operating results.

If Microsoft adds features to its Windows operating system or develops products that directly compete with products and services we provide, our revenue and operating results could be negatively impacted.

As the developer of Windows, Windows XP Embedded, Windows CE and Windows Mobile, Microsoft could add features to its operating systems or could develop products that directly compete with the products and services we provide to our customers. The ability of our customers, or potential customers, to obtain products and services directly from Microsoft that compete with our products and services could negatively affect our revenue and operating results. Even if the standard features of future Microsoft operating system software were more limited than our offerings, a significant number of our customers, and potential customers, might elect to accept more limited functionality in lieu of purchasing additional software from us or delay the purchase of our products and services while they perform a comparison of Microsoft s competing offerings. Moreover, the resulting competitive pressures could lead to price reductions for our products and reduce our revenue and gross profit margin accordingly and our operating results could be adversely impacted.

Microsoft has released Windows CE version 6.0 and version 5.0 of its Windows Mobile Smartphone and PocketPC operating systems which contain basic SDIO functionality and is therefore competitive with our SDIO Hx Now! and SDIO Hx product offerings. An agreement with Microsoft required us to deliver to Microsoft our SDIO Now! v.1.0 source code for inclusion into Windows CE 5.0 and Windows Mobile 5.0. Since that source code was delivered to Microsoft, we have continued to develop our SDIO Now! product line, introducing SDIO Now! v.2.0, v.2.2 and most recently SDIO Now! Hx, with new features and performance improvements that we believe are

important to customers. Additionally, we plan further enhancements to our SDIO Now! software product in 2007 and beyond. However, there can be no assurance that our next-generation SDIO Now! product offerings will continue to be competitive in the marketplace or that customers will not decide to use the basic functionality they receive from Microsoft as part of the operating system. Sales of SDIO Now! have traditionally represented the majority of our high-margin proprietary software revenue.

If the market for Windows Embedded operating systems and Windows Mobile targeted platforms fails to develop further, develops more slowly than expected, or declines, our business and operating results may be materially harmed.

Because a significant portion of our revenue to date has been generated by software products and engineering services targeted at the Windows Embedded operating systems and Windows Mobile platforms, if the market for these systems or platforms fails to develop further or develops more slowly than expected, or declines, our business and operating results could be negatively impacted. Market acceptance of Windows Embedded and Windows Mobile will depend on many factors, including:

Microsoft s development and support of the Windows Embedded and Windows Mobile markets. As the developer and primary promoter of Windows CE, Windows XP Embedded and Windows Mobile, if Microsoft were to decide to discontinue or lessen its support of these operating systems and platforms, potential customers could select competing operating systems, which could reduce the demand for our Windows Embedded and Windows Mobile software products and engineering services which is our primary focus today;

The ability of the Microsoft Windows Embedded operating systems and Windows Mobile software to compete against existing and emerging operating systems for the smart device market, including: VxWorks and pSOS from WindRiver Systems Inc.; Symbian and Palm OS from PalmSource, Inc.; JavaOS from Sun Microsystems, Inc.; and other proprietary operating systems. In particular, in the market for handheld devices, Windows Mobile faces intense competition from the Linux operating system. In the market for converged devices, Windows Mobile faces intense competition from the Symbian operating system. Windows Embedded operating systems and the Windows Mobile for Smartphone may be unsuccessful in capturing a significant share of these two segments of the smart device market, or in maintaining its market share therein;

The acceptance by OEMs and consumers of the mix of features and functions offered by Windows Embedded operating systems and Windows Mobile targeted platforms; and

The willingness of software developers to continue to develop and expand the applications that run on Windows Embedded operating systems and Windows Mobile targeted platforms. To the extent that software developers write applications for competing operating systems that are more attractive to smart device users than those available on Windows Embedded operating systems and Windows Mobile targeted platforms, potential purchasers could select competing operating systems over Windows Embedded operating systems and Windows Mobile targeted platforms.

General Business-Related Risk Factors

Our marketplace is extremely competitive, which may result in price reductions, lower gross profit margins and loss of market share.

The market for Windows-based embedded software and services is extremely competitive. Increased competition may result in price reductions, lower gross profit margin and loss of customers and market share, which would harm our business. We face competition from:

Our current and potential customers internal research and development departments, which may seek to develop their own proprietary products and solutions that compete with our proprietary software products and engineering services;

North American engineering service firms such as Intrinsyc, Vanteon and Teleca;

Off-shore development companies such as WiPro, particularly those focused on the North American marketplace;

ODMs, particularly those in Taiwan who are adding software development capabilities to their offerings;

Contract manufacturers who are adding software development capabilities to their offerings; and

Microsoft Embedded operating system distributors such as Arrow and Avnet. Larger customers of Microsoft Embedded operating systems are typically knowledgeable of the competing distributors in the North American market and, consequently, will often put large orders out to bid amongst the distributors, which can create margin pressure and make it difficult to maintain long-term relationships with these customers. The gross profit margin on sales of Microsoft Embedded Windows licenses is relatively low, historically about 14% on average. There can be no assurance that gross profit on future sales will not decline given these competitive pressures.

As we develop new products, particularly products focused on specific industries, we may begin competing with companies with which we have not previously competed. It is also possible that new competitors will enter the market or that our competitors will form alliances, including alliances with Microsoft, that may enable them to rapidly increase their market share. Microsoft has not agreed to any exclusive arrangement with us, nor has it agreed not to compete with us. Microsoft may decide to bring more of the core embedded development services and expertise that we provide in-house, possibly resulting in reduced product and service revenue opportunities for us. The barrier to entering the market as a provider of Windows-based smart device software and services is low. In addition, Microsoft has created marketing programs to encourage systems integrators to work on Windows Embedded operating system products and services. These systems integrators are given substantially the same access by Microsoft to the Windows technology as we are. New competitors may have lower overhead than we do and may be able to undercut our pricing. We expect that competition will increase as other established and emerging companies enter the Windows-based smart device market, and as new products and technologies are introduced.

Our ability to maintain or grow the portion of our software revenue attributable to our own proprietary software products is contingent on our ability to bring to market competitive, unique offerings that keep pace with technological changes and needs. If we are not successful in doing so, our business would be harmed.

Proprietary software product sales provide us with much higher gross profit margins than we typically receive from third-party software products and our engineering service offerings as well as other advantages. Increasing the number and amount of proprietary products we sell is an important part of our growth strategy. Our ability to maintain and increase the revenue contribution from proprietary software products is contingent on our ability to enhance the features and functionality of our current proprietary products as well as to devise, develop and introduce new products. There can be no assurance that we will be able to maintain and expand the number of proprietary products that we sell, and our failure to do so could negatively impact revenue and our operating results.

We may experience delays in our efforts to develop new products and services, and these delays could cause us to miss market opportunities which could negatively impact our revenue and operating results.

The market for Windows-based embedded software and services is very competitive. As a result, the life cycles of our products and services are difficult to estimate. To be successful, we believe we must continue to enhance our current offerings and provide new software product and service offerings with attractive features, prices and terms that appeal to our customers. We have experienced delays in enhancements and new product release dates in the past and may be unable to introduce enhancements or new products successfully or in a timely manner in the future. Our revenue and operating results may be negatively impacted if we delay releases of our products and product enhancements, or if we

fail to accurately anticipate our customers needs or technical trends and are unable to introduce new products and service offerings into the market successfully. In addition, our customers may defer or forego purchases of our products if we, Microsoft, our competitors or major hardware, systems or software vendors introduce or announce new products.

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If the market for smart devices develops more slowly than we expect, or declines, our revenue may not develop as anticipated, if at all, and our business would be harmed.

The market for smart devices is still emerging and the potential size of this market and the timing of its development are not known. As a result, our profit potential is uncertain and our revenue may not develop as anticipated, if at all. We are dependent upon the broad acceptance by businesses and consumers of a wide variety of smart devices, which will depend on many factors, including:

- The development of content and applications for smart devices;
- The willingness of large numbers of businesses and consumers to use devices such as smartphones, PDAs and handheld industrial data collectors to perform functions historically carried out manually, or by traditional PCs, including inputting and sharing data, communicating among users and connecting to the Internet; and
- The evolution of industry standards or the necessary infrastructure that facilitate the distribution of content over the Internet to these devices via wired and wireless telecommunications systems, satellite or cable.

The success and profitability of our engineering service offerings are contingent on our ability to differentiate our offerings adequately in the marketplace, which is, in turn, contingent on our ability to retain our engineering personnel and defend our billing rate structure against those of our competitors, including those using lower-cost offshore resources. If we are unable to do so successfully, our business could be harmed.

We are a leader in providing engineering services to smart device customers. Our market differentiation is created through several factors, including our experience with a variety of smart device platforms and applications. Our differentiation is contingent, in part, on our ability to attract and retain employees with this expertise, significantly all of whom are currently based in the United States. To the extent we are unable to retain critical engineering services talent and/or our competition is able to deliver the same services by using lower-cost offshore resources, our service revenue and operating results could be negatively impacted.

The success and profitability of our service engagements are contingent upon our ability to scope and bid engagements and deliver our services profitably. If we are unable to do so, our service revenue service gross profit margin and operating results could be negatively impacted.

Various factors may cause the total cost of service projects to exceed the original estimate provided to the customer or the contractual maximum in the case of fixed price contracts, including specification changes, customer deliverable delays, inadequate scoping and inefficient service delivery. If we are unable to adequately scope, bid and deliver on service engagements successfully, our service revenue, service gross profit and operating results could be negatively impacted. In addition, depending on the cause of an overrun for a given customer, we may also decide to provide pricing concessions to that customer which could negatively impact our service revenue, service gross profit and operating results.

We have entered into engineering service agreements in which we have agreed to perform our engineering service work at relatively low rates per hour in exchange for royalties, sometimes guaranteed, in the future. There is no guarantee that these arrangements will culminate as anticipated.

We have entered into service contracts that involve reducing up-front engineering service fees in return for a per-device royalty as our customers ship their devices, and we may enter into more such agreements in the future. Many of these contracts call for guaranteed royalty payments by our customers. Because we are delaying revenue past

the point where our services are performed, there is a risk that our customers may cancel their device projects or that their devices may not be successful in the market. In addition, these customers may not pay us all royalties owed, which could negatively impact our revenue and operating results.

Cooperation and support from silicon vendors is critical for the success of our hardware reference designs. Such cooperation cannot be assured.

We have been developing hardware reference designs based on the Marvell PXA Xscale architecture and plan to develop reference designs based on other silicon architectures. It is important that the silicon on which we base our reference designs receive continued support in the marketplace by the silicon vendors. For example, during the development of our designs, Intel made a strategic decision to sell its PXA Xscale division to Marvell which negatively impacted the sale of our Xscale-based reference designs. There can be no assurance that Marvell will continue to pursue and support the markets that we have been targeting with our reference designs. Cooperation and support from silicon vendors is critical to the success of our reference designs, and should silicon vendors not support our efforts, our revenue and operating results could be negatively impacted.

The long sales cycle of our products and services makes our revenue susceptible to fluctuations.

Our sales cycle is typically three to nine months because the expense and complexity of the software and engineering service offerings we sell generally require a lengthy customer approval process and may be subject to a number of significant risks over which we have little or no control, including:

- Customers budgetary constraints and internal acceptance review procedures;
- The timing of budget cycles; and
- The timing of customers competitive evaluation processes.

In addition, to successfully sell software and engineering service offerings, we must frequently educate our potential customers about the full benefits of these software and services, which can require significant time. If our sales cycle further lengthens unexpectedly, it could adversely affect the timing of our revenue which could cause our quarterly results to fluctuate.

Erosion of the financial condition of our customers could adversely affect our business.

Our business could be adversely affected should the financial condition of our customers erode, given that such erosion could reduce demand from those customers for our software and engineering services, could cause them to terminate their relationships with us, and/or could increase the credit risk of those customers. If the global information technology market weakens, the likelihood of the erosion of the financial condition of our customers increases, which could adversely affect the demand for our software and services. Additionally, while we believe that our allowance for doubtful accounts is adequate, those allowances may not cover actual losses, which could adversely affect our business and operating results.

We may be subject to product liability claims that could result in significant costs.

Our license, warranty and service agreements with our customers typically contain provisions designed to limit our exposure to potential product liability claims. It is possible, however, that these provisions may be ineffective under the laws of certain jurisdictions. Although we have not experienced any product liability claims to date, the sale and support of our products and services may be subject to such claims in the future. In addition, to the extent we develop and sell increasingly comprehensive, customized turnkey solutions for our customers, we may be increasingly subject to risks of product liability claims. There is a risk that any such claims or liabilities may exceed, or fall outside, the scope of our insurance coverage, and we may be unable to retain adequate liability insurance in the future. A product

liability claim brought against us, whether successful or not, could harm our business and operating results.

Past acquisitions have proven difficult to integrate, and future acquisitions, if any, could disrupt our business, dilute shareholder value and adversely affect our operating results.

We have acquired the technologies, assets and/or operations of other companies in the past and may acquire or make investments in companies, products, services and technologies in the future as part of our growth strategy. As an example, on June 30, 2005, we acquired certain assets of Vibren Technologies, Inc. for $500,000 in cash and the

assumption of certain liabilities and obligations. If we fail to properly evaluate, integrate and execute on our acquisitions and investments, our business and prospects may be seriously harmed. In some cases, we have implemented reductions in workforce and office closures in connection with an acquisition, which has resulted in significant costs to us. To successfully complete an acquisition, we must properly evaluate the technology, accurately forecast the financial impact of the transaction, including accounting charges and transaction expenses, integrate and retain personnel, combine potentially different corporate cultures and effectively integrate products and research and development, sales, marketing and support operations. If we fail to do any of these, we may suffer losses and impair relationships with our employees, customers and strategic partners. Additionally, management may be distracted from day-to-day operations. We also may be unable to maintain uniform standards, controls, procedures and policies, which are especially critical in light of the Sarbanes-Oxley and other corporate governance requirements, and significant demands may be placed on our management and our operations, information services and financial, legal and marketing resources. Finally, acquired businesses sometimes result in unexpected liabilities and contingencies, which could be significant.

Intellectual Property-Related Risk Factors

Our software and service offerings could infringe the intellectual property rights of third parties, which could expose us to additional costs and litigation and could adversely affect our ability to sell our products and services or cause shipment delays or stoppages.

It is difficult to determine whether our products and engineering services infringe third-party intellectual property rights, particularly in a rapidly evolving technological environment in which technologies often overlap and where there may be numerous patent applications pending, many of which are confidential when filed. If we were to discover that one of our products or service offerings, or a product based on one of our reference designs, violated a third-party s proprietary rights, we may not be able to obtain a license on commercially reasonable terms, or at all, to continue offering that product or service. Similarly, third parties may claim that our current or future products and services infringe their proprietary rights, regardless of whether such claims have merit. Any such claims could increase our costs and negatively impact our business and operating results. In certain cases, we have been unable to obtain indemnification against claims that third-party technology incorporated into our products and services infringe the proprietary rights of others. However, any indemnification we do obtain may be limited in scope or amount. Even if we receive broad third-party indemnification, these entities may not have the financial capability to indemnify us in the event of infringement. In addition, in some circumstances we are required to indemnify our customers for claims made against them that are based on our products or services. There can be no assurance that infringement or invalidity claims related to the products and services we provide, or arising from the incorporation by us of third-party technology, and claims for indemnification from our customers resulting from such claims, will not be asserted or prosecuted against us. Some of our competitors have, or are affiliated, with companies with substantially greater resources than we have, and these competitors may be able to sustain the costs of complex intellectual property litigation to a greater degree and for longer periods of time than we could. In addition, we expect that software developers will be increasingly subject to infringement claims as the number of products and competitors in the software industry grows, and as the functionality of products in different industry segments increasingly overlap. Such claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources in addition to potential product redevelopment costs and delays. Furthermore, if we were unsuccessful in resolving a patent or other intellectual property infringement action claim against us, we may be prohibited from developing or commercializing certain of our technologies and products, or delivering services based on the infringing technology, unless we obtain a license from the holder of the patent or other intellectual property rights. There can be no assurance that we would be able to obtain any such license on commercially favorable terms, or at all. If such license is not obtained, we would be required to cease these related business operations, which could have a material adverse effect on our business, revenue and operating results.

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If we fail to adequately protect our intellectual property rights, competitors may be able to use our technology or trademarks, which could weaken our competitive position, reduce our revenue and increase our costs.

If we fail to adequately protect our intellectual property, our competitive position could be weakened and our revenue adversely affected. We rely primarily on a combination of patent, copyright, trade secret and trademark laws, as well as confidentiality procedures and contractual provisions, to protect our intellectual property. These laws and procedures provide only limited protection. We have applied for a number of patents relating to our engineering work although we do not rely on patents as our primary defensive measure in protecting our intellectual property. These patents, both issued and pending, may not provide sufficiently broad protection, or they may not prove to be enforceable, against alleged infringers. There can be no assurance that any of our pending patents will be granted. Even if granted, these patents may be circumvented or challenged and, if challenged, may be invalidated. Any patents obtained may provide limited or no competitive advantage to us. It is also possible that another party could obtain patents that block our use of some, or all, of our products and services. If that occurred, we would need to obtain a license from the patent holder or design around those patents. The patent holder may or may not choose to make a license available to us at all or on acceptable terms. Similarly, it may not be possible to design around a blocking patent. In general, there can be no assurance that our efforts to protect our intellectual property rights through patent, copyright, trade secret and trademark laws will be effective to prevent misappropriation of our technology, or to prevent the development and design by others of products or technologies similar to or competitive with those developed by us.

We frequently license the source code of our products and the source code results of our services to customers. There can be no assurance that customers with access to our source code will comply with the license terms or that we will discover any violations of the license terms or, in the event of discovery of violations, that we will be able to successfully enforce the license terms and/or recover the economic value lost from such violations. To license some of our software products, we rely in part on shrinkwrap and clickwrap licenses that are not signed by the end user and, therefore, may be unenforceable under the laws of certain jurisdictions. As with other software, our products are susceptible to unauthorized copying and uses that may go undetected, and policing such unauthorized use is difficult. A significant portion of our marks include the word BSQUARE or the preface b. Other companies use forms of BSQUARE or the preface b in their marks alone, or in combination with other words, and we cannot prevent all such third-party uses. We license certain trademark rights to third parties. Such licensees may not abide by our compliance and quality control guidelines with respect to such trademark rights and may take actions that would harm our business.

The computer software market is characterized by frequent and substantial intellectual property litigation, which is often complex and expensive, and involves a significant diversion of resources and uncertainty of outcome. Litigation may be necessary in the future to enforce our intellectual property or to defend against a claim of infringement or invalidity. Litigation could result in substantial costs and the diversion of resources and could negatively impact our business and operating results.

Our software or hardware products or the third-party hardware or software integrated with our products may suffer from defects or errors that could impair our ability to sell our products and services.

Software and hardware components as complex as those needed for smart devices frequently contain errors or defects, especially when first introduced or when new versions are released. We have had to delay commercial release of certain versions of our products until problems were corrected and, in some cases, have provided product enhancements to correct errors in released products. Some of our contracts require us to repair or replace products that fail to work. To the extent that we repair or replace products our expenses may increase. In addition, it is possible that by the time defects are fixed, the market opportunity may decline which may result in lost revenue. Moreover, to the

extent that we provide increasingly comprehensive products and services, particularly those focused on hardware, and rely on third-party manufacturers and suppliers to manufacture these products, we will be dependent on the ability of third-party manufacturers to correct, identify and prevent manufacturing errors. Errors that are discovered after commercial release could result in loss of revenue or delay in market acceptance, diversion of development resources, damage to our reputation and increased service and warranty costs, all of which could negatively affect our business and operating results.

If we are unable to license key software from third parties, our business could be harmed.

We sometimes integrate third-party software with our proprietary software and engineering service offerings or sell such third-party software offerings on a standalone basis (e.g. embedded operating systems under our ODA with Microsoft). If our relationships with these third-party software vendors were to deteriorate, or be eliminated in their entirety, we might be unable to obtain licenses on commercially reasonable terms, if at all. In the event that we are unable to obtain these third-party software offerings, we would be required to develop this technology internally, assuming it was economically or technically feasible, or seek similar software offerings from other third parties assuming there were competing offerings in the marketplace, which could delay or limit our ability to introduce enhancements or new products, or to continue to sell existing products and engineering services, thereby negatively impacting our revenue and operating results.

Governace and Contract-Related Risk Factors

It might be difficult for a third-party to acquire us even if doing so would be beneficial to our shareholders.

Certain provisions of our articles of incorporation, bylaws and Washington law may discourage, delay or prevent a change in the control of us or a change in our management, even if doing so would be beneficial to our shareholders. Our Board of Directors has the authority under our amended and restated articles of incorporation to issue preferred stock with rights superior to the rights of the holders of common stock. As a result, preferred stock could be issued quickly and easily with terms calculated to delay or prevent a change in control of our company or make removal of our management more difficult. In addition, our Board of Directors is divided into three classes. The directors in each class serve for three-year terms, one class being elected each year by our shareholders. This system of electing and removing directors may discourage a third-party from making a tender offer or otherwise attempting to obtain control of our company because it generally makes it more difficult for shareholders to replace a majority of our directors. In addition, Chapter 19 of the Washington Business Corporation Act generally prohibits a target corporation from engaging in certain significant business transactions with a defined acquiring person for a period of five years after the acquisition, unless the transaction or acquisition of shares is approved by a majority of the members of the target corporation s Board of Directors prior to the time of acquisition. This provision may have the effect of delaying, deterring or preventing a change in control of our company. The existence of these anti-takeover provisions could limit the price that investors might be willing to pay in the future for shares of our common stock.

We will incur substantial costs to comply with the requirements of the Sarbanes-Oxley Act of 2002.

The Sarbanes-Oxley Act of 2002 (the Act) introduced new requirements regarding corporate governance and financial reporting. Among the many requirements is the requirement under Section 404 of the Act for management to annually assess and report on the effectiveness of our internal control over financial reporting and for our registered public accountant to attest to this report. The SEC has modified the effective date and adoption requirements of Section 404 implementation for non-accelerated filers, such as us, such that we are first required to issue our management report on internal control over financial reporting in our annual report on Form 10-K for the fiscal year ending December 31, 2007. We will be required to dedicate significant time and resources during fiscal 2007 to ensure compliance. The costs to comply with these requirements will likely be significant and adversely affect our operating results. In addition, there can be no assurance that we will be successful in our efforts to comply with Section 404. Failure to do so could result in penalties and additional expenditures to meet the requirements, which could affect the ability of our auditors to issue an unqualified report (currently required by December 31, 2008) which, in turn, may further adversely affect our business and operating results.

Non-compliance with our lease agreement could have a material adverse impact on our financial position.

If we default under our corporate headquarters lease, the landlord has the ability to demand cash payments forgiven in 2004 under the former headquarters lease. The amount of the forgiven payments for which the landlord has the ability to demand repayment, in the event of default, decreases on a straight-line basis over the length of our

ten-year headquarters lease. The total amount of cash payments forgiven for which the landlord has the ability to demand repayment was $1.8 million at December 31, 2006. Any breach of or non-compliance with these lease agreements could have a material adverse impact on our business.

Decreased effectiveness of equity compensation could adversely affect our ability to attract and retain employees, and required changes in accounting for equity compensation could adversely affect earnings.

We have historically used stock options and other forms of equity-related compensation as key components of our overall employee compensation program in order to align employees interests with the interests of our shareholders, encourage employee retention, and provide competitive compensation packages. Applicable stock exchange listing standards relating to obtaining shareholder approval of equity compensation plans could make it more difficult or expensive for us to grant options or new forms of equity instruments to employees in the future. As a result, we may incur increased compensation costs, change our equity compensation strategy or find it difficult to attract, retain and motivate employees, any of which could materially adversely affect our business.

International Operations-Related Risk Factors

Our international operations expose us to greater intellectual property, management, collections, regulatory and other risks.

Customers outside of North America generated approximately 5% of our total revenue for the year ended December 31, 2006. We currently have international operations in Taipei, Taiwan; Vancouver, British Columbia, Canada; and Tokyo, Japan. Our international activities and operations expose us to a number of risks, including the following:

- Greater difficulty in protecting intellectual property due to less stringent foreign intellectual property laws and enforcement policies;

- Longer collection cycles than we typically experience in the North America;

- Unfavorable changes in regulatory practices and tariffs;

- Complex and/or adverse tax laws and/or changes thereto. Additionally, we may be subject to income, withholding and other taxes for which we may realize no current benefit despite the existence of significant net operating losses and tax credits in the U.S.;

- Loss or reduction of withholding tax exemptions;

- The impact of fluctuating exchange rates between the U.S. dollar and foreign currencies; and

- General economic and political conditions in international markets which may differ from those in the U.S.

These risks could have a material adverse effect on the financial and managerial resources required to operate our foreign offices, as well as on our future international revenue, which could harm our business and operating results.

As we increase the amount of software development conducted in non-U.S. locations, potential delays and quality issues may impact our ability to timely deliver our software and services, potentially impacting our revenue and profitability.

We conduct development activities in non-U.S. locations, primarily India, through a partnership with a local company, and Taiwan, to take advantage of the high-quality, low-cost software development resources found in these countries. Additionally, we have plans to increase development activity in both our Taiwan operation and other non-U.S. locations as engineering demands necessitate the hiring of additional engineering personnel. To date, we have limited experience in managing large scale software development done in non-U.S. locations. Moving portions of our software development to these locations inherently increases the complexity of managing these programs and may result in delays in introducing new products to market, or delays in completing service projects for our customers, which in turn may adversely impact the revenue we recognize from related products and services and could also adversely impact the profitability of service engagements employing offshore resources.

As our customers seek more cost-effective locations to develop and manufacture their smart devices, particularly overseas locations, our ability to continue to sell these customers our products and services could be limited, which could negatively impact our revenue and operating results.

Due to competitive and other pressures, some of our customers have and others may seek to move the development and manufacturing of their smart devices to overseas locations which may limit our ability to sell these customers our products and services. As an example, under our OEM Distribution Agreement with Microsoft, we are only able to resell Microsoft Embedded operating systems largely in North America. If our customers, or potential customers, move their manufacturing overseas we may be restricted from reselling these customers Microsoft Embedded operating systems, or our other products and services, which could negatively impact our revenue and operating results.

Item 2. *Properties.*

Our corporate headquarters are located in 43,400 square feet of leased space in a single location in Bellevue, Washington. The underlying lease expires in 2014.

In North America, we also lease office space in San Diego, California; Longmont, Colorado; Akron, Ohio; and Vancouver, British Columbia, Canada. We also lease office space internationally in Taipei, Taiwan. Our facilities have sufficient capacity to support our current operational needs as well as short-term growth plans.

Item 3. *Legal Proceedings.*

IPO Litigation

In Summer and early Fall 2001, four purported shareholder class action lawsuits were filed in the United States District Court for the Southern District of New York against us, certain of our current and former officers and directors (the Individual Defendants), and the underwriters of our initial public offering (the Underwriter Defendants). The suits purport to be class actions filed on behalf of purchasers of our common stock during the period from October 19, 1999 to December 6, 2000. The complaints against us have been consolidated into a single action and a Consolidated Amended Complaint, which was filed on April 19, 2002 and is now the operative complaint.

The plaintiffs allege that the Underwriter Defendants agreed to allocate stock in our initial public offering to certain investors in exchange for excessive and undisclosed commissions and agreements by those investors to make additional purchases of stock in the aftermarket at pre-determined prices. The plaintiffs allege that the prospectus for our initial public offering was false and misleading in violation of the securities laws because it did not disclose these arrangements. The action seeks damages in an unspecified amount.

The action is being coordinated with approximately 300 other nearly identical actions filed against other companies. On July 15, 2002, we moved to dismiss all claims against us and the Individual Defendants. On October 9, 2002, the district court dismissed the Individual Defendants from the case without prejudice based upon stipulations of dismissal filed by the plaintiffs and the Individual Defendants. On February 19, 2003, the district court denied the motion to dismiss the complaint against us. On October 13, 2004, the district court certified a class in six of the approximately 300 other nearly identical actions (the focus cases) and noted that the decision is intended to provide strong guidance to all parties regarding class certification in the remaining cases. The Underwriter Defendants appealed this decision and the Second Circuit vacated the district court s decision granting class certification in the six focus cases on December 5, 2006. The plaintiffs have not yet moved to certify a class in our case.

We have approved a settlement agreement and related agreements which set forth the terms of a settlement between us, the Individual Defendants, the plaintiff class and the vast majority of the other approximately 300 issuer defendants. It is unclear what impact the Second Circuit s decision vacating class certification in the focus cases will have on the settlement, which has not yet been finally approved by the district court. On December 14, 2006, Judge Scheindlin held a hearing. The plaintiffs informed the district court that they planned to file a petition for rehearing and rehearing *en banc.* The district court stayed all proceedings, including a decision on final approval of the

settlement and any amendments of the complaints, pending the Second Circuit s decision on the plaintiffs petition for rehearing. The plaintiffs filed the petition for rehearing and rehearing *en banc* on January 5, 2007.

Pursuant to the settlement and related agreements, if the settlement receives final approval by the district court, the settlement provides for a release of us and the Individual Defendants for the conduct alleged in the action to be wrongful. We would agree to undertake certain responsibilities, including agreeing to assign away, not assert, or release certain potential claims we may have against the Underwriter Defendants. The settlement agreement also provides a guaranteed recovery of $1 billion to plaintiffs for the cases relating to all of the approximately 300 issuers. To the extent that the Underwriter Defendants settle all of the cases for at least $1 billion, no payment will be required under the issuers settlement agreement. To the extent that the Underwriter Defendants settle for less than $1 billion, the issuers are required to make up the difference. On April 20, 2006, JPMorgan Chase and the plaintiffs reached a preliminary agreement to settle for $425 million. The JPMorgan Chase preliminary agreement has not yet been approved by the district court. In an amendment to the issuers settlement agreement, the issuers insurers agreed that the JPMorgan Chase preliminary agreement, if approved, will only offset the insurers obligation to cover the remainder of the plaintiffs guaranteed $1 billion recovery by 50% of the value of the JPMorgan Chase settlement, or $212.5 million. Therefore, if the JPMorgan Chase preliminary agreement to settle is finalized and then approved by the district court, then the maximum amount that the issuers insurers will be potentially liable for is $787.5 million. It is unclear what impact the Second Circuit s decision vacating class certification in the focus cases will have on the JPMorgan Chase preliminary agreement.

We anticipate that any potential financial obligation of us to plaintiffs pursuant to the terms of the issuers settlement agreement and related agreements will be covered by existing insurance. We currently are not aware of any material limitations on the expected recovery of any potential financial obligation to plaintiffs from our insurance carriers. Our carriers are solvent, and we are not aware of any uncertainties as to the legal sufficiency of an insurance claim with respect to any recovery by plaintiffs. Therefore, we do not expect that the settlement will involve any payment by us. If material limitations on the expected recovery of any potential financial obligation to the plaintiffs from our insurance carriers should arise, our maximum financial obligation to plaintiffs pursuant to the settlement agreement would be less than $3.4 million. However, if the JPMorgan Chase preliminary agreement is preliminarily and then finally approved, our maximum financial obligation to the plaintiffs pursuant to the settlement agreement would be approximately $2.7 million.

There is no assurance that the district court will grant final approval to the issuers settlement. If the settlement agreement is not approved and we are found liable, we are unable to estimate or predict the potential damages that might be awarded, whether such damages would be greater than our insurance coverage, and whether such damages would have a material impact on our results of operations or financial condition in any future period.

Customer Litigation

As previously reported, we had been in dispute with a former customer (Former Customer) regarding payment of amounts due for a contract under which we provided professional engineering services. We had an account receivable outstanding with the Former Customer of $475,000 as of September 30, 2006 and increased the allowance for doubtful accounts by $475,000 in the fourth quarter of 2005 related to this account receivable. As a result of the dispute, we filed a Complaint for breach of contract and misappropriation of intellectual property against the Former Customer on December 22, 2005 in federal district court in the state of Delaware. On January 27, 2006, the Former Customer filed an Answer and Counterclaim against us, and we filed our Reply to the Former Customer s Answer and Counterclaim on February 16, 2006, denying all counterclaims against us.

On October 31, 2006, we and the Former Customer settled this dispute by entering into a settlement agreement (the Settlement Agreement). Under the Settlement Agreement, the Former Customer has agreed to pay a Settlement

Amount of $200,000 to us on or before December 31, 2009 and also provide certain intellectual property to us, under a license agreement. The Former Customer made an initial payment of $10,000 upon execution of the Settlement Agreement. The remaining amount owed to us under the Settlement Agreement will be satisfied through the purchase of Microsoft embedded operating systems from us or through commissions and royalties earned by us related to the sale of the Former Customer s intellectual property. The Former Customer s parent company has placed its common stock in escrow to guarantee performance under the Settlement Agreement, including an

agreement that the Settlement Amount is satisfied by December 31, 2009. Additionally, the Settlement Agreement provides that all claims between the parties are terminated. The settlement structure provides for the possibility of ongoing commission and royalty revenue to us after the satisfaction of the $200,000 settlement amount such that the total recovery may be greater than $200,000.

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

No matters were submitted to a vote of shareholders during the fourth quarter ended December 31, 2006.

PART II

Item 5. ***Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.***

Market Information

Our common stock is traded on the NASDAQ Global Market (formerly known as the NASDAQ National Market) under the symbol BSQR. The following table sets forth the high and low sale prices for our common stock for the periods indicated, as reported by the NASDAQ Global Market. These prices reflect the 1-for-4 reverse stock split that occurred effective October 7, 2005. For 20 trading days subsequent to and including the effective date of the reverse split, our common stock traded under the symbol BSQRD.

	High	Low
Year Ended December 31, 2006:		
First Quarter	$ 3.99	$ 2.77
Second Quarter	$ 3.04	$ 1.87
Third Quarter	$ 2.50	$ 1.93
Fourth Quarter	$ 3.00	$ 1.93
Year Ended December 31, 2005:		
First Quarter	$ 6.00	$ 1.84
Second Quarter	$ 2.32	$ 1.52
Third Quarter	$ 3.04	$ 1.84
Fourth Quarter	$ 4.06	$ 1.90

Holders

As of January 31, 2007 there were approximately 206 holders of record of our common stock. Because many shares of our common stock are held by brokers and other institutions on behalf of shareholders, we are unable to determine the total number of shareholders represented by these holders of record.

Dividends

We have never paid cash dividends on our common stock. We currently intend to retain any future earnings to fund future development and growth and, therefore, do not anticipate paying any cash dividends in the foreseeable future.

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Item 6. ***Selected Financial Data.***

The following selected consolidated financial data should be read in conjunction with the consolidated financial statements and the notes thereto in Item 8 of Part II, Financial Statements and Supplementary Data, and the information contained in Item 7 of Part II, Management s Discussion and Analysis of Financial Condition and Results of Operations. Historical results are not necessarily indicative of future results.

	Year Ended December 31,				
	2006	2005	2004	2003	2002
	(In thousands, except per share data)				
Consolidated Statements of Operations Data:					
Revenue	$ 49,815	$ 42,923	$ 38,920	$ 37,542	$ 37,506
Cost of revenue(1)	37,828	33,039	29,870	31,141	30,795
Gross profit	11,987	9,884	9,050	6,401	6,711
Operating expenses:					
Selling, general and administrative(1)	10,046	9,504	9,176	12,609	19,230
Research and development(1)	2,820	1,950	855	1,768	10,747
Acquired in-process research and development					1,698
Amortization of intangible assets				50	847
Impairment of goodwill and other intangible assets				453	6,472
Restructuring and other related charges (credits)			40	(2,960)	16,249
Total operating expenses	12,866	11,454	10,071	11,920	55,243
Loss from operations	(879)	(1,570)	(1,021)	(5,519)	(48,532)
Interest and other income (expense)	442	287	237	1,059	(1,900)
Loss from continuing operations before income taxes	(437)	(1,283)	(784)	(4,460)	(50,432)
Income tax provision	(29)	(14)	(11)	(75)	(1,696)
Loss from continuing operations	(466)	(1,297)	(795)	(4,535)	(52,128)
Loss from discontinued operations			(6,256)	(9,449)	(6,478)
Loss before cumulative effect of change in accounting principle	(466)	(1,297)	(7,051)	(13,984)	(58,606)
Cumulative effect of change in accounting principle					(14,932)
Net loss	$ (466)	$ (1,297)	$ (7,051)	$ (13,984)	$ (73,538)

Basic and diluted net loss per share:										
Loss from continuing operations	$	(0.05)	$	(0.14)	$	(0.08)	$	(0.49)	$	(5.73)
Loss from discontinued operations						(0.66)		(1.01)		(0.71)
Cumulative effect of change in accounting principle										(1.64)
Basic and diluted net loss per share	$	(0.05)	$	(0.14)	$	(0.74)	$	(1.50)	$	(8.08)

(1) Stock-based compensation expense:

Cost of revenue service	$	190	$		$		$		$	
Selling, general and administrative		445		17						
Research and development		80								
Total stock-based compensation expense	$	715	$	17	$		$		$	

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	2006	2005	December 31, 2004 (In thousands)	2003	2002
Consolidated Balance Sheet Data:					
Cash, cash equivalents, short-term investments and restricted cash	$ 11,109	$ 10,694	$ 12,943	$ 17,745	$ 35,425
Working capital	$ 10,252	$ 9,502	$ 11,125	$ 16,490	$ 27,957
Total assets	$ 19,676	$ 19,570	$ 18,944	$ 30,113	$ 53,569
Long-term obligations, net of current portion	$ 355	$ 379	$ 375	$	$ 5,431
Shareholders equity	$ 12,076	$ 11,463	$ 12,734	$ 19,338	$ 32,634

Item 7. ***Management s Discussion and Analysis of Financial Condition and Results of Operations.***

The following Management s Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with our consolidated financial statements and related notes. Some statements and information contained in this Management s Discussion and Analysis of Financial Condition and Results of Operations are not historical facts but are forward-looking statements. For a discussion of these forward-looking statements, and of important factors that could cause results to differ materially from the forward-looking statements contained in this report, see Item 1 of Part I, Business Forward-Looking Statements and Item 1A of Part I, Risk Factors.

Overview

We provide software and engineering services to the smart device marketplace. A smart device is a dedicated purpose computing device that typically has the ability to display information, runs an operating system (e.g., Microsoft® Windows® CE 6.0) and may be connected to a network via a wired or wireless connection. Examples of smart devices that we target include set-top boxes, home gateways, point-of-sale terminals, kiosks, voting machines, gaming platforms, PDAs, personal media players and smartphones. We primarily focus on smart devices that utilize embedded versions of the Microsoft Windows family of operating systems, specifically Windows CE, Windows XP Embedded and Windows Mobile™.

We have been providing software and engineering services to the smart device marketplace since our inception. Our customers include world class OEMs, ODMs, silicon vendors, peripheral vendors, and enterprises with customized device needs such as retailers and wireless operators that market and distribute connected smart devices. The software and engineering services we provide our customers are utilized and deployed throughout various phases of our customers device life cycle, including design, development, customization, quality assurance and deployment.

Until 2004, we were also in the business of manufacturing and distributing our own proprietary hardware device, called the Power Handheld, which was sold to telecommunication carriers. During the second quarter of 2004, we decided to discontinue this hardware business and end the manufacturing of the device. The hardware business segment is reported as a discontinued operation in our financial results.

Critical Accounting Judgments

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires estimates and assumptions that affect the reported amounts of assets and liabilities, revenue and expenses and related disclosures of contingent assets and liabilities in the consolidated financial statements and accompanying notes. The SEC has defined a company s critical accounting policies as those that are most important to

the portrayal of our financial condition and results of operations, and those that require us to make our most difficult and subjective judgments, often as a result of the need to make estimates related to matters that are inherently uncertain. Based on this definition, we have identified the critical accounting policies and judgments addressed below. We also have other key accounting policies, which involve the use of estimates, judgments and assumptions that are relevant to understanding our results. For additional information see Item 8 of Part II, Financial Statements and Supplementary Data Note 1 Description of Business and Accounting Policies.

Although we believe that our estimates, assumptions and judgments are reasonable, they are necessarily based upon presently available information. Actual results may differ significantly from these estimates under different assumptions, judgments or conditions.

Revenue Recognition

We recognize revenue from software and engineering service sales when the following four revenue recognition criteria are met: persuasive evidence of an arrangement exists; delivery has occurred or services have been rendered; the selling price is fixed or determinable; and collectibility is reasonably assured. Contracts and customer purchase orders are generally used to determine the existence of an arrangement. Shipping documents and customer acceptance, when applicable, are used to verify delivery. We assess whether the selling price is fixed or determinable based on the contract and payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. We assess collectibility based primarily on the creditworthiness of the customer as determined by credit checks and analysis, as well as the customer s payment history.

We recognize revenue upon shipment provided that no significant obligations remain on our part and substantive acceptance conditions, if any, have been met. We also enter into arrangements in which a customer purchases a combination of software licenses, engineering services and post-contract customer support or maintenance (PCS). As a result, significant contract interpretation is sometimes required to determine the appropriate accounting, including how the price should be allocated among the deliverable elements if there are multiple elements, whether undelivered elements are essential to the functionality of delivered elements, and when to recognize revenue. PCS includes rights to upgrades, when and if available, telephone support, updates, and enhancements. When vendor specific objective evidence (VSOE) of fair value exists for all elements in a multiple element arrangement, revenue is allocated to each element based on the relative fair value of each of the elements. VSOE of fair value is established by the price charged when the same element is sold separately. Accordingly, the judgments involved in assessing VSOE have an impact on the recognition of revenue in each period. Changes in the allocation of the sales price between deliverables might impact the timing of revenue recognition but would not change the total revenue recognized on the contract.

When elements such as software and engineering services are contained in a single arrangement, or in related arrangements with the same customer, we allocate revenue to each element based on its relative fair value, provided that such element meets the criteria for treatment as a separate unit of accounting. In the absence of fair value for a delivered element, we allocate revenue first to the fair value of the undelivered elements and allocate the residual revenue to the delivered elements. In the absence of fair value for an undelivered element, the arrangement is accounted for as a single unit of accounting, resulting in a delay of revenue recognition for the delivered elements until the undelivered elements are fulfilled. As a result, contract interpretations and assessments of fair value are sometimes required to determine the appropriate accounting.

Service revenue from fixed-priced contracts is recognized using the percentage of completion method. Percentage of completion is measured based primarily on input measures such as hours incurred to date compared to total estimated hours to complete, with consideration given to output measures, such as contract milestones, when applicable. We rely on estimates of total expected hours as a measure of performance and cost in order to determine the amount of revenue to be recognized. Revisions to hour and cost estimates are recorded in the period the facts that give rise to the revision become known. Service revenue from time and materials contracts and training services is recognized as services are performed.

When elements such as engineering services and royalties are contained in a single arrangement, we recognize revenue from engineering services as earned in accordance with the four revenue recognition criteria stated above. We recognize royalty revenue when we receive the royalty report from the customer, which is usually thirty to forty-five days after month end.

Deferred revenue includes deposits received from customers for service contracts and unamortized service contract revenue, customer advances under OEM licensing agreements and maintenance revenue. In instances where final acceptance of the software or services is specified by the customer, revenue is deferred until all acceptance criteria have been met.

Allowance for Doubtful Accounts

Our accounts receivable balances are net of an estimated allowance for doubtful accounts. We perform ongoing credit evaluations of our customers financial condition and generally do not require collateral. We estimate the collectability of our accounts receivable and record an allowance for doubtful accounts. We consider many factors when making this estimate, including analyzing accounts receivable and historical bad debts, customer concentrations, customer creditworthiness, current economic trends and changes in customer payment history, when evaluating the adequacy of the allowance for doubtful accounts. Because the allowance for doubtful accounts is an estimate, it may be necessary to adjust it if actual bad debt expense exceeds the estimated reserve.

Stock-Based Compensation

Effective January 1, 2006, we began recording compensation expense associated with stock options and other forms of equity compensation in accordance with Statement of Financial Accounting Standards No. 123R, *Share-Based Payment* (SFAS 123R), as interpreted by SEC Staff Accounting Bulletin No. 107. Prior to December 31, 2005, we accounted for stock options according to the provisions of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees,* and related interpretations, as permitted by SFAS 123, *Accounting for Stock-Based Compensation*, and, therefore, no related compensation expense was recorded for awards granted with no intrinsic value. We adopted the modified prospective transition method provided for under SFAS 123R and consequently have not retroactively adjusted results for prior periods. Under this transition method, compensation cost associated with stock options includes: 1) compensation cost related to the remaining unvested portion of all stock option awards granted prior to December 31, 2005, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123; and 2) compensation cost related to all stock option awards granted subsequent to December 31, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. We record expense over the vesting period using the straight-line method. Compensation expense for awards under SFAS 123R includes an estimate for forfeitures.

At December 31, 2006, total compensation cost related to stock options granted to employees under the Company s stock option plans but not yet recognized was $470,000, net of estimated forfeitures. This cost will be amortized on the straight-line method over a weighted-average period of approximately 1.4 years and will be adjusted for subsequent changes in estimated forfeitures.

Taxes

As part of the process of preparing our consolidated financial statements, we are required to estimate income taxes in each of the countries in which we operate. This process involves estimating our current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income, and, to the extent we believe that recovery is not likely, we must establish a valuation allowance. To the extent we establish a valuation allowance, or increase this allowance in a period, it may result in an expense within the tax provision in the statements of operations. Significant management judgment is required in determining our provision for income taxes, deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets. We have provided a full valuation allowance on deferred tax assets because of our uncertainty regarding their realizability based on our valuation estimates. If we determine that it is more likely than not that the deferred tax assets would be realized, the valuation allowance would be reversed. In order to realize our deferred tax assets, we must be able to generate sufficient taxable income. Additionally, because we do business in foreign tax jurisdictions, our sales may be subject to other taxes, particularly withholding taxes. The tax regulations governing withholding taxes are complex, causing us to have to make

assumptions about the appropriate tax treatment and estimates of resulting withholding taxes.

In the second quarter of 2005, we became aware that certain amounts remitted, or that were planned to be remitted, from our Taiwan subsidiary or Taiwanese customers might be subject to withholding tax at 20% of the amount remitted. In the fourth quarter of 2005, we began applying for withholding tax exemptions from the Taiwan government on all significant contracts on which withholding tax might be owed. When granted, these exemptions

eliminate any withholding tax and Taiwan-based income tax, as applicable, for the contract to which the exemption relates. To date, we have received approval for all withholding exemption applications that we have filed for which significant withholding tax might be owed. However, there is no assurance that future exemptions will be granted, and if we do not receive all, or some, of the exemptions for which we apply, we could be obligated to pay withholding tax in the future. We are continuing to evaluate alternative business and tax planning strategies to minimize corporate income and withholding tax obligations in connection with our Taiwan subsidiary.

Results of Operations

The following table presents certain financial data as a percentage of total revenue for the periods indicated. Our historical operating results are not necessarily indicative of the results for any future period.

	As a Percentage of Total Revenue Year Ended December 31,		
	2006	**2005**	**2004**
Consolidated Statements of Operations Data:			
Revenue:			
Software	66%	73%	73%
Service	34	27	27
Total revenue	100	100	100
Cost of revenue:			
Software	52	58	56
Service	24	19	21
Total cost of revenue	76	77	77
Gross profit	24	23	23
Operating expenses:			
Selling, general and administrative	20	22	24
Research and development	6	5	2
Total operating expenses	26	27	26
Loss from operations	(2)%	(4)%	(3)%

Comparison of the Years Ended December 31, 2006, 2005 and 2004

Revenue

Total revenue consists of sales of software and engineering services to smart device makers. Software revenue consists of sales of third-party software and sales of our own proprietary software products which include royalties from our software products, software development kits and smart device reference designs as well as royalties from our software products. Engineering service revenue is derived from hardware and software development, maintenance

and support contracts, fees for customer training, and rebillable expenses.

Total revenue was $49.8 million in 2006 and $42.9 million in 2005, representing an increase of $6.9 million or 16%. This increase was due to higher sales of software and engineering services discussed further below.

Total revenue was $42.9 million in 2005 and $38.9 million in 2004, representing an increase of $4 million or 10%. This increase was due to higher sales of software and professional engineering services discussed further below. A significant portion of our total revenue in 2004 was attributable to Cardinal Healthcare Systems (Cardinal), which accounted for 19% of our total revenue. In 2005, Cardinal represented $831,000, or 2%, of total revenue. In the second quarter of 2005, Cardinal began purchasing from a competitor and discontinued purchasing from us.

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Revenue from customers located outside of North America includes revenue attributable to our foreign operations, as well as software and services delivered to foreign customers from our operations located in North America. We currently have international operations in Taipei, Taiwan; Vancouver, British Columbia, Canada; and Tokyo, Japan. In the fourth quarter of 2003, we closed our Japan operations, but re-established a direct sales presence in Tokyo, Japan, in the fourth quarter of 2005. Revenue from customers located outside of North America was $2.7 million in 2006 and $2.3 million in 2005, representing an increase of $.4 million or 17%. This increase was primarily due to increased service revenue at our Taiwan subsidiary. Billable hours in Taiwan for 2006 increased 144% from 2005 offset by a 56% decline in our realized rate per hour in Taiwan attributable to some service contracts on which we have agreed to perform services at relatively low rates in exchange for per device royalties, some of which are guaranteed. Revenue from customers located outside of the United States was $3.8 million in 2005 and $4.8 million in 2004, representing a decrease of $1.0 million or 20%. This decrease was primarily due to a continued decrease in engineering projects in Asia.

Software revenue

Software revenue for 2006, 2005 and 2004 is presented below (dollars in thousands):

	Year Ended December 31,		
	2006	2005	2004
Software revenue:			
Third-party software	$ 30,317	$ 28,561	$ 25,663
BSQUARE proprietary software	2,617	2,649	2,701
Total software revenue	$ 32,934	$ 31,210	$ 28,364
Software revenue as a percentage of total revenue	66%	73%	73%
Third-party software revenue as a percentage of total software revenue	92%	92%	90%

The vast majority of our third-party software revenue is comprised of the resale of Microsoft Embedded operating systems. The majority of our proprietary software revenue is attributable to sales of our SDIO Now! software product.

Software revenue was $32.9 million in 2006 and $31.2 million in 2005, representing an increase of $1.7 million or 6%. This increase was primarily due to higher third-party software revenue of $1.8 million, partially offset by a decrease of $32,000 in proprietary software revenue. The increase in third-party software sales was primarily attributable to an increase in sales to new accounts obtained through a customer referral arrangement entered into in the fourth quarter of 2005. We expect third-party software sales in 2007 to increase approximately 5-10% from 2006 based on current industry projections, a new customer referral arrangement entered into in the fourth quarter of 2006 and growth in the market for Microsoft embedded server products which we resell.

Software revenue was $31.2 million in 2005 and $28.4 million in 2004, representing an increase of $2.8 million or 10%. Excluding sales to Cardinal of $831,000 in 2005 and $7.4 million in 2004, software sales to customers other than Cardinal increased $9.4 million or 45% from 2004. This increase was due to third-party software sales growth within our top-10 accounts, increases in new account revenue, higher per account revenue for non-top-10 accounts and an increase in customer referral revenue beginning in the fourth quarter of 2005. Effective October 1, 2005, we

entered into a relationship with a third party and obtained its customer list. Under this relationship, we paid a referral fee on the gross margin generated from these customers through September 30, 2006.

Proprietary software revenue was $2.6 million in 2006 and 2005 and $2.7 million in 2004. Revenue was flat due to decreased sales of our SDIO Now! product, offset by higher sales of our reference design products including Schema BSP and our IDP Development kits. Sales of our SDIO Now! software product fell primarily due to competing technology being introduced from Microsoft. Sales of our reference design products increased due to the acquisition of certain of these products from Vibren Technologies, Inc. in June 2005 coupled with the launch of our IDP 270 development platform. Proprietary software revenue in 2006 included $169,000 of royalty revenue from several Asia Pacific service contracts, which contain minimum guaranteed royalties. We expect proprietary

software revenue to increase approximately 50-85% in 2007 as compared to 2006 based on renewed strength of SDIO Now! product sales, increased reference design and related product sales due primarily to the introduction of our new IDP 320 development platform and royalty revenue stemming from the Asia Pacific contracts referenced previously assuming these customers fulfill their contractual obligations.

Service revenue

Service revenue for 2006, 2005 and 2004 is presented below (dollars in thousands):

	Year Ended December 31,		
	2006	**2005**	**2004**
Total service revenue	$ 16,881	$ 11,713	$ 10,556
Service revenue as a percentage of total revenue	34%	27%	27%

Service revenue was $16.9 million in 2006 and $11.7 million in 2005, representing an increase of $5.2 million or 44%. This increase was due to higher activity levels driven by overall market strength, sales improvements and improved personnel utilization. Billable hours increased 58%, while the realized rate per hour decreased 11%. Billable hour growth occurred both in North America and our Taiwan subsidiary. The decrease in our realized rate per hour was driven by our Taiwan subsidiary, where we are engaged in several contracts pursuant to which we have provided or are providing services at relatively low rates in exchange for royalty payments in the future, some of which are guaranteed. Royalties on such contracts are not recognized until reported by the customer.

Service revenue was $11.7 million in 2005 and $10.6 million in 2004, representing an increase of $1.1 million or 11%. This increase was due to higher activity levels driven by overall market strength, sales improvements and improved personnel utilization. The realized rate per hour in 2005 was up 14% from 2004, while billable hours remained relatively flat.

Gross profit

Cost of revenue related to software revenue consists primarily of license fees and royalties for third-party software and the costs of product media, product duplication and manuals. Amortization of intangible assets, acquired from Vibren in June 2005, is included in cost of software revenue and was $190,000 in 2006, $95,000 in 2005 and zero in 2004. Cost of revenue related to service revenue consists primarily of salaries and benefits for our engineers, contractor costs, plus related facilities and depreciation costs. Gross profit on the sales of third-party software products were also positively affected by rebates we received from Microsoft which we earn through the achievement of previously defined objectives. Rebates comprised $599,000 of our gross profit in 2006, $632,000 in 2005 and $360,000 in 2004.

The following table outlines software, services and total gross profit (dollars in thousands):

	Year Ended December 31,		
	2006	**2005**	**2004**
Software gross profit	$ 6,817	$ 6,531	$ 6,471
As a percentage of software revenue	21%	21%	23%

Service gross profit	$ 5,170	$ 3,353	$ 2,579
As a percentage of service revenue	31%	29%	24%
Total gross profit	$ 11,987	$ 9,884	$ 9,050
As a percentage of total revenue	24%	23%	23%

Software gross profit

Software gross profit as a percentage of software revenue was 21% in 2006 and 21% in 2005. Higher margins on third-party software sales were offset by lower margins on proprietary product sales primarily due to intangible asset amortization affecting proprietary software cost-of-sales for a full year in 2006 compared to half a year in 2005. Third-party software revenue typically generates a much lower profit margin than our proprietary software;

our proprietary software revenue has typically generated 90% and greater gross margins. The third-party software gross profit percentage was 14.9% in 2006, 14.0% in 2005 and 14.7% in 2004.

Software gross profit as a percentage of software revenue was 21% in 2005 and 23% in 2004. The decrease in software gross profit percentage was primarily due to the increase in lower margin third-party software revenue as a percentage of total software revenue.

We expect third-party software sales to continue to be a significant percentage of our software revenue, and, therefore, our software gross margin is likely to remain relatively low in the foreseeable future. We expect our third-party software gross profit margin to decline to approximately 13% in 2007, based on increased competitive pressures and lower projected rebates. We expect our proprietary software gross margin, historically very high, to improve in 2007 based on higher revenue levels and the discontinuance in the third quarter of 2007 of the Vibren intangible asset amortization discussed previously.

Service gross profit

Service gross profit was 31% in 2006, 29% in 2005 and 24% in 2004. The overall improvements in gross profit were attributable to increased service revenue, improved resource utilization, improved pricing and contract management, partially offset by a decrease in realized rate per hour for reasons discussed previously. Until the end of the second quarter of 2005, we generally employed more service engineering personnel than near-term service engineering demands dictated such that as revenue levels increased in 2004 and the first half of 2005, the service gross profit margin increased accordingly. In addition, our facilities and depreciation costs, a portion of which is included in service cost of revenue, are relatively fixed such that as service revenue levels increased in 2005 and 2006, service gross profit margin improved due to fixed costs being spread over a larger revenue base. Facilities and related allocations represented approximately 7% of total service cost of revenue in 2006 and 10% in 2005 and 2004.

Operating expenses

Selling, general and administrative

Selling, general and administrative expenses consist primarily of salaries and benefits for our sales, marketing and administrative personnel and related facilities and depreciation costs as well as professional services (e.g., legal and audit).

Selling, general and administrative expenses were $10.0 million in 2006 and $9.5 million in 2005, representing an increase of $500,000 or 5%. Selling, general and administrative expenses represented 20% of our total revenue in 2006 and 22% in 2005. Total selling, general and administrative expenses increased due to stock-based compensation expense of $445,000 recognized during 2006, higher facilities and related costs, higher personnel costs and higher sales commissions and bonuses, partially offset by lower bad debt expense, lower professional fees and lower marketing costs.

Selling, general and administrative expenses were $9.5 million in 2005 and $9.2 million in 2004, representing an increase of $328,000 or 4%. Selling, general and administrative expenses represented 22% of our total revenue in 2005 and 24% in 2004. Total selling, general and administrative expenses increased due to bad debt expense of $399,000 related to a customer contract dispute, higher facilities and related costs, higher personnel costs and higher recruiting costs to support increased hiring, partially offset by lower marketing costs, lower commissions and the audit settlement costs of $310,000 recognized in 2004 related to our OEM Distribution Agreement with Microsoft.

Research and development

Research and development expenses consist primarily of salaries and benefits for software development and quality assurance personnel, and related facilities and depreciation costs. Research and development expenses in all periods exclude expenses related to the hardware business unit, which are included in discontinued operations.

Research and development expenses were $2.8 million in 2006 and $2.0 million in 2005, representing an increase of $800,000 or 40%. Research and development expenses represented 6% of our total revenue in 2006 and 5% in 2005. During 2006, we increased our level of research and development in conjunction with the SDIO Now! version releases mentioned previously as well as the initiation and continuation of our reference design development efforts. The increase was specifically attributable to increased payroll and related expenses resulting from headcount growth as well as increased allocated expenses where service engineering personnel were contributing to the product development effort. We are continuing to execute and evolve our product strategy and expect to continue to invest in new product development initiatives during 2007.

Research and development expenses were $2.0 million in 2005 and $855,000 in 2004, representing an increase of $1.1 million or 128%. Research and development expenses represented 5% of our total revenue in 2005 and 2% in 2004. During 2005, we increased our level of research and development significantly in conjunction with the SDIO Now! version releases mentioned previously as well as the initiation of our PMP and other reference design development efforts. The increase was specifically attributable to increased payroll and related expenses resulting from headcount growth as well as increased allocated expenses where service engineering personnel were contributing to the product development effort.

Interest and other

Interest and other income consists of interest earnings on our cash, cash equivalents and short-term investments, as well as adjustments made to the carrying value of cost-based investments. Interest and other income was $442,000 in 2006 and $287,000 in 2005, representing an increase of $155,000, or 54%, with the increase attributable to higher balances in short-term investments and higher prevailing interest rates in 2006 as compared to 2005. Interest and other income was $287,000 in 2005 and $237,000 in 2004, representing an increase of $50,000, or 21%, with the increase attributable to generally higher prevailing interest rates in 2005 as compared to 2004.

Taxes

Federal, state and foreign income taxes resulted in a tax provision of $29,000 in 2006, $14,000 in 2005 and $11,000 in 2004, yielding an effective rate of (6.7%) in 2006, (1.1%) in 2005 and (0.2%) in 2004. The tax provision in all three years related to our Taiwan subsidiary.

We provided full valuation allowances on deferred tax assets during 2006, 2005 and 2004 because of uncertainty regarding their realizability. The increase in the valuation allowance on our deferred tax assets was $887,000 in 2006, $360,000 in 2005 and $3.2 million in 2004. At December 31, 2006 we had approximately $70.4 million of net operating loss carryforwards and $2.0 million of tax credit carryforwards, which begin to expire in 2021. In addition, we have $8.2 million of capital loss carryforwards, which expire in 2008. Utilization of these net operating losses and tax credits may be subject to an annual limitation due to provisions of the Internal Revenue Code of 1986, as amended. Events which cause limitations in the amount of net operating losses and tax credits that we may utilize in any one year include, but are not limited to, a cumulative ownership change of more than 50% as defined, over a three-year period.

In the second quarter of 2005, we became aware that certain amounts remitted, or that were planned to be remitted, from our Taiwan subsidiary or Taiwanese customers might be subject to withholding tax at 20% of the amount remitted. In the fourth quarter of 2005, we began applying for withholding tax exemptions from the Taiwan government on all significant contracts on which withholding tax might be owed. When granted, we expect these exemptions would eliminate any withholding tax and Taiwan-based income tax, as applicable, for the contract to which the exemption relates. To date, we have received approval for all withholding exemption applications that we

have filed for which significant withholding tax might be owed. However, there is no assurance that future exemptions will be granted and if we do not receive all, or some, of the exemptions for which we apply, we could be obligated to pay withholding tax in the future. We are continuing to evaluate alternative business and tax planning strategies to minimize corporate income and withholding tax obligations in connection with our Taiwan subsidiary.

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Loss from discontinued operations

During the second quarter of 2004, we decided to discontinue our hardware business and, consequently, the results of those operations have been accounted for and presented as a discontinued operation. A reconciliation of the loss from discontinued operations for 2004 is presented below (in thousands):

	Year Ended December 31,		
	2006	**2005**	**2004**
Hardware revenue	$	$	$ 890
Cost of hardware revenue			3,138
Gross profit (loss)			(2,248)
Operating expenses			2,272
Amortization of intangible assets			267
Restructuring and related charges			312
Impairment of assets			1,157
Loss from discontinued operation	$	$	$ (6,256)

Included in cost of hardware revenue in 2004 is a $1.6 million net charge related to the impairment of inventory. Included in operating expenses of the discontinued operations are $74,000 related to corporate allocations.

Restructuring and related charges included in loss from discontinued operations include the following (in thousands):

	Year Ended December 31,		
	2006	**2005**	**2004**
Employee separation	$	$	$ 194
Impairment of assets			1,157
Other charges			118
Total restructuring and impairment charges	$	$	$ 1,469

During the first quarter of 2004, we eliminated ten positions in the hardware business unit, representing 7% of our then remaining workforce. We incurred severance of $79,000 and $10,000 of related charges.

As a result of our decision to discontinue our hardware business, we recorded a $1.5 million charge in the second quarter of 2004, of which $608,000 related to the impairment of tooling, $585,000 related to the impairment of software licenses used in the device, $120,000 related to severance for eight employees terminated, representing 7% of our then remaining workforce, and $162,000 related to other charges.

Liquidity and Capital Resources

As of December 31, 2006, we had $11.1 million of cash, cash equivalents, short-term investments and restricted cash compared to $10.7 million at December 31, 2005. Specifically, we had $9.9 million of unrestricted cash, cash equivalents, and short-term investments and $1.2 million of restricted cash at December 31, 2006. Our restricted cash balance relates to the securitization of a letter of credit for our current corporate headquarters lease obligation, the majority of which will continue to secure that obligation through its expiration in 2014. During 2006, net cash provided by operating activities was $413,000. This cash provided was primarily attributable to a $129,000 decrease in accounts receivable driven by improved cash collections, offset by our net loss of $466,000 excluding the effect of non-cash expenses totaling $1.2 million. Our working capital at December 31, 2006 was $10.3 million compared to $9.5 million at December 31, 2005.

During 2005, net cash used in operating activities was $1.6 million, primarily attributable to our net loss of $1.3 million.

During 2004, net cash used in operating activities was $1.9 million, primarily attributable to our net loss of $7.1 million. The use of cash attributable to our net loss was largely offset by a $3.1 million non-cash impairment charge related to the discontinuance of our hardware business unit and a $2.7 million decrease in restricted cash related to planned reductions in letters of credit supporting our former corporate headquarters facility lease.

Investing activities used cash of $5.8 million in 2006 and provided cash of $4.3 million in 2005 and $648,000 in 2004. Investing activities in 2006 included $5.4 million used to purchase short-term investments and $357,000 used for capital equipment purchases. Investing activities in 2005 included $5.0 million provided by the maturity of short-term investments, offset by $500,000 of net cash used in the acquisition of certain assets of Vibren Technologies in the second quarter of 2005 and $226,000 used for capital equipment purchases. Investing activities in 2004 included $1.3 million provided by the maturity of short-term investments and $776,000 used for capital expenditures primarily related to the purchase of furniture, equipment and leasehold improvements for our new corporate headquarters in the second and third quarters of 2004.

Financing activities provided cash of $121,000 in 2006, $26,000 in 2005 and $461,000 in 2004 as a result of employees exercise of stock options.

Tabular Disclosure of Contractual Obligations

We have significant lease commitments, which expire through 2014. We have operating lease commitments for office space in Bellevue, Washington; San Diego, California; Longmont, Colorado; Vancouver, British Columbia, Canada; and Taipei, Taiwan. The following are our contractual commitments associated with these lease and other obligations (in thousands):

	Payments Due through Year Ended December 31:						
Contractual Obligations	**2007**	**2008**	**2009**	**2010**	**2011**	**Thereafter**	**Total**
Long-term debt obligations	$	$	$	$	$	$	$
Equipment financing obligations							
Operating lease obligations	1,024	952	853	926	975	2,889	7,619
Purchase obligations							
Other long-term obligations							
Total	$ 1,024	$ 952	$ 853	$ 926	$ 975	$ 2,889	$ 7,619

In addition to these lease obligations, we have the following future or potential cash commitment:

In February 2004, we signed an amendment to the lease for our former corporate headquarters and simultaneously entered into a ten-year lease for a new corporate headquarters, also located in Bellevue, Washington. The amendment of the former headquarters lease, which was scheduled to terminate on December 31, 2004, provided that no cash lease payments were to be made for the remainder of that lease term. Similarly, the new corporate headquarters lease also provided that no cash lease payments were to be made during 2004. However, if we default under our new corporate headquarters lease, the landlord has the ability to demand payment for cash payments forgiven in 2004 under the former headquarters lease. The amount of the forgiven payments for which the landlord can demand repayment was $1.8 million at December 31, 2006. The amount of the forgiven payments for which the landlord has the ability to demand

repayment decreases on the straight-line basis over the length of our new ten-year headquarters lease.

We believe that our existing cash, cash equivalents and short-term investments will be sufficient to meet our needs for working capital and capital expenditures for at least the next 12 months.

Related Party Transactions

Pursuant to a consulting agreement between us and Mr. Donald Bibeault, the Chairman of our Board of Directors, Mr. Bibeault provided us with onsite consulting services from July 2003, when he was appointed to our Board of Directors, to September 2006. We incurred expenses of $72,000 in 2006, $113,000 in 2005 and $158,000 in 2004 under this consulting agreement. On June 29, 2006, we and Mr. Bibeault agreed to terminate this consulting

agreement, effective September 30, 2006. Mr. Bibeault continues to serve as the Chairman of our Board of Directors.

Impact of New Accounting Pronouncements

Effective January 1, 2006, we began recording compensation expense associated with stock options and other forms of equity compensation in accordance with Statement of Financial Accounting Standards No. 123R, *Share-Based Payment*, (SFAS 123R) as interpreted by SEC Staff Accounting Bulletin No. 107. The following table presents stock-based compensation expense (in thousands):

	Year Ended December 31,		
	2006	**2005**	**2004**
Cost of revenue service	$ 190	$	$
Selling, general and administrative	445	17	
Research and development	80		
Total stock-based compensation expense	$ 715	$ 17	$

SFAS No. 154, Accounting Changes and Error Corrections, a Replacement of APB Opinion No. 20 and FASB Statement No. 3. SFAS 154 establishes, unless impracticable, retrospective application as the required method for reporting a change in accounting principle in the absence of explicit transition requirements specific to a newly adopted accounting principle. Previously, most changes in accounting principle were recognized by including the cumulative effect of changing to the new accounting principle in net income of the period of the change. SFAS 154 carries forward the guidance in APB Opinion 20 Accounting Changes, requiring justification of a change in accounting principle on the basis of preferability. SFAS 154 also carries forward without change the guidance contained in APB Opinion 20, for reporting the correction of an error in previously issued financial statements and for a change in an accounting estimate. The adoption of SFAS 154 on January 1, 2006 did not impact our financial position or results of operations.

SFAS No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140. SFAS 155 amends SFAS 133, Accounting for Derivative Instruments and Hedging Activities and SFAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. SFAS 155 (i) permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, (ii) clarifies which interest-only strips and principal-only strips are not subject to the requirements of SFAS 133, (iii) establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, (iv) clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and (v) amends SFAS 140 to eliminate the prohibition on a qualifying special purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. SFAS 155 is effective for us on January 1, 2007 and is not expected to have a material impact our financial position or results of operations.

SFAS No. 157, Fair Value Measurements. SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 is effective for us on January 1, 2008 and is not expected to have a material impact on our financial position or results of operations.

Financial Accounting Standards Board Staff Positions and Interpretations

FASB Staff Position (FSP) No. 115-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments. FSP 115-1 provides guidance for determining when an investment is considered impaired, whether impairment is other-than-temporary, and measurement of an impairment loss. An investment is

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considered impaired if the fair value of the investment is less than its cost. If, after consideration of all available evidence to evaluate the realizable value of its investment, impairment is determined to be other-than-temporary, then an impairment loss should be recognized equal to the difference between the investment s cost and its fair value. FSP 115-1 nullifies certain provisions of Emerging Issues Task Force (EITF) Issue No. 03-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments, while retaining the disclosure requirements of EITF 03-1 which were adopted in 2003. The adoption of FSP 115-1 on January 1, 2006 did not impact our financial position or results of operations.

FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement 109. Interpretation 48 prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Benefits from tax positions should be recognized in the financial statements only when it is more likely than not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. A tax position that meets the more-likely-than-not recognition threshold is measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. Interpretation 48 also provides guidance on the accounting for and disclosure of unrecognized tax benefits, interest and penalties. Interpretation 48 is effective for us on January 1, 2007 and is not expected to have a material impact on our financial position or results of operations.

SEC Staff Accounting Bulletins

Staff Accounting Bulletin (SAB) No. 108, Considering the Effects of a Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements. SAB 108 addresses how the effects of prior year uncorrected errors must be considered in quantifying misstatements in the current year financial statements. The effects of prior year uncorrected errors include the potential accumulation of improper amounts that may result in a material misstatement on the balance sheet or the reversal of prior period errors in the current period that result in a material misstatement of the current period income statement amounts. Adjustments to current or prior period financial statements would be required in the event that after application of various approaches for assessing materiality of a misstatement in current period financial statements and consideration of all relevant quantitative and qualitative factors, a misstatement is determined to be material. SAB 108 is applicable to all financial statements issued by us after November 15, 2006.

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

Interest Rate Risk. We primarily hold non-derivative financial instruments in our short-term investment portfolio. Our cash equivalents consist of high-quality securities, as specified in our investment policy guidelines. The policy limits the amount of credit exposure to any one issue to a maximum of 15% and any one issuer to a maximum of 10% of the total portfolio, with the exception of treasury securities, commercial paper and money market funds, which are exempt from size limitation. The policy limits all short-term investments to mature in two years or less, with the average maturity being one year or less. These securities are subject to interest rate risk and will decrease in value if interest rates increase.

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The following table presents the amounts of our short-term investments that are subject to market risk by range of expected maturity and weighted average interest rates as of December 31, 2006 and 2005. This table does not include cash equivalents or money market funds, as those funds are not subject to market risk.

	Maturing in			
	Three Months or Less	Three Months to One Year	Total	Fair Value
	(Dollars in thousands)			
As of December 31, 2006				
Included in short-term investments	$ 7,200	$ 226	$ 7,426	$ 7,426
Weighted average interest rate	5.34%			
As of December 31, 2005				
Included in short-term investments	$ 1,800	$	$ 1,800	$ 1,800
Weighted average interest rate	4.39%			

Foreign Currency Exchange Rate Risk. Currently, the majority of our revenue and expenses is denominated in U.S. dollars, and, as a result, we have not experienced significant foreign exchange gains or losses to date. While we have conducted some transactions in foreign currencies and expect to continue to do so, we do not anticipate that foreign exchange gains or losses will be significant. We have not engaged in foreign currency hedging to date, although we may do so in the future.

Our international business is subject to risks typical of international activity, including, but not limited to, differing economic conditions, changes in political climate, differing tax structures and regulations and other regulations and restrictions. Accordingly, our future results could be impacted by changes in these or other factors.

Our exposure to foreign exchange rate fluctuations can vary as the financial results of our foreign subsidiary are translated into U.S. dollars in consolidation. The effect of foreign exchange rate fluctuations for the year ended December 31, 2006 was not material.

Item 8. ***Financial Statements and Supplementary Data.***

BSQUARE CORPORATION

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REPORT OF MOSS ADAMS, LLP, INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders
BSQUARE Corporation

We have audited the accompanying consolidated balance sheet of BSQUARE Corporation as of December 31, 2006 and the related consolidated statements of operations, stockholders equity and cash flows for the year ended December 31, 2006. Our audits also included the financial statement schedule listed at Item 15(a)(2) for the year ended December 31, 2006. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company s internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of BSQUARE Corporation as of December 31, 2006 and the results of its operations and its cash flows for the year ended December 31, 2006, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule for the year ended December 31, 2006, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

As discussed in Note 1 to the consolidated financial statements, effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment.*

Moss Adams LLP

Seattle, Washington
February 15, 2007

REPORT OF ERNST & YOUNG LLP, INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders of BSQUARE Corporation

We have audited the accompanying consolidated balance sheet of BSQUARE Corporation and subsidiaries as of December 31, 2005, and the related consolidated statements of operations, shareholders equity, and cash flows for each of the two years in the period ended December 31, 2005. Our audits also included the financial statement schedule listed at Item 15(a)(2) for the years ended December 31, 2005 and 2004. These financial statements and schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company s internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of BSQUARE Corporation and subsidiaries at December 31, 2005, and the consolidated results of their operations and their cash flows for each of the two years in the period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule for the years ended December 31, 2005 and 2004, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

/s/ Ernst & Young LLP

Seattle, Washington
February 24, 2006

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BSQUARE CORPORATION

CONSOLIDATED BALANCE SHEETS

	December 31, 2006	December 31, 2005
	(In thousands, except share amounts)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 2,483	$ 7,694
Short-term investments	7,426	1,800
Accounts receivable, net of allowance for doubtful accounts of $198 at December 31, 2006 and $687 at December 31, 2005	7,167	7,296
Prepaid expenses and other current assets	421	440
Total current assets	17,497	17,230
Equipment, furniture and leasehold improvements, net	821	792
Intangible assets, net	101	304
Restricted cash	1,200	1,200
Other non-current assets	57	44
Total assets	$ 19,676	$ 19,570
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 2,634	$ 2,662
Other accrued expenses	2,877	3,298
Accrued compensation	1,046	964
Accrued legal fees	534	534
Deferred revenue	154	270
Total current liabilities	7,245	7,728
Deferred rent	355	379
Commitments and contingencies (Note 7)		
Shareholders equity:		
Preferred stock, no par value: 10,000,000 shares authorized; no shares issued and outstanding		
Common stock, no par value: 37,500,000 shares authorized; 9,617,755 shares issued and outstanding at December 31, 2006 and 9,553,566 shares issued and outstanding at December 31, 2005	119,229	118,393
Accumulated other comprehensive loss	(180)	(423)
Accumulated deficit	(106,973)	(106,507)
Total shareholders equity	12,076	11,463

Total liabilities and shareholders equity	$ 19,676	$ 19,570

See notes to Consolidated Financial Statements.

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BSQUARE CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended December 31,		
	2006	2005	2004
	(In thousands, except per share amounts)		
Revenue:			
Software	$ 32,934	$ 31,210	$ 28,364
Service	16,881	11,713	10,556
Total revenue	49,815	42,923	38,920
Cost of revenue:			
Software	26,117	24,679	21,893
Service(1)	11,711	8,360	7,977
Total cost of revenue	37,828	33,039	29,870
Gross profit	11,987	9,884	9,050
Operating expenses:			
Selling, general and administrative(1)	10,046	9,504	9,176
Research and development(1)	2,820	1,950	855
Restructuring and other related charges			40
Total operating expenses	12,866	11,454	10,071
Loss from operations	(879)	(1,570)	(1,021)
Interest and other income	442	287	237
Loss from continuing operations before income taxes	(437)	(1,283)	(784)
Income tax provision	(29)	(14)	(11)
Loss from continuing operations	(466)	(1,297)	(795)
Loss from discontinued operations			(6,256)
Net loss	$ (466)	$ (1,297)	$ (7,051)
Basic and diluted loss per share:			
Loss from continuing operations	$ (0.05)	$ (0.14)	$ (0.08)
Loss from discontinued operations	(0.00)	(0.00)	(0.66)
Basic and diluted loss per share	$ (0.05)	$ (0.14)	$ (0.74)
Shares used in calculation of basic and diluted loss per share	9,586	9,541	9,464

(1) Includes the following amounts related to stock-based compensation expense:

Cost of revenue service	$ 190	$	$
Selling, general and administrative	445	17	
Research and development	80		
Total stock-based compensation expense	$ 715	$ 17	$

See notes to Consolidated Financial Statements.

BSQUARE CORPORATION

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

	Preferred Stock Shares	Preferred Stock Amount	Common Stock Shares	Common Stock Amount	Accumulated Other Comprehensive Loss	Accumulated Deficit	Total Shareholders Equity
			(In thousands, except share amounts)				
Balance, January 1, 2004			9,375,493	$ 117,889	$ (392)	$ (98,159)	$ 19,338
Net loss						(7,051)	(7,051)
Foreign currency translation adjustment					(14)		(14)
Comprehensive loss							(7,065)
Exercise of stock options			157,589	461			461
Balance, December 31, 2004			9,533,082	118,350	(406)	(105,210)	12,734
Net loss						(1,297)	(1,297)
Foreign currency translation adjustment					(17)		(17)
Comprehensive loss							(1,314)
Exercise of stock options			20,484	26			26
Stock-based compensation				17			17
Balance, December 31, 2005			9,553,566	118,393	(423)	(106,507)	11,463
Net loss						(466)	(466)
Foreign currency translation adjustment					17		17
Unrealized gain on available-for-sale securities					226		226
Comprehensive loss							(223)
Exercise of stock options			64,189	121			121
Stock-based compensation				715			715
Balance, December 31, 2006		$	9,617,755	$ 119,229	$ (180)	$ (106,973)	$ 12,076

See notes to Consolidated Financial Statements.

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BSQUARE CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
	2006	2005	2004
	(In thousands)		
Cash flows from operating activities:			
Net loss	$ (466)	$ (1,297)	$ (7,051)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:			
Depreciation and amortization	532	379	584
Stock-based compensation	715	17	
Impairment and restructuring charges of discontinued operations			3,069
Decrease of assets of discontinued operations			781
Restructuring and other related charges			40
Other			(37)
Changes in operating assets and liabilities, net of effects of acquisitions and discontinued operations:			
Restricted cash			2,706
Accounts receivable, net	133	(2,465)	1,422
Prepaid expenses and other assets	7	(41)	841
Accounts payable and accrued expenses	(367)	1,979	(3,826)
Deferred revenue	(117)	(118)	(756)
Deferred rent	(24)	4	375
Net cash provided by (used in) operating activities	413	(1,542)	(1,852)
Cash flows from investing activities:			
Purchases of furniture, equipment and leasehold improvements	(357)	(226)	(776)
Maturity (purchases) of short-term investments, net	(5,400)	5,000	1,339
Acquisition of Vibren assets		(500)	
Proceeds from the disposal of equipment			85
Net cash provided by (used in) investing activities	(5,757)	4,274	648
Cash flows from financing activities:			
Proceeds from exercise of stock options	121	26	461
Net cash provided by financing activities	121	26	461
Effect of exchange rate changes on cash	12	(7)	(14)
Net increase (decrease) in cash and cash equivalents	(5,211)	2,751	(757)
Cash and cash equivalents, beginning of year	7,694	4,943	5,700
Cash and cash equivalents, end of year	$ 2,483	$ 7,694	$ 4,943

See notes to Consolidated Financial Statements.

BSQUARE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Description of Business and Accounting Policies

Description of Business

BSQUARE Corporation (BSQUARE), a Washington corporation, and its subsidiaries (collectively, the Company) provides software and engineering services to the smart device marketplace. A smart device is a dedicated purpose computing device that typically has the ability to display information, runs an operating system (e.g., Microsoft® Windows® CE) and may be connected to a network via a wired or wireless connection. Examples of smart devices that BSQUARE targets include set-top boxes, home gateways, point-of-sale terminals, kiosks, voting machines, gaming platforms, personal digital assistants (PDAs), personal media players and smartphones.

The Company s software and engineering services are focused on devices running versions of the Microsoft Windows family of embedded operating systems, specifically Windows CE, Windows XP Embedded and Windows Mobile™.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All intercompany balances and transactions have been eliminated.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates. Estimates are used for, but not limited to, recognizing revenue, assessing the collectability of accounts receivable, the adequacy of the allowance for doubtful accounts, the realization of deferred tax assets and contingencies. Estimates and assumptions are reviewed periodically, and the effects of revisions are reflected in the consolidated financial statements in the period they are determined to be necessary.

Earnings Per Share

Basic earnings per share is computed using the weighted average number of common shares outstanding during the period, and excludes any dilutive effects of common stock equivalent shares, such as options and warrants (using the treasury stock method) and convertible securities (using the if-converted method). Diluted earnings per share is computed using the weighted average number of common and common stock equivalent shares outstanding during the period; common stock equivalent shares are excluded from the computation if their effect is antidilutive. Common stock equivalent shares were 2,069,530 at December 31, 2006, 1,860,368 at December 31, 2005 and 1,765,058 at December 31, 2004.

Cash and Cash Equivalents

Cash and cash equivalents include demand deposits, money market accounts and all highly liquid debt instruments with a maturity date at the time of purchase of three months or less.

Restricted Cash

Restricted cash represents deposits held at a financial institution as security for an outstanding letter of credit expiring through 2014 related to the Company s headquarters lease obligation.

BSQUARE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Short-term Investments

The Company s short-term investments consist primarily of investment-grade marketable securities, which are classified as held-to-maturity and recorded at amortized cost, which approximates fair value. Due to the short-term nature of these investments, changes in market interest rates would not have a significant impact on their fair value. In addition, the Company holds investments in equity securities, which are classified as available-for-sale.

Financial Instruments and Concentrations of Risk

The Company has the following financial instruments: cash and cash equivalents, short-term investments, accounts receivable, accounts payable and accrued liabilities. The carrying value of these instruments approximates fair value based on their liquidity or short-term nature.

Allowance for Doubtful Accounts

The Company s accounts receivable balances are net of an estimated allowance for doubtful accounts. The Company performs ongoing credit evaluations of its customers financial condition and generally does not require collateral. The Company estimates the collectability of our accounts receivable and records an allowance for doubtful accounts. The Company considers many factors when making this estimate, including analyzing accounts receivable and historical bad debts, customer concentrations, customer creditworthiness, current economic trends and changes in customer payment history when evaluating the adequacy of the allowance for doubtful accounts. Because the allowance for doubtful accounts is an estimate, it may be necessary to adjust it if actual bad debt expense exceeds the estimated reserve.

Furniture, Equipment and Leasehold Improvements

Furniture, equipment and leasehold improvements are stated at cost less accumulated depreciation and amortization. Depreciation is provided on the straight-line method over estimated useful lives:

		(0.91)	1.52	3.51	3.68
Earnings (loss) per common share (diluted)					
Net income (loss) from continuing operations	2.83	(0.95)	1.45	2.48	3.50
Earnings (loss) per common share (diluted)	2.83	(0.91)	1.51	3.50	3.67
Dividends per common share declared	2.72	2.72	2.68	2.56	2.28
Stock price at year-end	$ 48.51	$41.99	$42.98	$51.69	$54.03
Book value per share	$ 37.57	$37.51	$40.66	$42.58	$35.61
Return on average equity	7.7 %	(2.4)%	3.6 %	8.5 %	10.6 %
Number of common stock shareholders	30,352	32,755	34,016	35,212	19,837
Number of employees	4,612	5,025	5,191	5,231	3,326

(1) Certain amounts have been retrospectively adjusted due to a change in accounting policy in 2010. See Note 1(d) "Change in Accounting Policy,"

for more information.

(2) Includes the impact of the PEC merger on February 21, 2007.

(3) Includes the impact of the acquisition of natural gas distribution operations by MGU on April 1, 2006, and MERC on July 1, 2006.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

INTRODUCTION

Integrys Energy Group is a diversified energy holding company with regulated natural gas and electric 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).

Strategic Overview

Integrys Energy Group's goal is to create long-term value for shareholders and customers through growth in its core regulated businesses. Integrys Energy Group also has a nonregulated energy services business segment that is smaller than it was historically with significantly reduced credit and collateral support requirements.

The essential components of Integrys Energy Group's business strategy are:

Maintaining and Growing a Strong Regulated Utility Base – A strong regulated utility base is essential to maintaining a strong balance sheet, predictable cash flows, the desired risk profile, attractive dividends, and quality credit ratings. This is critical to Integrys Energy Group's success as a strategically focused regulated business. Integrys Energy Group believes the following projects have helped, or will help, maintain and grow its regulated utility base and meet its customers' needs:

- An accelerated annual investment in natural gas distribution facilities (primarily replacement of cast iron mains) at PGL.

- WPS's continued investment in environmental projects to improve air quality and meet the requirements set by environmental regulators. Capital projects to construct and/or upgrade equipment to meet or exceed required environmental standards are planned each year.

- Integrys Energy Group's approximate 34% ownership interest in ATC, a transmission company that had over $2.9 billion of transmission assets at December 31, 2010. ATC plans to invest approximately $3.4 billion during the next ten years. Although ATC's equity requirements to fund its capital investments will primarily be met by earnings reinvestment, Integrys Energy Group plans to continue to fund its share of the equity portion of future ATC growth as necessary.

For more detailed information on Integrys Energy Group's capital expenditure program, see "Liquidity and Capital Resources, Capital Requirements."

Operating a Nonregulated Energy Services Business Segment with a Controlled Risk and Capital Profile – Through its nonregulated Integrys Energy Services subsidiary, Integrys Energy Group provides retail natural gas and electric products to end-use customers in the northeast quadrant of the United States. Integrys Energy Group has repositioned this subsidiary from a focus on significant growth in wholesale and retail electric markets across the United States and Canada, to a focus on operating within select retail electric and natural gas markets in its current market footprint where it has experience and believes it will have the most success growing its recurring customer based business. The current strategy is intended to result in more dependable cash and earnings contributions with a controlled risk and

capital profile. In addition, Integrys Energy Services continues to invest in and promote renewable energy in the United States. Clean, renewable, and efficient energy sources are developed, acquired, owned, and operated by Integrys Energy Services. Integrys Energy Services assists customers with selecting an energy solution that meets their needs and collaborates with energy developers of wholesale energy projects to overcome challenges with integrating the technical, regulatory, and financial aspects of their projects.

Integrating Resources to Provide Operational Excellence – Integrys Energy Group is committed to integrating resources of all its businesses, while meeting all applicable legal and regulatory requirements. This will provide the best value to customers and shareholders by leveraging the individual capabilities and expertise of each business and lowering costs. "Operational Excellence" initiatives were implemented to encourage top performance in the areas of project management, process improvement, contract administration, and compliance in order to reduce costs and manage projects and activities within appropriate budgets, schedules, and regulations.

Placing Strong Emphasis on Asset and Risk Management – Integrys Energy Group's asset management strategy calls for the continuous assessment of existing assets, the acquisition of assets, and contractual commitments to obtain resources that complement its existing business and strategy. The goal is to provide the most efficient use of resources while maximizing return and maintaining an acceptable risk profile. This strategy focuses on acquiring assets consistent with strategic plans and disposing of assets, including property, plant, and equipment and entire business units, which are no longer strategic to ongoing operations, are not performing as needed, or have an unacceptable risk profile. Integrys Energy Group maintains a portfolio approach to risk and earnings.

Integrys Energy Group's risk management strategy includes the management of market, credit, liquidity, and operational risks through the normal course of business. Forward purchases and sales of electric capacity, energy, natural gas, and other commodities and the use of derivative financial instruments, including commodity swaps and options, allow for opportunities to reduce the risk associated with price movement in a volatile energy market. Each business unit manages the risk profile related to these instruments consistent with Integrys Energy Group's risk management policies, which are approved by the Board of Directors. The Corporate Risk Management Group, which reports through the Chief Financial Officer, provides corporate oversight.

Continuing Emphasis on Safe, Reliable, Competitively Priced, and Environmentally Sound Energy and Energy Related Services – Integrys Energy Group's mission is to provide customers with the best value in energy and energy related services. By effectively operating a mixed portfolio of generation assets and investing in new generation and natural gas distribution assets, while maintaining or exceeding environmental standards, Integrys Energy Group is able to provide a safe, reliable, value-priced service to its customers. Integrys Energy Group concentrates its efforts on improving and operating efficiently in order to reduce costs and maintain a low risk profile. Integrys Energy Group actively evaluates opportunities for adding more renewable generation to provide additional environmentally sound energy to its portfolio. Ensuring continued reliability for its customers, Integrys Energy Group is effectively operating a mixed portfolio of generation assets and investing in new generation and distribution assets.

RESULTS OF OPERATIONS

Earnings Summary

	Year Ended December 31				
(Millions, except per share amounts)	2010	2009*	2008*	Change in 2010 Over 2009	Change in 2009 Over 2008
Natural gas utility operations	$84.0	$(172.1)	$84.5	N/A	N/A
Electric utility operations	109.8	88.9	92.6	23.5 %	(4.0)%
Integrys Energy Services operations	3.3	3.8	(71.4)	(13.2)%	N/A
Electric transmission investment	46.2	45.5	39.7	1.5 %	14.6 %
Holding company and other operations	(22.4)	(35.7)	(28.9)	(37.3)%	23.5 %
Net income (loss) attributed to common shareholders	$220.9	$(69.6)	$116.5	N/A	N/A
Basic earnings (loss) per share	$2.85	$(0.91)	$1.52	N/A	N/A
Diluted earnings (loss) per share	$2.83	$(0.91)	$1.51	N/A	N/A
Average shares of common stock					
Basic	77.5	76.8	76.7	0.9 %	0.1 %
Diluted	78.0	76.8	77.0	1.6 %	(0.3)%

* Certain amounts have been retrospectively adjusted due to a change in accounting policy in the fourth quarter of 2010. See Note 1(d), "Change in Accounting Policy," for more information.

2010 Compared with 2009

Integrys Energy Group recognized net income attributed to common shareholders of $220.9 million ($2.83 diluted earnings per share) in 2010 compared with a net loss attributed to common shareholders of $69.6 million ($0.91 net loss per share) in 2009. The primary driver of the $290.5 million increase in earnings was an after-tax noncash goodwill impairment loss of $248.8 million recorded in 2009, compared with no goodwill impairment losses in 2010. Other factors contributing to the increase were the combined approximate $69 million after-tax positive impact on margins of electric and natural gas distribution rate increases effective in 2010, and a $22.5 million after-tax reduction in restructuring expenses year over year. These increases in earnings were partially offset by after-tax impairment charges of $25.9 million in 2010 related to three natural gas-fired generation plants at Integrys Energy Services.

2009 Compared with 2008

Integrys Energy Group recognized a net loss attributed to common shareholders of $69.6 million ($0.91 net loss per share) in 2009 compared with net income attributed to common shareholders of $116.5 million ($1.51 diluted earnings per share) in 2008. The primary drivers of the $186.1 million decrease in earnings were a $242.3 million after-tax year-over-year increase in noncash goodwill impairment losses, $27.2 million of after-tax restructuring charges recorded in 2009, and $17.3 million of after-tax net losses on dispositions in 2009 related to the Integrys Energy Services strategy change. These decreases in earnings were partially offset by a $127.3 million after-tax increase in margins at Integrys Energy Services, primarily due to the positive year-over-year impact of noncash inventory valuation adjustments recorded in prior periods, partially offset by noncash accounting losses in 2009 versus noncash accounting gains in 2008 due to derivative fair value adjustments.

Regulated Natural Gas Utility Segment Operations

	Year Ended December 31			Change in 2010 Over 2009	Change in 2009 Over 2008
	2010	2009	2008		
Revenues	$2,057.2	$2,237.5	$3,025.9	(8.1)%	(26.1)%
Purchased natural gas costs	1,152.0	1,382.0	2,147.7	(16.6)%	(35.7)%
Margins	905.2	855.5	878.2	5.8%	(2.6)%
Operating and maintenance expense	542.1	532.6	539.1	1.8%	(1.2)%
Goodwill impairment loss	-	291.1	6.5	(100.0)%	4,378.5%
Restructuring expense	(0.2)	6.9	-	N/A	N/A
Depreciation and amortization expense	130.9	106.1	108.3	23.4%	(2.0)%
Taxes other than income taxes	34.4	33.4	32.1	3.0%	4.0%
Operating income (loss)	198.0	(114.6)	192.2	N/A	N/A
Miscellaneous income	1.6	3.1	7.0	(48.4)%	(55.7)%
Interest expense	(49.7)	(52.2)	(56.6)	(4.8)%	(7.8)%
Other expense	(48.1)	(49.1)	(49.6)	(2.0)%	(1.0)%
Income (loss) before taxes	$149.9	$(163.7)	$142.6	N/A	N/A
Throughput in therms					
Residential	1,496.4	1,602.8	1,708.9	(6.6)%	(6.2)%
Commercial and industrial	455.5	501.4	550.8	(9.2)%	(9.0)%
Interruptible	39.8	51.3	60.1	(22.4)%	(14.6)%
Interdepartmental	13.9	9.5	28.6	46.3%	(66.8)%
Transport	1,728.4	1,641.6	1,834.0	5.3%	(10.5)%
Total throughput in therms	3,734.0	3,806.6	4,182.4	(1.9)%	(9.0)%
Weather					
Average heating degree days	6,440	7,061	7,257	(8.8)%	(2.7)%

2010 Compared with 2009

Revenues

Regulated natural gas utility segment revenues decreased $180.3 million year over year, driven by:

- An approximate $132 million decrease in revenues as a result of the 1.9% lower natural gas throughput volumes, related to:
  - An approximate $76 million decrease driven by lower weather-normalized volumes. Residential customer volumes decreased, which Integrys Energy Group attributes to energy conservation, efficiency efforts, and general

economic conditions. In addition, some former MGU residential and small commercial and industrial retail customers have become transportation customers under a Michigan customer choice program, which resulted in reduced revenues of approximately $6 million in 2010 related to the pass-through of the cost of natural gas but had no impact on margins. These decreases were partially offset by a year-over-year net increase in commercial and industrial sales volumes for both retail and transportation customers, driven by certain transportation customers of MERC and MGU.

- An approximate $66 million decrease as a result of warmer year-over-year weather during the heating season, as evidenced by the 8.8% decrease in average heating degree days.

- Partially offsetting these decreases was the approximate $10 million positive year-over-year impact of decoupling mechanisms for residential, small commercial and industrial, and transportation customers. Under decoupling, certain of Integrys Energy Group's regulated natural gas utilities 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 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 in the first quarter of 2010 but was not reached in 2009.

· An approximate $127 million decrease in revenues as a result of an approximate 9% year-over-year decrease in the average per-unit cost of natural gas sold. 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 $18 million net decrease in revenues driven by lower recovery of approximately $25 million of environmental cleanup expenditures related to former manufactured gas plant sites, partially offset by an approximate $7 million increase related to recoveries received in 2010 under the PGL and NSG bad debt riders. These amounts were offset by a net decrease in operating and maintenance expense resulting from lower net amortization of the related regulatory assets and, therefore, had no impact on earnings. Recoveries under these riders represent net billings to customers of the excess or deficiency of actual 2008 and 2009 bad debt expense over bad debt expense reflected in utility rates during those same periods. See Note 24, "Regulatory Environment," for more information on the PGL and NSG bad debt riders.

· Partially offsetting these decreases was the approximate $96 million positive impact of natural gas distribution rate increases. These rate increases were necessary, in part, to recover higher operating expenses (as discussed below). See Note 24, "Regulatory Environment," for more information on these rate increases.

- The rate increases at PGL and NSG had an approximate $77 million positive impact on revenues.

- The rate increase at WPS had an approximate $13 million positive impact on revenues.

- The rate increase at MGU had an approximate $3 million positive impact on revenues.

- A rate increase at MERC related to its conservation improvement program had an approximate $3 million positive impact on revenues. This amount is offset by a corresponding increase in operating and maintenance expense and, therefore, had no impact on earnings.

Margins

Regulated natural gas utility segment margins increased $49.7 million year over year, driven by the approximate $96 million positive impact of the rate increases, partially offset by:

· An approximate $28 million decrease in margins resulting from lower natural gas throughput volumes, resulting from:

- An approximate $19 million decrease related to warmer year-over-year weather during the heating season.

- An approximate $19 million decrease related to lower weather-normalized volumes, primarily attributed to residential customer conservation, efficiency efforts, and general economic conditions, partially offset by the favorable net impact of increased commercial and industrial sales volumes for certain retail and transportation customers of MERC and MGU.

- Partially offsetting these decreases was the approximate $10 million positive impact from decoupling mechanisms in place at certain of Integrys Energy Group's regulated natural gas utilities.

· An approximate $18 million net decrease in margins driven by lower recovery of environmental cleanup expenditures related to former manufactured gas plant sites, partially offset by an increase in margins related to recoveries received under the PGL and NSG bad debt riders. These amounts were offset by a net decrease in operating and maintenance expense resulting from lower net 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 $312.6 million year over year. This increase was primarily driven by the positive year-over-year impact of a $291.1 million noncash goodwill impairment loss that was recorded in the first quarter of 2009. Also contributing to the increase was the $49.7 million increase in the natural gas margins discussed above, partially offset by a $28.2 million increase in other operating expenses. See Note 9, "Goodwill and Other Intangible Assets," for information related to the goodwill impairment loss recorded in 2009.

The $28.2 million year-over-year increase in other operating expenses primarily related to:

· A $24.8 million increase in depreciation and amortization expense, primarily due to the ICC's rate order for PGL and NSG, effective January 28, 2010, which allows earlier recovery in rates for net dismantling costs by including them as a component of depreciation rates applied to natural gas distribution assets. The increase also includes a $2.5 million write-off of MGU assets for which rate recovery is currently being contested.

· A $12.9 million increase in expenses related to energy conservation programs and enhanced efficiency initiatives.

· A $9.8 million increase in employee benefit costs, primarily driven by an increase in other postretirement benefit costs.

· A $7.4 million increase in asset usage charges from IBS related to implementation of both a work asset management system for natural gas operations and a newer version of an Enterprise Resource Planning system for finance and supply chain services.

· A $4.9 million increase in stock-based compensation expense. See Note 20, "Stock-Based Compensation," for more information.

· These increases were partially offset by:

- An approximate $18 million net decrease due to approximately $25 million of lower amortization of the regulatory asset related to environmental cleanup expenditures for manufactured gas plant sites, partially offset by approximately $7 million of amortization related to the regulatory assets recorded as a result of the PGL and NSG bad debt riders. This net decrease was passed through to customers in rates and, therefore, had no impact on earnings.

- A $7.1 million decrease in restructuring expenses recorded in 2009 related to a reduction in workforce. See Note 3, "Restructuring Expense," for more information.

- A $6.1 million decrease in labor costs as a result of the reduction in workforce and company-wide furloughs implemented as a part of previously announced cost management efforts.

2009 Compared with 2008

Revenues

Regulated natural gas utility segment revenues decreased $788.4 million, driven by:

- An approximate $648 million decrease in revenues as a result of an approximate 30% decrease in the average per-unit cost of natural gas sold by the regulated natural gas utilities during 2009 compared with 2008. 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 $166 million decrease in revenues as a result of lower year-over-year natural gas throughput volumes, driven by:

  - An approximate $83 million decrease related to lower weather-normalized volumes, including residential customer volumes, resulting from customer conservation and efficiency efforts. Lower volumes were also driven by decreased commercial and industrial customer volumes resulting from reduced demand related to changes in customers' plant operations and a decline in customer base at PGL and MGU, both of which Integrys Energy Group attributed to the general economic slowdown.

  - An approximate $70 million decrease as a result of warmer year-over-year weather during the heating season as indicated by the 2.7% decrease in average heating degree days.

  - An approximate $19 million decrease related to a reduction in volumes sold to the electric utility segment driven by the availability of lower cost power from MISO, resulting in a decrease in the need for the electric utility to run its natural gas-fired peaking generation units.

  - This decrease in revenues was partially offset by the $6 million positive impact of decoupling mechanisms that were first effective for PGL and NSG on March 1, 2008, and for WPS on January 1, 2009. Under decoupling, these utilities 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.

- An approximate $20 million year-over-year net decrease in revenues from lower recovery of environmental cleanup expenditures at PGL and NSG related to former manufactured gas plant sites, partially offset by higher recovery of EEP expenses. The EEP program was established in the 2008 PGL and NSG rate cases and is designed to encourage energy efficiency initiatives.

- The decrease in revenues was partially offset by the approximate $29 million year-over-year net positive impact of natural gas distribution rate cases and changes in rate design at the regulated natural gas utilities. See Note 24, "Regulatory Environment," for more information on these rate cases.

- Effective January 14, 2009, MGU received a final rate order from the MPSC for a natural gas distribution rate increase. On June 29, 2009, MERC received a final rate order granting a natural gas distribution rate increase. Prior to this final order, MERC had been granted interim rate relief effective October 1, 2008. Together, these rate increases had an approximate $19 million positive impact on revenue.

- In 2009, PGL and NSG received the full impact of their 2008 natural gas distribution rate orders, which were effective February 14, 2008, and drove an approximate $5 million increase in revenue year over year.

- Effective January 1, 2009, the PSCW required WPS to change its retail natural gas distribution rate design which incorporates higher volumetric rates and lower fixed customer charges. In 2009, revenue increased approximately $5 million related to this change in rate design.

Margins

Regulated natural gas utility segment margins decreased $22.7 million, driven by:

- An approximate $27 million year-over-year decrease in margins resulting from the 9.0% decrease in natural gas throughput volumes attributed to the negative impact of the general economic slowdown, customer conservation and efficiency efforts, and warmer year-over-year weather. This decrease in margins includes the impact of decoupling mechanisms that were first effective for PGL and NSG on March 1, 2008, and for WPS on January 1, 2009. 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. Approximately $7 million of additional margin was recognized at WPS due to a shortfall from the rate case authorized margin during 2009.

- An approximate $20 million year-over-year net decrease in margins due to lower recovery of environmental cleanup expenditures at PGL and NSG related to former manufactured gas plant sites, partially offset by an increase in recovery of EEP expenses. This decrease in margin was offset by a net decrease in operating expense from both the amortization of the related regulatory asset and EEP expenses and, therefore, had no impact on earnings.

- An approximate $2 million year-over-year decrease in margins at MGU related to an adjustment in the third quarter of 2008 for recovery of natural gas costs in a MPSC proceeding.

- The decrease in margins was partially offset by the approximate $29 million net positive year-over-year impact of rate orders and impacts of rate design changes at the regulated natural gas utilities.

Operating Income (Loss)

Operating results at the regulated natural gas utility segment decreased $306.8 million, from operating income of $192.2 million in 2008, to an operating loss of $114.6 million in 2009. This decrease was primarily driven by a year-over-year increase in noncash goodwill impairment losses of $284.6 million and the $22.7 million decrease in natural gas margin, partially offset by a $0.5 million decrease in other operating expenses. See Note 9, "Goodwill and Other Intangible Assets," for information related to the goodwill impairment losses recorded in 2009 and 2008.

The year-over-year decrease in other operating expenses primarily related to:

- An approximate $20 million net decrease in amortization of the regulatory asset related to environmental cleanup expenditures of manufactured gas plant sites, partially offset by an increase in EEP expenses. Both of these costs were recovered from customers in rates.

·

A $17.7 million decrease in bad debt expense driven by the impact lower energy prices had on overall accounts receivable balances and the implementation of bad debt expense tracking mechanisms at PGL, NSG, and MGU. PGL and NSG elected during the third quarter of 2009, under a new Illinois state law, to file for recovery from or refund to customers the difference between actual bad debt expense reported as a component of earnings and the bad debt expense included in utility rates retroactive to January 1, 2008. Bad debt expense also decreased as a result of MGU's rate order effective January 1, 2010, which established a bad debt expense tracking mechanism that allows for the deferral and subsequent recovery or refund of 80% of the difference between actual bad debt write-offs (net of recoveries) and bad debt expense included in utility rates. The bad debt mechanism allowed recovery of a portion of the December 31, 2009 accounts receivable reserve representing future bad debt write-offs. The decrease in bad debt expense attributed to the implementation of bad debt expense tracking mechanisms at the natural gas utilities was $9.3 million.

· These decreases were partially offset by:

- A $13.4 million increase in employee benefit costs, partially related to an increase in pension expense resulting from negative pension investment returns in 2008, as well as higher health care expenses in 2009.

- Restructuring expenses of $6.9 million related to a reduction in workforce. See Note 3, "Restructuring Expense," for more information.

- A $5.5 million increase in natural gas maintenance costs, primarily related to increased system inspection and maintenance requirements.

- A $5.0 million increase in expenses related to workers compensation claims.

- A $3.0 million charge related to an expected settlement with the ICC at PGL and NSG related to fiscal years 2001 through 2004 natural gas costs. See Note 15, "Commitments and Contingencies," for more information.

- A $2.5 million increase in amortization of a regulatory asset related to conservation program initiatives.

Regulated Electric Utility Segment Operations

	Year Ended December 31			Change in 2010 Over 2009	Change in 2009 Over 2008
	2010	2009	2008		
Revenues	$1,338.9	$1,301.6	$1,328.9	2.9 %	(2.1)%
Fuel and purchased power costs	563.9	584.5	651.5	(3.5)%	(10.3)%
Margins	775.0	717.1	677.4	8.1 %	5.9 %
Operating and maintenance expense	417.2	392.0	375.3	6.4 %	4.4 %
Restructuring expense	(0.3)	8.6	-	N/A	N/A
Depreciation and amortization expense	94.7	90.3	84.3	4.9 %	7.1 %
Taxes other than income taxes	45.6	46.6	44.3	(2.1)%	5.2 %
Operating income	217.8	179.6	173.5	21.3 %	3.5 %
Miscellaneous income	1.5	4.8	6.0	(68.8)%	(20.0)%
Interest expense	(43.9)	(41.6)	(36.7)	5.5 %	13.4 %
Other expense	(42.4)	(36.8)	(30.7)	15.2 %	19.9 %
Income before taxes	$175.4	$142.8	$142.8	22.8 %	- %
Sales in kilowatt-hours					
Residential	3,114.3	3,043.0	3,064.5	2.3 %	(0.7)%

Commercial and industrial	8,439.6	8,155.5	8,632.8	3.5 %	(5.5)%
Wholesale	4,994.7	5,079.1	4,764.6	(1.7)%	6.6 %
Other	39.1	40.0	42.6	(2.3)%	(6.1)%
Total sales in kilowatt-hours	16,587.7	16,317.6	16,504.5	1.7 %	(1.1)%
Weather – WPS:					
Heating degree days	7,080	7,962	7,969	(11.1)%	(0.1)%
Cooling degree days	616	274	464	124.8 %	(40.9)%
Weather – UPPCO:					
Heating degree days	8,002	9,317	9,348	(14.1)%	(0.3)%
Cooling degree days	301	99	138	204.0 %	(28.3)%

2010 Compared with 2009

Revenues

Regulated electric utility segment revenues increased $37.3 million year over year, driven by:

- The approximate $21 million combined positive impact of retail electric rate increases at both WPS and UPPCO, effective January 1, 2010. These rate increases were necessary, in part, for recovery of higher operating expenses (as discussed below).

- An approximate $16 million increase in revenues due to a 7.5% increase in sales volumes to large commercial and industrial customers at WPS, primarily related to changes in the business operations of these customers year over year.

- An approximate $13 million increase in revenues due to a 2.7% increase in sales volumes to residential customers and a 0.9% increase in sales volumes to small commercial and industrial customers at WPS, primarily related to warmer year-over-year weather during the cooling season as evidenced by the increase in cooling degree days.

- An approximate $4 million increase in opportunity sales at WPS, made possible by the availability of low-cost energy from Weston 4.

- These increases in regulated electric utility segment revenues were partially offset by an approximate $18 million decrease in revenues from wholesale customers at WPS, primarily due to lower fuel costs. Fuel costs are passed directly through to wholesale customers in rates.

Margins

Regulated electric utility segment margins increased $57.9 million year over year, driven by:

- An approximate $26 million increase in margins driven by lower fuel and purchased power costs incurred during 2010 as compared with authorized fuel and purchased power cost recovery rates.

- The approximate $21 million combined positive impact of retail electric rate increases at both WPS and UPPCO, effective January 1, 2010.

- An approximate $7 million increase in margins due to a 2.7% increase in sales volumes to residential customers at WPS, primarily related to warmer year-over-year weather during the cooling season, as evidenced by the increase in cooling degree days. Margins were impacted by the year-over-year increase in sales volumes because WPS reached the annual $14.0 million electric decoupling cap in the second quarter of 2010 and 2009 and remained over the cap through the end of both years. Therefore, no additional decoupling deferral was allowed for additional shortfalls from authorized margin for the remainder of both years. Under decoupling, WPS is allowed to defer (up to the established cap) the difference between its actual margin and the rate case authorized margin recognized from residential and small commercial and industrial customers.

- An approximate $7 million increase in margins due to a 7.5% increase in sales volumes to large commercial and industrial customers at WPS, primarily related to changes in the business operations of these customers year over year.

- These increases in regulated electric utility segment margins were partially offset by an approximate $2 million decrease in margins from WPS's wholesale customers, primarily due to a decrease in sales volumes.

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Operating Income

Operating income at the regulated electric utility segment increased $38.2 million year over year, driven by the $57.9 million increase in margins, partially offset by a $19.7 million increase in operating expenses.

The year-over-year increase in operating expenses was the result of:

- A $13.9 million increase in electric transmission expense.

- A $12.7 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 $4.4 million increase in depreciation and amortization expense, primarily related to the Crane Creek Wind Farm being placed in service for accounting purposes in December 2009.

- A $3.9 million increase in stock-based compensation expense. See Note 20, "Stock-Based Compensation," for more information.

- A $3.6 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 on plan assets from prior years.

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

  - An $8.9 million year-over-year decrease in restructuring expenses related to a reduction in workforce. See Note 3, "Restructuring Expense," for more information.

  - A $6.2 million decrease in labor costs, driven by the reduction in workforce and company-wide furloughs implemented as part of previously announced cost management efforts.

  - A $2.1 million decrease in electric maintenance expense at WPS, primarily related to a greater number of planned outages at its generation plants during 2009 compared with 2010.

Other Expense

Other expense at the regulated electric utility segment increased $5.6 million year over year, driven by a decrease in AFUDC, primarily related to the construction of the Crane Creek Wind Farm in 2009.

2009 Compared with 2008

Revenues

Regulated electric utility segment revenues decreased $27.3 million year over year, driven by:

- A 5.5% decrease in commercial and industrial sales volumes and a 0.7% decrease in residential sales volumes, which resulted in an approximate $23 million year-over-year decrease in revenues, after the impact of decoupling. The primary drivers of the decrease were:

  - An approximate $31 million year-over-year decrease due to lower demand related to changes in commercial and industrial customers' plant operations, which Integrys Energy Group attributed mainly to the general economic slowdown.

  - An approximate $6 million decrease primarily related to cooler year-over-year weather during the cooling season as evidenced by the decrease in cooling degree days at both WPS and UPPCO.

- These decreases in volumes were partially offset by the $14.0 million impact that decoupling, which went into effect on January 1, 2009, had on WPS's revenue. The four-year pilot program for electric decoupling has an annual $14.0 million cap for the deferral of any excess or shortfall from the rate case authorized margin. This cap was reached during the second quarter of 2009; therefore, no additional decoupling deferral was allowed for additional shortfalls from authorized margin for the second half of the year.

· An approximate $22 million year-over-year reduction in revenues related to refunds due to customers in both 2009 and 2008 related to WPS's over-collection of fuel costs. On April 23, 2009, the PSCW made 2009 fuel cost recovery subject to refund, effective April 25, 2009, as actual and projected fuel costs for the remainder of the year were estimated to be below the 2% fuel window. See Note 24, "Regulatory Environment," for more information on WPS's fuel window.

· An approximate $14 million year-over-year decrease in opportunity sales driven by lower demand and the availability of lower cost power from the MISO market.

· These decreases in regulated electric utility segment revenues were partially offset by:

- An approximate $19 million increase in revenues driven by higher wholesale volumes due to an increase in contracted sales volumes to a large wholesale customer and an increase in the wholesale demand rate, effective January 1, 2009, to recover costs related to Weston 4.

- An approximate $15 million increase in revenues from the combined effect of the July 4, 2008 fuel surcharge, a portion of which was incorporated into WPS's 2009 non-fuel base retail electric rates, and the full year's benefit of the 2008 retail electric rate increase, effective January 16, 2008, for WPS.

Margins

The regulated electric utility segment margins increased $39.7 million year over year, driven by:

· An approximate $20 million year-over-year increase in margins from wholesale customers related to increases in contracted sales volumes with an existing customer and an increase in the wholesale demand rate, effective January 1, 2009, to recover costs related to Weston 4.

· An approximate $14 million year-over-year increase in margins from the combined effect of the July 4, 2008 fuel surcharge, a portion of which was incorporated into WPS's 2009 non-fuel base retail electric rates, and the full year's benefit of the 2008 retail electric rate increase, effective January 16, 2008, for WPS.

· An approximate $11 million year-over-year increase in WPS's regulated electric utility margins due to fuel and purchased power costs that were approximately $12 million lower than what was recovered in rates during 2009, compared with fuel and purchased power costs that were approximately $1 million lower than what was recovered in rates during

2008.

- The increase in margins was partially offset by an approximate $4 million year-over-year decrease in margin, after the impact of the WPS decoupling mechanism, caused by a 4.3% year-over-year decrease in sales volumes to residential and commercial and industrial customers. The $14.0 million impact of decoupling partially offset the approximate $18 million decrease in margins due to lower sales volumes, which was attributed to the general economic slowdown and cooler year-over-year weather during the cooling season.

Operating Income

Operating income at the regulated electric utility segment increased $6.1 million year over year, driven by the $39.7 million increase in margins, partially offset by a $33.6 million increase in operating expenses.

The year-over-year increase in operating expenses was driven by:

- $8.6 million in restructuring expenses related to a reduction in workforce. See Note 3, "Restructuring Expense," for more information.

- An $8.2 million increase in electric maintenance expenses at WPS, primarily related to a greater number of planned outages at the generation plants during 2009, compared with 2008.

- An $8.1 million increase in employee benefit costs, primarily related to an increase in pension expense driven partially by negative pension investment returns in 2008, as well as higher health care expenses in 2009.

- A $5.6 million increase in depreciation and amortization expense at WPS, primarily related to Weston 4 being placed in service for accounting purposes in April 2008.

Other Expense

Other expense at the regulated electric utility segment increased $6.1 million year over year, driven by:

- A $4.9 million increase in interest expense, primarily related to increased long-term borrowings at WPS in December 2008. The additional borrowings were utilized to fund various construction projects, most notably the Crane Creek wind generation project in Iowa.

- A $2.5 million decrease in interest earned on the transmission facilities WPS funded on ATC's behalf. WPS was reimbursed by ATC for these transmission facilities in April 2008.

Electric Transmission Investment Segment Operations

2010 Compared with 2009

Miscellaneous Income

Miscellaneous income at the electric transmission investment segment increased $2.3 million during 2010, compared with 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 increased investment in transmission equipment and facilities for improved reliability.

2009 Compared with 2008

Miscellaneous Income

Miscellaneous income at the electric transmission investment segment increased $9.2 million during 2009 compared with 2008, 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 increased investment in transmission equipment and facilities for improved reliability.

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Integrys Energy Services Nonregulated Segment Operations

(Millions, except natural gas sales volumes)	Year Ended December 31 2010		2009 (3)	2008	Change in 2010 Over 2009	Change in 2009 Over 2008
Revenues	$1,823.7		$3,994.0	$9,735.2	(54.3)%	(59.0)%
Cost of fuel, natural gas, and purchased power	1,614.3		3,696.1	9,649.5	(56.3)%	(61.7)%
Margins	209.4		297.9	85.7	(29.7)%	247.6%
Margin Detail						
Realized retail electric margins	85.4	(1)	82.0	62.3	4.1%	31.6%
Realized wholesale electric margins	(8.2)	(2)	40.3	30.9	N/A	30.4%
Realized energy asset margins	34.5		37.9	28.5	(9.0)%	33.0%
Fair value adjustments	36.0		29.9	(137.4)	20.4%	N/A
Electric and other margins	147.7		190.1	(15.7)	(22.3)%	N/A
Realized retail natural gas margins	50.0		68.7	51.5	(27.2)%	33.4%
Realized wholesale natural gas margins	(3.3)		40.8	64.1	N/A	(36.3)%
Lower-of-cost-or-market inventory adjustments	6.8		155.4	(167.3)	(95.6)%	N/A
Fair value adjustments	8.2		(157.1)	153.1	N/A	N/A
Natural gas margins	61.7		107.8	101.4	(42.8)%	6.3%
Operating and maintenance expense	117.6		188.6	181.2	(37.6)%	4.1%
Impairment losses on property, plant, and equipment	43.2		0.7	0.5	6,071.4%	40.0%
Restructuring expense	8.3		27.2	-	(69.5)%	N/A
Net loss on Integrys Energy Services' dispositions related to strategy change	14.1		28.9	-	(51.2)%	N/A
Depreciation and amortization	17.2		19.0	14.5	(9.5)%	31.0%
Taxes other than income taxes	5.0		7.4	7.8	(32.4)%	(5.1)%
Operating income (expense)	4.0		26.1	(118.3)	(84.7)%	N/A
Miscellaneous income	9.1		6.0	8.7	51.7%	(31.0)%
Interest expense	(6.7)		(13.1)	(12.1)	(48.9)%	8.3%
Other income (expense)	2.4		(7.1)	(3.4)	N/A	108.8%
Income (loss) before taxes	$6.4		$19.0	$(121.7)	(66.3)%	N/A
Physically settled volumes						
Retail electric sales volumes in kwh	12,647.9		15,045.3	16,561.3	(15.9)%	(9.2)%
Wholesale electric sales volumes in kwh	1,319.9		3,965.2	4,634.1	(66.7)%	(14.4)%
Retail natural gas sales volumes in bcf	133.3		236.7	336.0	(43.7)%	(29.6)%
Wholesale natural gas sales volumes in bcf	27.5		402.5	594.9	(93.2)%	(32.3)%

kwh – kilowatt-hours
bcf – billion cubic feet

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

(2) This amount includes negative margin of $9.3 million related to the settlement of wholesale supply contracts in connection with Integrys Energy Services' strategy change.

(3) Certain amounts have been retrospectively adjusted due to a change in accounting policy in the fourth quarter of 2010. See Note 1(d), "Change in Accounting Policy," for more information.

2010 Compared with 2009

Revenues

Revenues decreased $2,170.3 million during 2010, compared with 2009, as a result of Integrys Energy Group's decision to reduce the scale, scope, and risk attributes of Integrys Energy Services by focusing on selected retail electric and natural gas markets in the United States and investments in energy assets with renewable attributes. See Note 4, "Dispositions," for a discussion of the dispositions completed in connection with Integrys Energy Services' strategy change. Also contributing to the decrease in revenues were lower energy prices, as the average market price of natural gas and electricity decreased approximately 7% and 4% respectively, year over year.

Margins

Integrys Energy Services' margins decreased $88.5 million during 2010, compared with 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 increased $3.4 million during 2010, compared with 2009, driven by:

A $9.2 million increase in margins in the Illinois market, primarily driven by a change in pricing methodology and customer mix that was implemented as part of Integrys Energy Services' strategy change.

A $5.5 million increase in margins in the Michigan market. This increase was driven by higher sales volumes due to increased marketing efforts.

The above increases in realized retail electric margins were partially offset by a $9.0 million decrease in margins related to the sale of the Texas retail electric business in June 2010, driven by reduced sales volumes and a $1.4 million decrease related to the settlement of supply contracts. See Note 4, "Dispositions," for a discussion of this sale.

Realized wholesale electric margins

Realized wholesale electric margins decreased $48.5 million year over year, including negative margins of $9.3 million in 2010 related to the settlement of wholesale supply contracts in connection with Integrys Energy Services' strategy change. 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, which was completed in February 2010. See Note 4, "Dispositions," for more information on Integrys Energy Services' sale of its United States wholesale electric marketing and trading business.

Fair value adjustments

Integrys Energy Services' electric margins from fair value adjustments increased $6.1 million year over year. Fair value adjustments required under derivative accounting rules primarily relate to derivative electric supply contracts used to economically hedge risks associated with electric sales contracts.

Natural Gas Margins

Realized retail natural gas margins

Realized retail natural gas margins decreased $18.7 million during 2010, compared with 2009, driven by:

A $7.6 million decrease driven by reduced sales volumes due to the sale of Integrys Energy Services' Canadian retail natural gas portfolio in September 2009. See Note 4, "Dispositions," for a discussion of this sale.

A $7.5 million decrease in margins in the Illinois market, primarily due to the negative year-over-year impact of the withdrawal of a significant amount of natural gas from storage in the first half of 2009, resulting in higher realized margins during that period. Also contributing to the decrease were lower sales volumes resulting from Integrys Energy Services' strategy change.

Realized wholesale natural gas margins

Realized wholesale natural gas margins decreased $44.1 million year over year due to Integrys Energy Services completing the sale of substantially all of its wholesale natural gas business in December 2009. Additional components of the wholesale natural gas business were sold in March 2010 and May 2010. The remaining realized wholesale natural gas activity at Integrys Energy Services is related to residual contracts that will settle in the first half of 2011. The risks associated with these residual contracts are economically hedged. See Note 4, "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 $148.6 million year over year decrease in margins from lower-of-cost-or-market inventory adjustments was driven by a lower volume of inventory withdrawn from storage in 2010 for which write-downs had previously been recorded.

Fair value adjustments

Integrys Energy Services' natural gas margins from fair value adjustments increased $165.3 million year over year. 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 decreased $22.1 million year over year, driven by the $88.5 million decrease in margins discussed above, and a $43.2 million noncash impairment loss related to three natural gas-fired generation plants in the third quarter of 2010. These decreases were partially offset by a $71.0 million decrease in operating and maintenance expense, an $18.9 million decrease in restructuring expense, and a $14.8 million decrease in the net loss on Integrys Energy Services' dispositions related to its 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 $46.0 million year-over-year decrease in employee payroll and benefit related expenses, primarily due to the reduction in workforce associated with Integrys Energy Services' strategy change.

- A $10.5 million year-over-year decrease in bad debt expense driven by the partial recovery in 2010 of receivables fully reserved in prior years, and a decrease in reserves resulting from reduced business activity.

- The $9.0 million positive year-over-year 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 $8.0 million year-over-year decrease in broker commissions, contractor expenses, and various other fees, resulting from reduced business activity associated with Integrys Energy Services' strategy change.

The above decreases in operating and maintenance expense were partially offset by $8.1 million of intercompany fees related to a credit agreement established in 2010 with the holding company.

Other Income (Expense)

Integrys Energy Services' other income increased $9.5 million year over year, driven by a $4.3 million gain reclassified from accumulated other comprehensive income in 2010 related to foreign currency translation adjustments recorded in prior periods, as well as a $6.4 million decrease in interest expense driven by reduced business size, as a result of Integrys Energy Services' strategy change.

2009 Compared with 2008

Revenues

- Revenues decreased $5,741.2 million in 2009, compared with 2008, primarily due to:
  - Lower energy prices, as the average market price of natural gas and electricity decreased approximately 45% and 40% year over year, respectively.
  - Lower sales volumes, as wholesale transactions were scaled back in conjunction with the global credit crisis in the latter half of 2008 and Integrys Energy Services' strategy change and ultimate decision to exit its wholesale natural gas and electric businesses.

Margins

Integrys Energy Services' margins increased $212.2 million in 2009, compared with 2008. The significant items contributing to the change in margin were as follows:

Electric and Other Margins

Realized retail electric margins

The realized retail electric margin increased $19.7 million year over year, driven by:

A $14.1 million increase in the more mature markets, such as Illinois and New York, as Integrys Energy Services realized the benefits of including higher capital costs in its pricing in the first half of the year.

A $6.5 million increase from operations in the Texas market. This increase was a result of the positive year-over-year impact of lower ancillary service costs compared to the prior year and the effects of Hurricane Ike in the third quarter of 2008. Hurricane Ike disrupted the electric infrastructure in Texas for a period of time, causing some of Integrys Energy Services' customers to be without electricity or buy only a fraction of their normal energy usage during that period.

Realized wholesale electric margins

Realized wholesale electric margins increased $9.4 million year over year. In general, realized margins are impacted by transaction activity in prior periods, as Integrys Energy Services recognizes realized margin when the contracts actually settle, which typically occurs over a 12- to 24-month period from the time the contract was actually entered into. In 2009, realized margins benefited from the settlement of contracts that were entered into prior to the

implementation of Integrys Energy Services' strategy change.

Wholesale transactions and structured origination activity were scaled back in conjunction with the global credit crisis in the latter half of 2008 and continued to be scaled back with Integrys Energy Services' strategy change and ultimate decision to exit its wholesale electric business.

Fair value adjustments

Integrys Energy Services' electric margins from fair value adjustments increased $167.3 million year over year. Fair value adjustments required under derivative accounting rules primarily relate to derivative electric supply contracts used to economically hedge risks associated with electric sales contracts. The fair value adjustments recorded in 2009 include margin reductions of $2.0 million related to the settlement of derivative contracts entered into with the purchaser of the Canadian electric power portfolio, as discussed in Note 4, "Dispositions."

Natural Gas Margins

Realized retail natural gas margins

Realized retail natural gas margins increased $17.2 million, due to Integrys Energy Services' withdrawal of a significant amount of natural gas during 2009 in order to improve its liquidity position, recognizing realized gains on these natural gas storage withdrawals. Also, per-unit retail natural gas margins were higher year over year as more recently contracted sales commitments reflect increased business risk and financing costs in the pricing. Offsetting the increase was a decrease in Integrys Energy Services' natural gas sales volumes year over year. Integrys Energy Services significantly reduced the number of natural gas storage transactions entered into as Integrys Energy Group implemented its strategy change for its nonregulated energy services business segment.

Realized wholesale natural gas margins

Realized wholesale natural gas margins decreased $23.3 million year over year. Wholesale natural gas transactions were scaled back in conjunction with the global credit crisis in the latter half of 2008 and Integrys Energy Services' strategy change and ultimate decision to exit its wholesale natural gas business. The reduced activity had a negative impact on realized margins in 2009.

Lower-of-cost-or-market inventory adjustments

The combination of lower-of-cost-or-market inventory write-downs and withdrawals of natural gas from storage for which write-downs had previously been recorded resulted in a $322.7 million year-over-year increase in natural gas margins. The average market price of natural gas decreased approximately 5% during 2009 and decreased approximately 22% during 2008, driving a positive year-over-year change in natural gas margins of $129.2 million related to lower-of-cost-or-market inventory write-downs. The natural gas withdrawn from storage and sold to customers in 2009 had a $193.5 million lower cost basis as a result of lower-of-cost-or-market inventory write-downs recorded in prior periods.

Fair value adjustments

Integrys Energy Services' natural gas margins from fair value adjustments decreased $310.2 million year over year. 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. The fair value adjustments recorded in 2009 include a net increase in margin of $14.4 million related to the settlement of derivative contracts entered into with the purchasers of the wholesale natural gas marketing business and the Canadian natural gas portfolio, as discussed in Note 4, "Dispositions."

Operating Income (Loss)

Integrys Energy Services' operating income increased $144.4 million year over year. This increase resulted from the $212.2 million increase in margin discussed above, partially offset by losses of $28.9 million related to dispositions completed in connection with the strategy change; $27.2 million of restructuring expenses, which included employee-related costs, the write-off of capitalized development costs related to software that will not be utilized because of the restructuring, and consulting and legal fees; a $7.4 million increase in operating and maintenance expense; and a $4.5 million increase in depreciation and amortization expense primarily related to renewable energy asset additions.

The increase in operating and maintenance expense was driven by a one-time $9.0 million novation fee related to an agreement with a counterparty that enabled Integrys Energy Services to reduce collateral support requirements.

See Note 3, "Restructuring Expense," for a discussion of restructuring charges.

Holding Company and Other Segment Operations

(Millions)	Year Ended December 31 2010	2009	2008	Change in 2010 Over 2009	Change in 2009 Over 2008
Operating income (loss)	$8.3	$(1.9)	$(0.7)	N/A	171.4%
Other expense	(45.9)	(58.1)	(53.2)	(21.0)%	9.2%
Net loss before taxes	$(37.6)	$(60.0)	$(53.9)	(37.3)%	11.3%

2010 Compared with 2009

Operating Income (Loss)

Operating income at the holding company and other segment increased $10.2 million, driven by $8.1 million of intercompany fees charged by the holding company to Integrys Energy Services related to a credit agreement established in 2010.

Other Expense

Other expense at the holding company and other segment decreased $12.2 million, driven by a $14.6 million decrease in external interest expense.

2009 Compared with 2008

Operating Income (Loss)

Operating loss at the holding company and other segment increased $1.2 million during 2009 compared with 2008, driven by restructuring expenses related to Integrys Energy Group's reduction in workforce, and by a decrease in operating income from MERC's nonutility home services business.

Other Expense

Other expense at the holding company and other segment increased $4.9 million during 2009 compared with 2008, driven by a $4.3 million increase in interest expense at the holding company primarily due to an increase in long-term borrowings in the second quarter of 2009 and an increase in the amortization of deferred financing fees related to credit facilities entered into in the second quarter of 2009 and the fourth quarter of 2008, partially offset by a decrease in interest expense on commercial paper.

Provision for Income Taxes

	Year Ended December 31					
	2010		2009	*	2008	*
Effective Tax Rate	39.9	%	624.6	%	34.7	%

* Percentages have been retrospectively adjusted due to a change in accounting policy in 2010. See Note 1(d), "Change in Accounting Policy," for more information.

2010 Compared with 2009

The effective tax rate for 2010 decreased compared with 2009 primarily because a significant portion of Integrys Energy Group's $291.1 million noncash pre-tax goodwill impairment loss recorded in 2009 was not deductible for tax purposes. Also contributing to the change in the year-over-year 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 this legislation, Integrys Energy Group expensed $10.8 million of noncash deferred income tax benefits during 2010, which were previously recognized as a reduction in the provision for income taxes. This amount excluded $1.0 million for which UPPCO was authorized recovery from ratepayers.

2009 Compared with 2008

The effective tax rate for 2009 increased compared with 2008 primarily because a significant portion of Integrys Energy Group's $291.1 million noncash pre-tax goodwill impairment loss was not deductible for tax purposes. Although Integrys Energy Group had $13.4 million of income before taxes for 2009, it recorded an $83.7 million provision for income taxes because $186.2 million of the total pre-tax goodwill impairment loss was not deductible for income tax purposes.

Discontinued Operations, Net of Tax

2010 Compared with 2009

Income from discontinued operations, net of tax, decreased $2.6 million in 2010 compared with 2009.

During 2009, Integrys Energy Services recognized a $3.9 million ($2.4 million after tax) gain on the sale of its energy management consulting business in discontinued operations. During 2010, Integrys Energy Services recorded a $0.2 million after-tax gain in discontinued operations when contingent payments were earned related to the sale of this business.

2009 Compared with 2008

Income from discontinued operations, net of tax, decreased $1.9 million in 2009 compared with 2008.

During 2009, Integrys Energy Services completed the sale of its energy management consulting business. The gain on the sale of this business recorded in discontinued operations was $3.9 million ($2.4 million after tax).

During 2008, Integrys Energy Services recognized a $6.3 million ($3.8 million after tax) gain on the sale of its subsidiary, Mid-American Power, LLC, in discontinued operations when a contingent payment was earned.

For more information on the discontinued operations discussed above, see Note 4, "Dispositions," and Note 25, "Segments of Business."

BALANCE SHEET

Cash and cash equivalents increased $134.5 million, from $44.5 million at December 31, 2009, to $179.0 million at December 31, 2010. For a detailed explanation of the change in the cash and cash equivalents balance, see "Liquidity and Capital Resources."

Collateral on deposit decreased $151.6 million (82.0%), from $184.9 million at December 31, 2009, to $33.3 million at December 31, 2010. Collateral on deposit at Integrys Energy Services decreased $155.9 million, driven by reduced business size as a result of its strategy change.

At December 31, 2010, compared to December 31, 2009, total assets from risk management activities decreased $1,991.2 million (85.9%) and total liabilities from risk management activities decreased $2,000.9 million (83.7%). At Integrys Energy Services, total assets from risk management activities decreased $1,988.0 million and total liabilities from risk management activities decreased $2,000.0 million, driven by reduced business size as a result of its strategy change.

Detailed explanations for changes in the short-term and long-term debt balances year over year are included in Note 11, "Short-Term Debt and Lines of Credit," and Note 12, "Long-Term Debt."

Detailed explanations for changes in the deferred income taxes balances year over year are included in Note 14, "Income Taxes."

Asset retirement obligations increased $126.1 million (64.7%) from $194.8 million at December 31, 2009, to $320.9 million at December 31, 2010. Asset retirement obligations increased $123.7 million at PGL due to revisions made to estimated cash flows related to asset retirement obligations for natural gas distribution pipes. See Note 13, "Asset Retirement Obligations," for more information.

LIQUIDITY AND CAPITAL RESOURCES

Integrys Energy Group believes that its cash balances, liquid assets, operating cash flows, access to equity and debt capital markets, and available borrowing capacity provide adequate resources to fund ongoing operating requirements and future capital expenditures related to expansion of existing businesses and development of new projects. Integrys Energy Group's borrowing costs can be impacted by short-term and long-term debt ratings assigned by independent credit rating agencies, as well as the market rates for interest. Integrys Energy Group's operating cash flows and access to capital markets can be impacted by macroeconomic factors outside of its control.

Operating Cash Flows

2010 Compared with 2009

Net cash provided by operating activities was $725.2 million during 2010, compared with $1,606.3 million during 2009. The $881.1 million year-over-year decrease in net cash provided by operating activities was mainly driven by:

- A $746.5 million net decrease in cash provided by working capital, driven by:
  - A $767.2 million year-over-year decrease in cash generated from customer collections, primarily due to the Integrys Energy Services strategy change, as well as lower year-over-year natural gas prices, which impacted both the regulated natural gas segment and Integrys Energy Services.

- A $393.0 million year-over-year decrease in cash generated from reduced inventory levels, mainly the result of the withdrawal of a significant amount of natural gas from storage at Integrys Energy Services during 2009 in order to improve its liquidity position.

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- Partially offsetting these changes was a $578.9 million year-over-year decrease in cash used to pay accounts payable balances, driven by smaller accounts payable balances at Integrys Energy Services as a result of the strategy change, as well as lower year-over-year natural gas prices.

- Also offsetting these changes was a year-over-year increase in cash flows of $118.1 million due to a decrease in cash collateral provided to counterparties, due primarily to the change in Integrys Energy Services' business related to its strategy change.

· A $175.8 million year-over-year increase in deferred income taxes and investment tax credits, primarily driven by a change in tax accounting related to capitalization of overhead costs and legislation providing for bonus depreciation during 2010.

· A $148.5 million year-over-year increase in contributions to pension and other postretirement benefit plans.

2009 Compared with 2008

Net cash provided by operating activities was $1,606.3 million during 2009, compared with net cash used for operating activities of $250.0 million during 2008. The $1,856.3 million year-over-year increase in net cash provided by operating activities was mainly driven by a $1,734.8 million decrease in working capital requirements, partially due to a $444.1 million decrease in inventories during 2009, compared with a $312.0 million increase in inventories during 2008. This change was primarily a result of an increase in natural gas withdrawn from storage in 2009 due to the previously announced strategy change at Integrys Energy Services, as well as lower year-over-year natural gas prices. Also contributing to the decrease in working capital requirements was an $864.8 million decrease in accounts receivables and accrued unbilled revenues during 2009, compared with a $207.7 million increase in accounts receivables and accrued unbilled revenues during 2008, primarily the result of lower natural gas prices and the Integrys Energy Services strategy change. Additionally, during 2009, Integrys Energy Group had a $45.5 million net return of margin from various exchanges, compared with the net payment of $239.2 million of margin posted to various exchanges during 2008, primarily due to the strategy change. Partially offsetting these changes was a $604.7 million decrease in accounts payable during 2009, compared with a $53.2 million decrease in accounts payable during 2008, primarily the result of lower natural gas prices.

Investing Cash Flows

2010 Compared with 2009

Net cash used for investing activities was $199.7 million during 2010, compared with $440.7 million during 2009. The $241.0 million year-over-year decrease in net cash used for investing activities was primarily driven by a $185.4 million year-over-year decrease in cash used to fund capital expenditures (discussed below), as well as a $27.2 million year-over-year decrease in capital contributions to equity method investments during 2010, mainly related to ATC capital contributions. Also contributing to the year-over-year decrease in net cash used for investing activities was a year-over-year increase in proceeds received from the sale or disposal of assets, primarily related to Integrys Energy Services' strategy change. For more information on these dispositions, see Note 4, "Dispositions."

2009 Compared with 2008

Net cash used for investing activities was $440.7 million during 2009, compared with $452.2 million during 2008. The $11.5 million year-over-year decrease in net cash used for investing activities was primarily driven by the $88.6 million decrease in cash used to fund capital expenditures (discussed below) and the payment of $17.4 million in 2008 related to WPS's funding of the construction of the transmission facilities required to support Weston 4, partially offset by the 2008 reimbursement of $99.7 million from ATC related to WPS's construction of the transmission facilities required to support Weston 4.

Capital Expenditures

Capital expenditures by business segment for the years ended December 31 were as follows:

Reportable Segment (millions)	2010	2009	2008
Electric utility	$87.2	$250.4	$207.4
Natural gas utility	133.6	136.9	237.3
Integrys Energy Services	15.2	22.4	68.1
Holding company and other	22.8	34.5	20.0
Integrys Energy Group consolidated	$258.8	$444.2	$532.8

The decrease in capital expenditures at the electric utility segment in 2010 compared with 2009 was primarily due to decreased expenditures related to the Crane Creek Wind Farm project, which was placed in service for accounting purposes in December 2009. The decrease in capital expenditures at the holding company and other segment was mainly due to lower expenditures in 2010 related to software projects.

The increase in capital expenditures at the electric utility segment in 2009 compared with 2008 was primarily due to the Crane Creek Wind Farm project, partially offset by the year-over-year decrease in capital expenditures associated with Weston 4. The decrease in capital expenditures at the natural gas utility segment in 2009 compared with 2008 was primarily due to a decrease in costs related to the construction of natural gas laterals that connected WPS's natural gas distribution system to the Guardian II natural gas pipeline, which was completed in February 2009. The decrease in capital expenditures at Integrys Energy Services in 2009 compared with 2008 was primarily driven by fewer expenditures related to renewable energy projects in 2009 compared with 2008.

Financing Cash Flows

2010 Compared with 2009

Net cash used for financing activities was $391.4 million during 2010, compared with $1,378.4 million during 2009. The $987.0 million year-over-year decrease in net cash used for financing activities was primarily driven by:

- A $761.5 million year-over-year decrease in the net repayment of short-term borrowings.

- A $298.6 million decrease due to net natural gas loan proceeds at Integrys Energy Services of $15.4 million during 2010, compared with the net repayment of $283.2 million of natural gas loans during 2009.

- Partially offsetting these changes were $157.8 million of payments made during 2010 to buyers of the wholesale natural gas and electric businesses and payments for settlement of out-of-the-money transactions that were executed at the time of sale, compared with $33.9 million of proceeds received upon the sale of substantially all of the wholesale natural gas business during 2009. The out-of-the-money transactions were replacement supply trades for the retained retail operations and were transacted at the original transfer price between Integrys Energy Services' wholesale and retail businesses. Payments made to the buyers to settle the replacement supply contracts were funded with proceeds received from the settlement of the related retail electric and retail natural gas sales contracts.

2009 Compared with 2008

Net cash used for financing activities was $1,378.4 million during 2009, compared with net cash provided by financing activities of $911.3 million during 2008. The $2,289.7 million year-over-year increase in net cash used for financing activities was primarily driven by $973.6 million of net repayments of short-term debt and notes payable in 2009, compared with $725.4 million of net short-term and notes payable borrowings in 2008. The repayments in 2009 were made possible by the increase in net cash provided by operating activities. Also, as a result of the previously announced strategy change at Integrys Energy Services, fewer structured natural gas loan agreements were entered into in 2009, compared with 2008, resulting in a $368.4 million year-over-year decrease in proceeds from the sale of borrowed natural gas. Additionally, Integrys Energy Services had a $188.0 million year-over-year increase in the purchase of natural gas to repay structured natural gas loan agreements, many of which were entered into in 2008.

Significant Financing Activities

The quarterly common stock dividend per share in 2010 remained the same as in 2009. In February 2009, Integrys Energy Group increased its quarterly common stock dividend to 68 cents per share.

Beginning February 11, 2010, Integrys Energy Group issued new shares of common stock to meet the requirements of its Stock Investment Plan, Dividend Reinvestment Plan, and certain stock-based employee benefit and compensation plans. From January 1, 2010 to February 10, 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 no outstanding commercial paper borrowings at December 31, 2010, and $212.1 million at December 31, 2009. Integrys Energy Group had short-term notes payable outstanding of $10.0 million at December 31, 2010, and 2009. Integrys Energy Group had no borrowings under revolving credit facilities at December 31, 2010, and 2009. See Note 11, "Short-Term Debt and Lines of Credit," for more information.

For information on the issuance and redemption of long-term debt at Integrys Energy Group and its subsidiaries, see Note 12, "Long-Term Debt."

Credit Ratings

Integrys Energy Group uses internally generated funds, commercial paper borrowings, and other short-term borrowings to satisfy most of its capital requirements. Integrys Energy Group also periodically issues long-term debt and common stock to reduce short-term debt, maintain desired capitalization ratios, and fund future growth.

Integrys Energy Group, WPS, and PGL have their own commercial paper borrowing programs.

WPS periodically issues long-term debt and receives equity contributions from Integrys Energy Group to reduce short-term debt, fund future growth, and maintain capitalization ratios as authorized by the PSCW.

PGL and NSG periodically issue long-term debt in order to reduce short-term debt, refinance maturing securities, maintain desired capitalization ratios, and fund future growth. The specific forms of long-term financing, amounts, and timing depend on business needs, market conditions, and other factors.

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

Credit Ratings	Standard & Poor's	Moody's
Integrys Energy Group		
Issuer credit rating	BBB+	N/A
Senior unsecured debt	BBB	Baa1
Commercial paper	A-2	P-2
Credit facility	N/A	Baa1
Junior subordinated notes	BBB-	Baa2
WPS		
Issuer credit rating	A-	A2
First mortgage bonds	N/A	Aa3
Senior secured debt	A	Aa3
Preferred stock	BBB	Baa1
Commercial paper	A-2	P-1
Credit facility	N/A	A2
PGL		
Issuer credit rating	BBB+	A3
Senior secured debt	A-	A1
Commercial paper	A-2	P-2
NSG		
Issuer credit rating	BBB+	A3
Senior secured debt	A	A1

Credit ratings are not recommendations to buy or sell securities and are subject to change, and each rating should be evaluated independently of any other rating.

On January 21, 2011, Standard & Poor's revised the outlook for Integrys Energy Group, PGL, and NSG to "positive" from "stable." According to Standard & Poor's, the revised outlook reflects their view that there is at least a one-in-three probability that Integrys Energy Group will improve its business risk profile over the intermediate term and maintain its improved financial measures despite its increased capital spending. WPS's outlook remains "stable."

On May 27, 2010, Moody's revised the outlook for Integrys Energy Group and all of its subsidiaries to "stable" from "negative." According to Moody's, the revised outlook reflected a reduced business risk profile driven by the recently completed restructuring of Integrys Energy Services into a smaller segment with significantly reduced collateral requirements. Moody's also raised the following ratings of Integrys Energy Group's subsidiaries:

- The senior secured debt rating and first mortgage bonds rating of WPS were raised from "A1" to "Aa3."
- The senior secured debt ratings of PGL and NSG were raised from "A2" to "A1."

According to Moody's, the upgrade follows the August 2009 upgrade of the senior secured ratings of the majority of its investment grade regulated utilities (issuers with negative outlooks were excluded from the August 2009 upgrade).

Future Capital Requirements and Resources

Contractual Obligations

The following table shows the contractual obligations of Integrys Energy Group, including its subsidiaries, as of December 31, 2010.

	Payments Due By Period				
(Millions)	Total Amounts Committed	2011	2012 to 2013	2014 to 2015	2016 and Thereafter
Long-term debt principal and interest payments (1)	$ 3,634.9	$ 595.2	$ 770.2	$ 381.4	$ 1,888.1
Operating lease obligations	56.4	9.8	17.7	7.8	21.1
Commodity purchase obligations (2)	2,828.8	743.5	947.4	430.3	707.6
Purchase orders (3)	233.1	230.3	2.8	-	-
Pension and other postretirement funding obligations (4)	627.3	132.1	214.0	120.0	161.2
Uncertain tax positions (5)	3.3	3.3	-	-	-
Total contractual cash obligations	$ 7,383.8	$ 1,714.2	$ 1,952.1	$ 939.5	$ 2,778.0

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

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

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

(4) Obligations for pension and other postretirement benefit plans, other than the Integrys Energy Group Retirement Plan, cannot reasonably be estimated beyond 2013.

(5) The obligation for the liability of $27.1 million related to uncertain tax positions that extend beyond 2011 is not reflected in the table as the amount and timing of the payments are uncertain. See Note 14, "Income Taxes," for more information on uncertain tax positions.

The table above does not reflect any payments related to the manufactured gas plant remediation liability of $642.5 million at December 31, 2010, as the amount and timing of payments are uncertain. Integrys Energy Group anticipates incurring costs annually to remediate these sites, but 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. See Note 15, "Commitments and Contingencies," for more information about environmental liabilities.

Capital Requirements

As of December 31, 2010, capital expenditures by company for the three-year period 2011 through 2013 were anticipated to be as follows:

(Millions)	
WPS	
Environmental projects	$316.8
Electric and natural gas distribution projects	123.5
Electric and natural gas delivery and customer service projects	32.8
Other projects	123.9
UPPCO	
Repairs and safety measures at hydroelectric facilities	10.3
Other projects	36.1
MGU	
Natural gas pipe distribution system, underground natural gas storage facilities, and other projects	32.9
MERC	
Natural gas pipe distribution system and other projects	51.3
PGL	
Natural gas pipe distribution system, underground natural gas storage facilities, and other projects (1)	610.9
NSG	
Natural gas pipe distribution system and other projects	48.6
Integrys Energy Services	
Solar and other projects (2)	162.0
IBS	
Corporate services infrastructure projects	66.6
Total capital expenditures	$1,615.7

(1) Includes approximately $300 million of incremental expenditures related to the accelerated replacement of cast iron mains at PGL in 2011, 2012, and 2013. On January 21, 2010, the ICC approved a rider mechanism to allow PGL to recover these incremental costs. See Note 24, "Regulatory Environment," for more information.

(2) Includes approximately $90 million of equity capital expected to be contributed through 2012 to INDU Solar Holdings, LLC, which was created in October 2010 through wholly owned subsidiaries of both Integrys Energy Services and Duke Energy Generation Services to build and finance distributed solar projects throughout the United States.

Integrys Energy Group expects to provide additional capital contributions to ATC (not included in the above table) of approximately $10 million in 2011, $10 million in 2012, and $5 million in 2013.

All projected capital and investment expenditures are subject to periodic review and may vary significantly from the estimates depending on a number of factors, including, but not limited to, industry restructuring, regulatory constraints

and requirements, changes in tax laws and regulations, acquisition and development opportunities, market volatility, and economic trends.

Capital Resources

Management exercises discretion regarding the liquidity and capital resource needs of its business segments. This includes the ability to prioritize the use of capital and debt capacity, to determine cash management policies, to utilize risk management policies to hedge the impact of volatile commodity prices, and to make decisions regarding capital requirements. Integrys Energy Group plans to meet its capital requirements for the period 2011 through 2013 primarily through internally generated funds (net of forecasted dividend payments) and debt and equity financings. During 2011, approximately $900 million of Integrys Energy Group's revolving credit facilities will mature. It is the intent of management to renew a substantial portion of the maturing credit facilities before the end of the second quarter of 2011. Integrys Energy Group plans to maintain current debt to equity ratios at appropriate levels to support current credit ratings and corporate growth. Management believes Integrys Energy Group has adequate financial flexibility and resources to meet its future needs.

Under an existing shelf registration statement, Integrys Energy Group may issue debt, equity, certain types of hybrid securities, and other financial instruments. Specific terms and conditions of securities issued will be determined prior to the actual issuance of any specific security.

Under an existing shelf registration statement, WPS may issue up to $250.0 million of senior debt securities with amounts, prices, and terms to be determined at the time of future offerings. In December 2008, WPS issued $125.0 million of 6.375%, 7-year Senior Notes under this shelf registration statement.

At December 31, 2010, Integrys Energy Group and each of its subsidiaries were in compliance with all respective covenants related to outstanding short-term and long-term debt and expect to be in compliance with all such debt covenants for the foreseeable future.

See Note 11, "Short-Term Debt and Lines of Credit," for more information on Integrys Energy Group's credit facilities and other short-term credit agreements, including short-term debt covenants. See Note 12, "Long-Term Debt," for more information on Integrys Energy Group's long-term debt and related covenants.

Other Future Considerations

Decoupling

In certain jurisdictions, decoupling mechanisms have been implemented, which allow utilities to adjust rates going forward to recover or refund all or a portion of the differences between the actual and authorized margin per customer impact of variations in volumes. The mechanisms do not adjust for changes in volume resulting from changes in customer count. Decoupling for residential and small commercial and industrial sales was approved by the ICC on a four-year trial basis for PGL and NSG, effective March 1, 2008. Interveners, including the Illinois Attorney General, oppose decoupling and have appealed the ICC's approval. PGL and NSG actively support the ICC's decision to approve decoupling. Included in their February 15, 2011 rate case filing, PGL and NSG requested that decoupling be approved on a permanent basis. The PSCW approved the implementation of decoupling on a four-year trial basis, effective January 1, 2009, for WPS's natural gas and electric residential and small commercial sales. This decoupling mechanism includes an annual $14.0 million cap for electric service and an annual $8.0 million cap for natural gas service. Decoupling for UPPCO was approved for all customer groups by the MPSC, effective January 1, 2010. The MPSC granted an order, effective January 1, 2010, approving a decoupling mechanism for MGU as a pilot program which adjusts for the impact on revenues of changes in weather-normalized use per customer for residential and small commercial customers, but does not adjust for weather-related usage. In Minnesota, MERC proposed a decoupling mechanism in its November 30, 2010 general rate case filing. See Note 24, "Regulatory Environment," for more information.

Impairment Testing

Integrys Energy Group performs its required annual goodwill impairment tests each April 1. Interim impairment tests are performed between required annual testing dates when impairment indicators are present. Any annual or interim goodwill impairment test could result in the recognition of a goodwill impairment loss. See Note 9, "Goodwill and Other Intangible Assets," for more information on goodwill balances for Integrys Energy Group's reporting units at December 31, 2010. See "Critical Accounting Policies, Goodwill Impairment," for more information on the 2010 annual goodwill impairment test.

Integrys Energy Group also performs regular asset impairment tests related to other long-lived assets, including the portfolio of merchant power plants owned and operated by Integrys Energy Services. See Note 5, "Property, Plant, and Equipment," for more information on Integrys Energy Group's impairment losses recorded during 2010.

Climate Change

The EPA began regulating greenhouse gas emissions under the CAA in January 2011, by applying 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 issued guidance that defines BACT in terms of improvements in energy efficiency as opposed to relying on pollution control equipment. In December 2010, the EPA announced its intent to develop new source performance standards for greenhouse gas emissions for new and modified, as well as existing, electric utility steam generating units. The EPA plans to propose standards in 2011 and finalize standards in 2012. 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. Currently there is no applicable federal or state legislation pending that specifically addresses greenhouse gas emissions.

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.

The majority of Integrys Energy Group's generation and distribution facilities are located in the upper Midwest region of the United States. The same is true for the majority of its customers' facilities. The physical risks posed by climate change for these areas are not expected to be significant at this time. Ongoing evaluations will be conducted as more information on the extent of such physical changes becomes available.

Property Tax Assessment on Natural Gas

Integrys Energy Group's natural gas retailers, including its five natural gas utilities, purchase storage services from pipeline companies on the pipelines' interstate natural gas storage and transmission systems. Once a shipper, such as the subsidiaries of Integrys Energy Group, delivers natural gas to the pipeline's system, that specific natural gas cannot be physically traced back to the shipper, and the physical location of that specific natural gas is not ascertainable. Some states tax natural gas as personal property and have recently sought to assess personal property tax obligations against natural gas quantities held as working natural gas in facilities located in their states. Because the pipeline does not have title to the working natural gas inventory in these facilities, the state imposes the tax on the shippers as of the assessment date, based on allocated quantities. Shippers that are being assessed a tax are actively protesting these property tax assessments. PGL and MERC are currently pursuing protests through litigation in Texas and Kansas,

respectively.

Federal Health Care Reform

In March 2010, the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010 (HCR) were signed into law. HCR contains various provisions that will affect the cost of providing health care coverage to active and retired employees of Integrys Energy Group and their dependents. Although these provisions become effective at various times over the next 10 years, some provisions that affect the cost of providing benefits to retirees were reflected in 2010.

Most notably, there is a provision of HCR that, beginning in 2013, eliminates the tax deduction for employer-paid postretirement prescription drug charges to the extent those charges will be offset by the receipt of a federal Medicare Part D subsidy. As a result, Integrys Energy Group was required to eliminate a portion of its deferred tax asset related to postretirement benefits. The total amount of the deferred tax asset that was reduced for the loss of the deduction was $11.8 million, of which $10.8 million flowed through to net income as a component of income tax expense, and $1.0 million was deferred for regulatory recovery at UPPCO. Integrys Energy Group is seeking recovery in rates for the income impacts of this tax law change related to regulated utility operations in the majority of its jurisdictions. If recovery in rates becomes probable, income tax expense would be reduced in that period, but at this time Integrys Energy Group is not able to predict how much will ultimately be recovered in rates.

Other provisions of HCR include the elimination of certain annual and lifetime maximum benefits, broadening of plan eligibility requirements, elimination of pre-existing condition restrictions, an excise tax on high-cost health plans, changes to the Medicare Part D prescription drug program, and numerous other changes. Integrys Energy Group began participation in the Early Retiree Reinsurance Program that became effective on June 1, 2010. Integrys Energy Group continues to assess the extent to which the provisions of the new law will affect its future health care and related employee benefit plan costs.

Wisconsin Fuel Rules

Assembly Bill (AB) 600 was signed into law on May 18, 2010. AB 600 streamlines the current fuel rule administered by the PSCW. The current rule results in regulatory lag and hampers the ability of the PSCW to respond to rapid changes in fuel costs. AB 600 provides that the utility will defer any change in approved fuel costs in excess of a percentage set by the PSCW. The new rules will apply to WPS's 2011 fuel costs.

Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)

The Dodd-Frank Act was signed into law in July 2010. Although a few provisions were effective with the passing of the act, the majority of the rules to implement the provisions will be finalized and become effective over the 18 months following the signing of the act. Depending on the final rules, certain provisions of the Dodd-Frank Act relating to derivatives could increase capital and/or collateral requirements. Final rules for these provisions are expected in the second quarter of 2011. Integrys Energy Group is monitoring developments related to this act and their impacts on its future results of operations, cash flows, and financial position.

Recent Tax Law Changes

In January 2011, the Taxpayer Accountability and Budget Stabilization Act was enacted in Illinois. This act increases the corporate combined income tax rate from 7.3% to 9.5% retroactively to January 1, 2011. Rates decrease to 7.75% after 2014 and return to 7.3% after 2024. Integrys Energy Group and its subsidiaries will have to adjust deferred taxes to reflect the changes in the tax rate, effective in the first quarter of 2011. Due to the effects of regulation, and the timing of the February 2011 rate filings for PGL and NSG, Integrys Energy Group does not anticipate a material impact on income from this legislation.

In December 2010, President Obama signed into law The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. This act includes tax incentives, such as an extension and increase of bonus depreciation, the extension of the research and experimentation credit, and the

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extension of treasury grants in lieu of claiming the investment tax credit for certain renewable energy investments. In September 2010, President Obama signed into law the Small Business Jobs Act of 2010. This act includes tax incentives, such as an extension to bonus depreciation and changes to listed property, that affect Integrys Energy Group. Integrys Energy Group anticipates that these tax law changes will likely result in $140.0 million to $240.0 million of reduced cash payments for taxes during 2011 and 2012. These incentives may also have the effect of reducing utility rate base and, thus, future earnings relative to prior expectations. Integrys Energy Group is evaluating the most appropriate manner to deploy the additional cash, which may include, among other things, making incremental contributions to its various employee benefit plans or funding additional capital investments.

Illinois Manufactured Gas Plant Legislation

Senate Bill (SB) 3388 would require PGL and NSG either to enter into 30-year purchase contracts for manufactured gas produced from an Illinois coal and petroleum coke plant to be built on the south side of Chicago or to elect to file biennial rate proceedings before the ICC in 2011, 2013, and 2015. The stated mission of this coal to gas project is to use Illinois coal and petroleum coke to mass produce manufactured gas and sell its entire offput to the four largest Illinois natural gas utilities in equal amounts. Under certain assumptions, the Illinois Power Authority may allocate the offput based on therms sold by these utilities, but no utility would be required to take more than 42% of the total plant offput. SB 1927 is similar legislation for a manufactured gas project to be located in Jefferson County, Illinois. It would require PGL and NSG either to enter into 10-year purchase contracts, with the offput of the project allocated among the four largest Illinois natural gas utilities based on therms sold, or agree to biennial rate filings for 2011, 2013, and 2015. Both bills were passed by the General Assembly and were sent to the Governor for signature in January 2011. The Governor has 60 days to act.

OFF BALANCE SHEET ARRANGEMENTS

See Note 16, "Guarantees," for information regarding guarantees.

CRITICAL ACCOUNTING POLICIES

Integrys Energy Group has determined that the following accounting policies are critical to the understanding of its financial statements because their application requires significant judgment and reliance on estimations of matters that are inherently uncertain. Integrys Energy Group's management has discussed these critical accounting policies with the Audit Committee of the Board of Directors.

Risk Management Activities

Integrys Energy Group has entered into contracts that are accounted for as derivatives. All derivative contracts are recorded at fair value on the Consolidated Balance Sheets, unless they qualify for the normal purchases and sales exception, which provides that recognition of gains and losses in the consolidated financial statements is not required until the settlement of the contracts. Changes in fair value, except effective portions of derivative instruments designated as hedges or qualifying for regulatory deferral, generally affect net income (loss) attributed to common shareholders at each financial reporting date until the contracts are ultimately settled.

At December 31, 2010, those derivatives not designated as hedges were primarily commodity contracts used to manage price risk associated with natural gas and electricity purchase and sale activities. Cash flow hedge accounting treatment may be used when Integrys Energy Group enters into contracts to buy or sell a commodity at a fixed price for future delivery to protect future cash flows corresponding with anticipated physical sales or purchases. In addition, Integrys Energy Group uses cash flow hedge accounting to protect against changes in interest rates. Fair value hedge accounting may be used when Integrys Energy Group holds assets, liabilities, or firm commitments and

enters into transactions that hedge the risk of changes in commodity prices or interest rates. To the extent that the hedging instrument is fully effective in offsetting the transaction being hedged, there is no impact on net income (loss) attributed to common shareholders prior to settlement of the hedge.

Integrys Energy Group has based its valuations on observable inputs whenever possible. However, at times, the valuation of certain derivative instruments requires the use of internally developed valuation techniques and/or significant unobservable inputs. These valuations require a significant amount of management judgment and are classified as Level 3 measurements. Of the total risk management assets on Integrys Energy Group's Consolidated Balance Sheets, $58.8 million (18.0%) were classified as Level 3 measurements. Of the total risk management liabilities, $38.1 million (9.8%) were classified as Level 3 measurements. Integrys Energy Group believes these valuations represent the fair values of these instruments as of the reporting date; however, the actual amounts realized upon settlement of these instruments could vary materially from the reported amounts due to movements in market prices and changes in the liquidity of certain markets.

As a component of fair value determinations, Integrys Energy Group considers counterparty credit risk (including its own credit risk) and liquidity risk. The liquidity component of the fair value determination may be especially subjective when limited liquid market information is available. Changes in the underlying assumptions for the credit and liquidity risk components of fair value at December 31, 2010, would have had the following effects:

Change in Risk Components	Effect on Fair Value of Net Risk Management Liabilities at December 31, 2010 (Millions)
100% increase	$6.0 decrease
50% decrease	$3.0 increase

These hypothetical changes in fair value would be included in current and long-term assets and liabilities from risk management activities on the Consolidated Balance Sheets and as part of nonregulated revenues on the Consolidated Statements of Income, unless the related contracts are designated as cash flow hedges, in which case potential changes would be included in Other Comprehensive Income – Cash Flow Hedges on the Consolidated Statements of Common Shareholders' Equity to the extent they are considered effective for offsetting future cash flows of the related hedged transactions.

Goodwill Impairment

Integrys Energy Group reviews goodwill for impairment as required by GAAP. Goodwill is tested for impairment using a two-step process that begins with an estimation of the fair value of a reporting unit. A reporting unit can be an operating segment, or one level below an operating segment, as defined by the Segment Reporting Topic of the FASB ASC. At Integrys Energy Group, goodwill has been assigned to each of the five reporting units that comprise the natural gas utility segment and also to the Integrys Energy Services segment. The carrying value of goodwill by reporting unit and reportable segment for the year ended December 31, 2010 was:

(Millions)	Carrying Value of Goodwill
WPS	$36.4
PGL	401.2
NSG	36.1
MERC	127.7
MGU	34.5
Total Natural Gas Utility Segment	$635.9
Integrys Energy Services	6.6
Balance at December 31, 2010	$642.5

The goodwill for each of the reporting units is tested for impairment annually on April 1 or more frequently when events or circumstances warrant. The fair market value of each reporting unit is estimated using certain key assumptions that require significant judgment. This judgment includes developing cash flow

projections (including the selection of appropriate returns on equity, long-term growth rates, and capital expenditure levels), selecting appropriate discount rates, and identifying relevant market comparables.

2010 Impairment Test

Integrys Energy Group completed its annual goodwill impairment tests for all of its reporting units that carry a goodwill balance as of April 1, 2010. The estimated fair value for the PGL, NSG, MERC, and MGU reporting units was determined by using an equal weighting of the income approach and the market approach methodologies.

The income approach was based on discounted cash flows which were derived from internal forecasts and economic expectations. Key assumptions used to determine fair value under the income approach included the cash flow period, terminal values based on a terminal growth rate, and the discount rate. The discount rate represents the estimated cost of debt and equity financing weighted by the percentage of debt and equity in a company's target capital structure. The discount rates used in the income approach for PGL, NSG, MERC, and MGU ranged from 6.75% to 7.0%. The discount rate used for Integrys Energy Services was 10.2%. The terminal growth rates used in the income approach ranged from 2% to 3%.

The market approach for PGL, NSG, MERC, and MGU utilized the guideline company method, which calculates valuation multiples based on operating and valuation metrics from publicly traded guideline companies in the regulated natural gas distribution industry. Multiples derived from the guideline companies provided an indication of how much a knowledgeable investor in the marketplace would be willing to pay for an investment in a similar company. These multiples were then applied to the appropriate operating metric for PGL, NSG, MERC, and MGU to determine indications of fair value.

No impairment was recorded in 2010 as a result of these tests. However, the fair value calculated in the first step of the test for MGU approximated the carrying value of this reporting unit. Therefore, any deterioration of the market-related factors used in the impairment analysis could potentially result in a future impairment loss for all or a portion of the $34.5 million of goodwill recorded at MGU.

The fair value of the WPS natural gas utility reporting unit currently exceeds the carrying amount by a significant amount, such that Integrys Energy Group believes WPS is unlikely to fail step one of the goodwill impairment test in the foreseeable future.

Receivables

The regulated natural gas and electric utilities and Integrys Energy Services accrue estimated amounts of revenues for services rendered but not yet billed. Estimated unbilled revenues are calculated using a variety of factors based on customer class or contracted rates. At December 31, 2010 and 2009, Integrys Energy Group's unbilled revenues were $339.1 million and $337.0 million, respectively. Any difference between actual revenues and the estimates are recorded in revenue in the next period. Differences historically have not been significant.

Pension and Other Postretirement Benefits

The costs of providing non-contributory defined benefit pension benefits and other postretirement benefits, described in Note 17, "Employee Benefit Plans," are dependent upon numerous factors resulting from actual plan experience and assumptions regarding future experience.

Pension and other postretirement benefit costs are impacted by actual employee demographics (including age, compensation levels, and employment periods), the level of contributions made to the plans, and earnings on plan assets. Pension and other postretirement benefit costs may be significantly affected by changes in key actuarial

assumptions, including anticipated rates of return on plan assets, discount rates, and expected health care cost trends. Changes made to the plan provisions may also impact current and future pension and other postretirement benefit costs.

Integrys Energy Group's pension and other postretirement benefit plan assets are primarily made up of equity and fixed income investments. Fluctuations in actual equity and fixed income market returns, as well as changes in general interest rates, may result in increased or decreased benefit costs in future periods. Management believes that such changes in costs would be recovered at the regulated segments through the ratemaking process.

The following table shows how a given change in certain actuarial assumptions would impact the projected benefit obligation and the reported net periodic pension cost. Each factor below reflects an evaluation of the change based on a change in that assumption only.

Actuarial Assumption (Millions, except percentages)	Percentage-Point Change in Assumption	Impact on Projected Benefit Obligation	Impact on 2010 Pension Cost
Discount rate	(0.5)	$86.1	$7.5
Discount rate	0.5	(79.1)	(7.1)
Rate of return on plan assets	(0.5)	N/A	5.4
Rate of return on plan assets	0.5	N/A	(5.4)

The following table shows how a given change in certain actuarial assumptions would impact the accumulated other postretirement benefit obligation and the reported net periodic other postretirement benefit cost. Each factor below reflects an evaluation of the change based on a change in that assumption only.

Actuarial Assumption (Millions, except percentages)	Percentage-Point Change in Assumption	Impact on Postretirement Benefit Obligation	Impact on 2010 Postretirement Benefit Cost
Discount rate	(0.5)	$ 34.0	$ 2.4
Discount rate	0.5	(30.9)	(2.0)
Health care cost trend rate	(1.0)	(56.6)	(8.1)
Health care cost trend rate	1.0	68.2	9.1
Rate of return on plan assets	(0.5)	N/A	1.1
Rate of return on plan assets	0.5	N/A	(1.1)

The discount rates are selected based on hypothetical bond portfolios consisting of non-callable (or callable with make-whole provisions), non-collateralized, high-quality corporate bonds with maturities between 0 and 30 years. The bonds are generally rated "Aa" with a minimum amount outstanding of $50 million. From the hypothetical bond portfolios, a single rate is determined that equates the market value of the bonds purchased to the discounted value of the plans' expected future benefit payments.

Integrys Energy Group establishes its expected return on asset assumption based on consideration of historical and projected asset class returns, as well as the target allocations of the benefit trust portfolios. The assumed long-term rate of return was 8.5% in 2010, 2009, and 2008. For 2010, 2009, and 2008, the actual rates of return on pension plan assets, net of fees, were 13.0%, 22.0%, and (25.9)%, respectively.

The determination of expected return on qualified plan assets is based on a market-related valuation of assets, which reduces year-to-year volatility. Cumulative gains and losses in excess of 10% of the greater of the pension or other postretirement benefit obligation or market-related value are amortized over the average remaining future service to expected retirement ages. Changes in fair value are recognized over the subsequent five years for plans sponsored by WPS, while differences between actual investment returns and the expected return on plan assets are recognized over

a five-year period for pension plans sponsored by IBS and PEC. Because of this method, the future value of assets will be impacted as previously deferred gains or losses are included in market-related value.

In selecting assumed health care cost trend rates, past performance and forecasts of health care costs are considered. For more information on health care cost trend rates and a table showing future

payments that Integrys Energy Group expects to make for pension and other postretirement benefits, see Note 17, "Employee Benefit Plans."

Regulatory Accounting

The electric and natural gas utility segments of Integrys Energy Group follow the guidance under the Regulated Operations Topic of the FASB ASC, and the financial statements reflect the effects of the ratemaking principles followed by the various jurisdictions regulating these segments. Certain items that would otherwise be immediately recognized as revenues and expenses are deferred as regulatory assets and regulatory liabilities for future recovery or refund to customers, as authorized by Integrys Energy Group's regulators. Future recovery of regulatory assets is not assured, and is generally subject to review by regulators in rate proceedings for matters such as prudence and reasonableness. Management regularly assesses whether these regulatory assets and liabilities are probable of future recovery or refund by considering factors such as changes in the regulatory environment, earnings at the electric and natural gas utility segments, and the status of any pending or potential deregulation legislation. Once approved, the regulatory assets and liabilities are amortized into income over the rate recovery period. If recovery or refund of costs is not approved or is no longer deemed probable, these regulatory assets or liabilities are recognized in current period income.

The application of the Regulated Operations Topic of the FASB ASC would be discontinued if all or a separable portion of Integrys Energy Group's electric and natural gas utility segment's operations would no longer meet the criteria for application. Assets and liabilities recognized solely due to the actions of rate regulation would no longer be recognized on the balance sheet, but rather classified as an extraordinary item in income for the period in which the discontinuation occurred. A write-off of all of Integrys Energy Group's regulatory assets and regulatory liabilities at December 31, 2010, would result in a 16.4% decrease in total assets and a 5.7% decrease in total liabilities. The two largest regulatory assets at December 31, 2010, related to environmental remediation costs and unrecognized pension and other postretirement benefit costs. A write-off of the regulatory asset related to environmental remediation costs at December 31, 2010, would result in a 6.7% decrease in total assets. A write-off of the unrecognized pension and other postretirement benefit related regulatory asset at December 31, 2010, would result in a 5.5% decrease in total assets. See Note 7, "Regulatory Assets and Liabilities," for more information.

Tax Provision

Integrys Energy Group is required to estimate income taxes for each of the jurisdictions in which it operates as part of the process of preparing Integrys Energy Group's consolidated financial statements. This process involves estimating actual current tax liabilities together with assessing temporary differences resulting from differing treatment of items, such as depreciation, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within Integrys Energy Group's Consolidated Balance Sheets. Integrys Energy Group must also assess the likelihood that its deferred tax assets will be recovered through future taxable income. To the extent Integrys Energy Group believes that recovery is not likely, it must establish a valuation allowance, which is offset by an adjustment to the provision for income taxes in the Consolidated Statements of Income.

Uncertainty associated with the application of tax statutes and regulations and the outcomes of tax audits and appeals requires that judgments and estimates be made in the accrual process and in the calculation of effective tax rates. Only income tax benefits that meet the "more likely than not" recognition threshold may be recognized or continue to be recognized. Changes in the unrecognized tax benefits are estimated based on an evaluation of the degree of uncertainty, the nature of an event that could cause a change, and an estimate of the range of reasonably possible changes.

Significant management judgment is required in determining Integrys Energy Group's provision for income taxes, deferred tax assets and liabilities, the liability for unrecognized tax benefits, and any valuation allowance recorded against deferred tax assets. The assumptions involved are supported by historical data, reasonable projections, and technical interpretations of applicable tax laws and regulations

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across multiple taxing jurisdictions. Significant changes in these assumptions could have a material impact on Integrys Energy Group's financial condition and results of operations. See Note 1(p), "Summary of Significant Accounting Policies – Income Taxes," and Note 14, "Income Taxes," for a discussion of accounting for income taxes.

IMPACT OF INFLATION

Integrys Energy Group's financial statements are prepared in accordance with GAAP. The statements provide a reasonable, objective, and quantifiable statement of financial results, but generally do not evaluate the impact of inflation. For Integrys Energy Group's regulated operations, to the extent it is not recovering the effects of inflation, it will file rate cases as necessary in the various jurisdictions in which it operates. Integrys Energy Group's nonregulated businesses include inflation in forecasted costs.

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ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market Risks and Other Significant Risks

Integrys Energy Group has potential market risk exposure related to commodity price risk (including regulatory recovery risk), interest rate risk, and equity return and principal preservation risk. Integrys Energy Group is also exposed to other significant risks due to the nature of its subsidiaries' businesses and the environment in which it operates. Integrys Energy Group has risk management policies in place to monitor and assist in controlling these risks and may use derivative and other instruments to manage some of these exposures, as further described below.

Commodity Price Risk and Regulatory Recovery Risk

Utilities

The electric utilities of Integrys Energy Group purchase coal, natural gas, and fuel oil for use in power generation. They also buy power from the MISO market at a price that is often reflective of the underlying cost of natural gas used in power generation. Prudent fuel and purchased power costs are recovered from customers under one-for-one recovery mechanisms by UPPCO, and by the wholesale electric operations and Michigan retail electric operations of WPS. The costs of natural gas used by the natural gas utilities are also generally recovered from customers under one-for-one recovery mechanisms. These recovery mechanisms greatly reduce commodity price risk for the utilities.

WPS's Wisconsin retail electric operations do not have a one-for-one recovery mechanism for price fluctuations. Instead, a "fuel window" mechanism partially mitigates the year-to-year price risk. See Note 1(f), "Summary of Significant Accounting Policies – Revenue and Customer Receivables," for more information.

To manage commodity price risk, the regulated utilities enter into contracts of various durations for the purchase and/or sale of natural gas, fuel for electric generation, and electricity. In addition, the electric operations of WPS and UPPCO, and the natural gas operations of WPS, PGL, NSG, and MERC employ risk management techniques, which include the use of derivative instruments such as swaps, futures, and options.

Integrys Energy Services

Integrys Energy Services seeks to reduce market price risk from its generation and energy supply portfolios through the use of various financial and physical instruments. Additionally, Integrys Energy Services uses volume limits and stop loss limits to limit its exposure to commodity price movements.

To measure commodity price risk exposure, Integrys Energy Group employs a number of controls and processes, including a value-at-risk (VaR) analysis of its exposures. Integrys Energy Services' VaR calculation is utilized to quantify exposure to market risk associated with its open commodity positions (primarily natural gas and power positions). The VaR calculation excludes the positions created by owning energy assets and associated coal, sulfur dioxide emission allowances, renewable energy credits, and other ancillary fuels. Additionally, financial transmission rights, certain electric ancillary services, and certain portions of long-dated natural gas storage and transportation contracts are also excluded from the VaR calculation. The capped downside nature of the risks and duration of these positions would result in a VaR that would not be representative of the actual exposure. Therefore, Integrys Energy Services evaluates the exposures for these types of contracts by assessing the maximum potential loss of the positions, which is either the cost of the physical asset or the fixed demand charges for the contract.

VaR is a probabilistic approach to quantifying the exposure to market risk. The VaR amount represents an estimate of the potential change in fair value that could occur from changes in market factors, within a

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given confidence level, if an instrument or portfolio is held for a specified time period. In addition to VaR, Integrys Energy Services employs other risk measurements including mark-to-market valuations, stress testing, and scenario-based testing. In conjunction with the VaR analysis, these other risk measurements provide the risk management analysis for Integrys Energy Services' risk exposure.

VaR is not necessarily indicative of actual results that may occur. VaR has a number of limitations that are important to consider when evaluating the calculation results. Most importantly, VaR does not represent the maximum potential loss of the portfolio. Price movements outside of the relevant confidence levels can and do occur and may result in losses exceeding the reported VaR. Large short-term price moves can be caused by catastrophic weather events or other drivers of short-term supply and demand disruptions. Also, the holding period may not always be an adequate assessment of the timeframe to close out positions. Short-term reductions in market liquidity could cause Integrys Energy Services to hold positions open longer than anticipated, resulting in greater than predicted losses. Additionally, there are other risks not captured by the VaR metric including, but not limited to, the risk of customer and vendor nonperformance and the risks associated with the liquidity in the markets in which Integrys Energy Services transacts. Customer and vendor nonperformance risk could result in bad debt losses, realized and unrealized losses on commodity contracts, or increased supply costs in the event that contractual obligations of counterparties are not met. Market liquidity risk refers to the risk that Integrys Energy Services will not be able to efficiently enter or exit commodity positions.

Integrys Energy Services' VaR is calculated using non-discounted positions with a delta-normal approximation based on a one-day holding period and a 95% confidence level, as well as a ten-day holding period and a 99% confidence level. The delta-normal approximation is based on the assumption that changes in the value of the portfolio over short time periods, such as one day or ten days, are normally distributed. Integrys Energy Services' VaR calculation includes financial and physical commodity instruments, such as forwards, futures, swaps, and options, as well as natural gas inventory, natural gas storage, and transportation contracts, to the extent such positions are significant, but excludes the positions mentioned above.

The VaR for Integrys Energy Services' portfolio at a 95% confidence level and a one-day holding period is presented in the following table:

(Millions)	2010	2009
As of December 31	$0.2	$0.6
Average for 12 months ended December 31	0.3	0.8
High for 12 months ended December 31	0.3	1.1
Low for 12 months ended December 31	0.2	0.6

The VaR for Integrys Energy Services' portfolio at a 99% confidence level and a ten-day holding period is presented in the following table:

(Millions)	2010	2009
As of December 31	$1.1	$2.9
Average for 12 months ended December 31	1.4	3.8
High for 12 months ended December 31	1.5	4.7
Low for 12 months ended December 31	1.1	2.9

The average, high, and low amounts were computed using the VaR amounts at each of the four quarter ends.

The year-over-year decrease in VaR was driven primarily by reduced business size, as a result of Integrys Energy Services' strategy change.

Interest Rate Risk

Integrys Energy Group is exposed to interest rate risk resulting from its variable rate long-term debt and short-term borrowings. Exposure to interest rate risk is managed by limiting the amount of variable rate obligations and continually monitoring the effects of market changes on interest rates. Integrys Energy Group enters into long-term fixed rate debt when it is advantageous to do so. Integrys Energy Group may also enter into derivative financial instruments, such as swaps, to mitigate interest rate exposure.

Due to decreases in short-term borrowings in 2010, Integrys Energy Group has decreased its exposure to variable interest rates. Based on the variable rate debt of Integrys Energy Group outstanding at December 31, 2010, a hypothetical increase in market interest rates of 100 basis points would have increased annual interest expense by $1.4 million. Comparatively, based on the variable rate debt outstanding at December 31, 2009, an increase in interest rates of 100 basis points would have increased annual interest expense by $3.5 million. This sensitivity analysis was performed assuming a constant level of variable rate debt during the period and an immediate increase in interest rates, with no other changes for the remainder of the period.

Equity Return and Principal Preservation Risk

Integrys Energy Group currently funds liabilities related to employee benefits through various external trust funds. The trust funds are managed by numerous investment managers and hold investments primarily in debt and equity securities. Changes in the market value of these investments can have an impact on the future expenses related to these liabilities. Declines in the equity markets or declines in interest rates may result in increased future costs for the plans and require contributions into the plans. Integrys Energy Group monitors the trust fund portfolio by benchmarking the performance of the investments against certain security indices. Most of the employee benefit costs relate to Integrys Energy Group's regulated utilities. As such, the majority of these costs are recovered in customers' rates, mitigating most of the equity return and principal preservation risk on these exposures. Also, the likelihood of an increase in the employee benefit obligations, which the investments must fund, has been partially mitigated as a result of certain employee groups no longer being eligible to participate in, or accumulate benefits in, certain pension and other postretirement benefit plans. Specifically, effective January 1, 2008, the defined benefit pension plans were closed to all Integrys Energy Group non-union new hires. Effective May 1, 2008, and July 1, 2008, the defined benefit pension plans were closed to new union hires at PGL and NSG, respectively. Effective April 19, 2009, and December 18, 2009, the defined benefit pension plans were closed to new union hires at UPPCO and WPS, respectively. Effective January 15, 2010, the defined benefit pension plans were closed to new Local 12295 union hires at MGU.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

A. MANAGEMENT REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The management of Integrys Energy Group and its subsidiaries is responsible for establishing and maintaining adequate internal control over financial reporting. Integrys Energy Group's control systems were designed to provide reasonable assurance to Integrys Energy Group's management and Board of Directors regarding the preparation and fair presentation of published financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Integrys Energy Group's management assessed the effectiveness of its internal control over financial reporting as of December 31, 2010. In making this assessment, it used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control – Integrated Framework. Based on this assessment, management believes that, as of December 31, 2010, Integrys Energy Group's internal control over financial reporting is effective.

Integrys Energy Group, Inc.'s independent registered public accounting firm has issued an audit report on the effectiveness of Integrys Energy Group's internal control over financial reporting.

B. REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have audited the internal control over financial reporting of Integrys Energy Group, Inc. and subsidiaries (the "Company") as of December 31, 2010, based on criteria established in Internal Control –Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2010, based on the criteria established in Internal Control –Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements and financial statement schedules as of and for the year ended December 31, 2010 of the Company and our report dated February 23, 2011 expressed an unqualified opinion on those financial statements and financial statement schedules.

/s/ Deloitte & Touche LLP

Milwaukee, Wisconsin
February 23, 2011

C. CONSOLIDATED STATEMENTS OF INCOME

Year Ended December 31 (Millions, except per share data)	2010	2009	2008
Utility revenues	$3,368.5	$3,495.8	$4,309.9
Nonregulated revenues	1,834.7	4,004.0	9,737.9
Total revenues	5,203.2	7,499.8	14,047.8
Utility cost of fuel, natural gas, and purchased power	1,685.5	1,919.8	2,744.1
Nonregulated cost of fuel, natural gas, and purchased power	1,619.8	3,701.3	9,654.3
Operating and maintenance expense	1,045.6	1,098.4	1,080.7
Impairment losses on property, plant, and equipment	43.2	0.7	0.5
Net loss on Integrys Energy Services' dispositions related to strategy change	14.1	28.9	-
Restructuring expense	7.9	43.5	-
Goodwill impairment loss	-	291.1	6.5
Depreciation and amortization expense	265.8	230.6	221.4
Taxes other than income taxes	93.2	96.3	93.6
Operating income	428.1	89.2	246.7
Miscellaneous income	91.5	89.0	87.3
Interest expense	(147.9)	(164.8)	(158.1)
Other expense	(56.4)	(75.8)	(70.8)
Income before taxes	371.7	13.4	175.9
Provision for income taxes	148.2	83.7	61.1
Net income (loss) from continuing operations	223.5	(70.3)	114.8
Discontinued operations, net of tax	0.2	2.8	4.7
Net income (loss)	223.7	(67.5)	119.5
Preferred stock dividends of subsidiary	(3.1)	(3.1)	(3.1)
Noncontrolling interest in subsidiaries	0.3	1.0	0.1
Net income (loss) attributed to common shareholders	$220.9	$(69.6)	$116.5
Average shares of common stock			
Basic	77.5	76.8	76.7
Diluted	78.0	76.8	77.0
Earnings (loss) per common share (basic)			
Net income (loss) from continuing operations	$2.85	$(0.95)	$1.46
Discontinued operations, net of tax	-	0.04	0.06
Earnings (loss) per common share (basic)	$2.85	$(0.91)	$1.52
Earnings (loss) per common share (diluted)			

Net income (loss) from continuing operations	$2.83	$(0.95)	$1.45
Discontinued operations, net of tax	-	0.04	0.06
Earnings (loss) per common share (diluted)	$2.83	$(0.91)	$1.51

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

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D. CONSOLIDATED BALANCE SHEETS

At December 31 (Millions)	2010	2009
Assets		
Cash and cash equivalents	$179.0	$44.5
Collateral on deposit	33.3	184.9
Accounts receivable and accrued unbilled revenues, net of reserves of $41.9 and $57.5, respectively	832.1	958.0
Inventories	247.9	304.3
Assets from risk management activities	236.9	1,522.1
Regulatory assets	117.9	121.1
Deferred income taxes	67.7	92.9
Assets held for sale	-	26.5
Prepaid federal income tax	142.7	93.1
Other current assets	192.9	164.8
Current assets	2,050.4	3,512.2
Property, plant, and equipment, net of accumulated depreciation of $2,900.2 and $2,846.9, respectively	5,013.4	4,941.8
Regulatory assets	1,495.1	1,434.9
Assets from risk management activities	89.4	795.4
Goodwill	642.5	642.5
Other long-term assets	526.0	517.8
Total assets	$9,816.8	$11,844.6
Liabilities and Equity		
Short-term debt	$10.0	$222.1
Current portion of long-term debt	476.9	116.5
Accounts payable	453.0	639.4
Liabilities from risk management activities	289.6	1,607.1
Accrued taxes	90.2	81.9
Regulatory liabilities	75.7	100.4
Liabilities held for sale	-	0.3
Other current liabilities	262.4	380.0
Current liabilities	1,657.8	3,147.7
Long-term debt	2,161.6	2,394.7
Deferred income taxes	860.5	652.9
Deferred investment tax credits	45.2	46.0
Regulatory liabilities	316.2	277.6
Environmental remediation liabilities	643.9	658.8
Pension and other postretirement benefit obligations	603.4	640.7
Liabilities from risk management activities	99.7	783.1
Asset retirement obligations	320.9	194.8
Other long-term liabilities	150.6	148.1

Long-term liabilities	5,202.0	5,796.7
Commitments and contingencies		
Common stock - $1 par value; 200,000,000 shares authorized; 77,781,685 shares issued;		
77,350,079 shares outstanding	77.8	76.4
Additional paid-in capital	2,540.4	2,497.8
Retained earnings	350.8	337.0
Accumulated other comprehensive loss	(44.7)	(44.0)
Shares in deferred compensation trust	(18.5)	(17.2)
Total common shareholders' equity	2,905.8	2,850.0
Preferred stock of subsidiary - $100 par value; 1,000,000 shares authorized;		
511,882 shares issued; 510,495 shares outstanding	51.1	51.1
Noncontrolling interest in subsidiaries	0.1	(0.9)
Total liabilities and equity	$9,816.8	$11,844.6

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

E. CONSOLIDATED STATEMENTS OF EQUITY

	Integrys Energy Group Common Shareholders' Equity								
(Millions)	Deferred Compensation Trust and Treasury Stock	Common Stock	Additional Paid In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Common Shareholders' Equity	Preferred Stock of Subsidiary	Noncontrolling Interest	Total Equity
Balance at December 31, 2007	$ (15.0)	$ 76.4	$ 2,473.8	$ 701.9	$ (1.3)	$ 3,235.8	$ 51.1	$ -	$ 3,286.9
Net income attributed to common shareholders	-	-	-	116.5	-	116.5	-	(0.1)	116.4
Other comprehensive income (loss)									
Cash flow hedges (net of tax of $33.7)	-	-	-	-	(52.8)	(52.8)	-	-	(52.8)
Unrecognized pension and other postretirement costs (net of tax of $8.1)	-	-	-	-	(12.7)	(12.7)	-	-	(12.7)
Available-for-sale securities (net of tax of $0.3)	-	-	-	-	(0.5)	(0.5)	-	-	(0.5)
Foreign currency translation (net of tax of $3.4)	-	-	-	-	(5.5)	(5.5)	-	-	(5.5)
Comprehensive income						45.0			44.9
Cumulative effect of change in accounting principle	-	-	-	4.5	-	4.5	-	-	4.5
Effects of changing pension plan measurement date pursuant to SFAS No. 158	-	-	-	(3.5)	-	(3.5)	-	-	(3.5)
Purchase of deferred compensation shares	(2.7)	-	-	-	-	(2.7)	-	-	(2.7)
	0.1	-	12.5	-	-	12.6	-	-	12.6

Stock based compensation									
Dividends on common stock	-	-	-	(203.9)	-	(203.9)	-	-	(203.9)
Net contributions from noncontrolling parties	-	-	-	-	-	-	-	0.1	0.1
Other	1.1	-	1.6	(0.8)	-	1.9	-	-	1.9
Balance at December 31, 2008	$ (16.5)	$ 76.4	$ 2,487.9	$ 614.7	$ (72.8)	$ 3,089.7	$ 51.1	$ -	$ 3,140.8
Net loss attributed to common shareholders	-	-	-	(69.6)	-	(69.6)	-	(1.0)	(70.6)
Other comprehensive income (loss)									
Cash flow hedges (net of tax of $17.0)	-	-	-	-	31.5	31.5	-	-	31.5
Unrecognized pension and other postretirement costs (net of tax of $3.2)	-	-	-	-	(6.7)	(6.7)	-	-	(6.7)
Available-for-sale securities (net of tax of $0.1)	-	-	-	-	(0.1)	(0.1)	-	-	(0.1)
Foreign currency translation (net of tax of $2.6)	-	-	-	-	4.1	4.1	-	-	4.1
Comprehensive loss						(40.8)			(41.8)
Purchase of deferred compensation shares	(3.1)	-	-	-	-	(3.1)	-	-	(3.1)
Stock based compensation	0.1	-	11.3	-	-	11.4	-	-	11.4
Dividends on common stock	-	-	-	(206.9)	-	(206.9)	-	-	(206.9)
Net contributions from noncontrolling parties	-	-	-	-	-	-	-	0.1	0.1
Other	2.3	-	(1.4)	(1.2)	-	(0.3)	-	-	(0.3)
Balance at December 31, 2009	$ (17.2)	$ 76.4	$ 2,497.8	$ 337.0	$ (44.0)	$ 2,850.0	$ 51.1	$ (0.9)	$ 2,900.2
Net income attributed to common shareholders	-	-	-	220.9	-	220.9	-	(0.3)	220.6
Other comprehensive income (loss)									
	-	-	-	-	4.5	4.5	-	-	4.5

Cash flow hedges (net of tax of $4.7)									
Unrecognized pension and other postretirement costs (net of tax of $2.0)	-	-	-	-	(2.8)	(2.8)	-	-	(2.8)
Foreign currency translation (net of tax of $1.5)	-	-	-	-	(2.4)	(2.4)	-	-	(2.4)
Comprehensive income						220.2			219.9
Issuance of common stock	-	1.3	54.5	-	-	55.8	-	-	55.8
Purchase of deferred compensation shares	(1.2)	-	-	-	-	(1.2)	-	-	(1.2)
Stock based compensation	-	-	4.0	-	-	4.0	-	-	4.0
Dividends on common stock	-	-	-	(208.7)	-	(208.7)	-	-	(208.7)
Other	(0.1)	0.1	(15.9)	1.6	-	(14.3)	-	1.3	(13.0)
Balance at December 31, 2010	$ (18.5)	$ 77.8	$ 2,540.4	$ 350.8	$ (44.7)	$ 2,905.8	$ 51.1	$ 0.1	$ 2,957.0

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

F. CONSOLIDATED STATEMENTS OF CASH FLOWS

Year Ended December 31 (Millions)	2010	2009	2008
Operating Activities			
Net income (loss)	$223.7	$(67.5)	$119.5
Adjustments to reconcile net income (loss) to net cash provided by (used for) operating activities			
Discontinued operations, net of tax	(0.2)	(2.8)	(4.7)
Goodwill impairment loss	-	291.1	6.5
Impairment losses on property, plant, and equipment	43.2	0.7	0.5
Depreciation and amortization expense	265.8	230.6	221.4
Recoveries and refunds of regulatory assets and liabilities	28.7	40.8	50.7
Net unrealized (gains) losses on nonregulated energy contracts	(55.8)	104.2	(15.8)
Nonregulated lower of cost or market inventory adjustments	0.9	44.2	167.3
Bad debt expense	48.0	54.6	76.8
Pension and other postretirement expense	67.6	72.4	50.7
Pension and other postretirement contributions	(201.8)	(53.3)	(40.8)
Deferred income taxes and investment tax credits	234.1	58.3	72.3
Loss (gain) on sale of assets	11.4	24.1	(1.7)
Equity income, net of dividends	(14.5)	(16.1)	(15.1)
Other	33.3	37.7	9.9
Changes in working capital			
Collateral on deposit	163.6	45.5	(239.2)
Accounts receivable and accrued unbilled revenues	97.6	864.8	(207.7)
Inventories	51.1	444.1	(312.0)
Other current assets	(85.5)	39.6	(124.6)
Accounts payable	(25.8)	(604.7)	(53.2)
Other current liabilities	(160.2)	(2.0)	(10.8)
Net cash provided by (used for) operating activities	725.2	1,606.3	(250.0)
Investing Activities			
Capital expenditures	(258.8)	(444.2)	(532.8)
Proceeds from the sale or disposal of assets	66.0	44.6	31.1
Capital contributions to equity method investments	(6.9)	(34.1)	(37.8)
Cash paid for transmission interconnection	-	-	(17.4)
Proceeds received from transmission interconnection	-	-	99.7
Other	-	(7.0)	5.0
Net cash used for investing activities	(199.7)	(440.7)	(452.2)
Financing Activities			
Short-term debt, net	(212.1)	(815.7)	569.7
Issuance of notes payable	-	-	155.7
Redemption of notes payable	-	(157.9)	-
Proceeds from sale of borrowed natural gas	21.9	162.0	530.4
Purchase of natural gas to repay natural gas loans	(6.5)	(445.2)	(257.2)
Issuance of long-term debt	250.0	230.0	181.5

Repayment of long-term debt	(117.2)	(157.8)	(58.1)
Payment of dividends			
Preferred stock	(3.1)	(3.1)	(3.1)
Common stock	(186.1)	(206.9)	(203.9)
Issuance of common stock	33.2	-	-
Proceeds from derivative contracts related to divestitures classified as financing activities	-	33.9	-
Payments made on derivative contracts related to divestitures classified as financing activities	(157.8)	-	-
Other	(13.7)	(17.7)	(3.7)
Net cash (used for) provided by financing activities	(391.4)	(1,378.4)	911.3
Change in cash and cash equivalents - continuing operations	134.1	(212.8)	209.1
Change in cash and cash equivalents - discontinued operations			
Net cash provided by investing activities	0.4	3.2	3.8
Net change in cash and cash equivalents	134.5	(209.6)	212.9
Cash and cash equivalents at beginning of year	44.5	254.1	41.2
Cash and cash equivalents at end of year	$179.0	$44.5	$254.1

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

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G. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1--SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Nature of Operations--Integrys Energy Group is a holding company whose primary wholly owned subsidiaries at December 31, 2010, included WPS, UPPCO, MGU, MERC, PGL, NSG, IBS, and Integrys Energy Services. Of these subsidiaries, six are regulated electric and/or natural gas utilities, one, IBS, is a centralized service company, and one, Integrys Energy Services, is a nonregulated retail energy supply and services company. In addition, Integrys Energy Group has an approximate 34% interest in ATC.

The term "utility" refers to the regulated activities of the electric and natural gas utility segments, while the term "nonutility" refers to the activities of the electric and natural gas utility segments that are not regulated. The term "nonregulated" refers to activities at Integrys Energy Services, the Integrys Energy Group holding company, and the PEC holding company.

(b) Consolidated Basis of Presentation--The consolidated financial statements include the accounts of Integrys Energy Group and all majority owned subsidiaries, after eliminating intercompany transactions and balances. The cost method of accounting is used for investments when Integrys Energy Group does not have significant influence over the operating and financial policies of the investee. Investments in businesses not controlled by Integrys Energy Group, but over which it has significant influence regarding the operating and financial policies of the investee, are accounted for using the equity method. For additional information on equity method investments, see Note 8, "Investments in Affiliates, at Equity Method." These consolidated financial statements also reflect Integrys Energy Group's proportionate interests in certain jointly owned utility facilities.

(c) Use of Estimates--Integrys Energy Group prepares its consolidated financial statements in conformity with accounting principles generally accepted in the United States of America. Integrys Energy Group makes estimates and assumptions that affect assets, liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from these estimates.

(d) Change in Accounting Policy--During the fourth quarter of 2010, Integrys Energy Group changed its method of accounting for ITCs from the flow-through method to the deferral method. Under the flow-through method used prior to this change in accounting, Integrys Energy Group reduced the provision for income taxes by the amount of the ITC in the year in which the credit was received. Under the deferral method, Integrys Energy Group records the ITCs as a deferred credit and amortizes such credit as a reduction to the provision for income taxes over the life of the asset that generated the ITC.

Consistent with its nonregulated operations, Integrys Energy Group's regulated natural gas and electric utilities historically used the flow-through method of accounting for ITCs. However, after also applying the Regulated Operations Topic of the FASB ASC, accounting for ITCs for regulated operations effectively resulted in the deferral of such credits because the benefit reduces customer rates and the provision for income taxes over the life of the asset that generated the ITC. As a result, the change in accounting method in 2010 only impacted financial statement line items for the nonregulated energy services operations.

Although both the flow-through and deferral methods are acceptable for recording ITCs, the guidance in the Income Tax Topic of the FASB ASC states that the deferral method is the preferred method. Integrys Energy Group also believes the deferral method is preferable in these circumstances because it results in better matching of the benefit of the ITC with the cost of the investment over its useful life, reflecting more meaningful information about a project's

return.

The change in accounting policy to adopt the deferral method for ITCs was completed in accordance with the Accounting Changes and Error Corrections Topic of the FASB ASC. Accordingly, the change in accounting policy has been applied retrospectively by adjusting the financial statement amounts for the prior periods presented. The change in accounting policy had no impact on Integrys Energy Group's consolidated financial statements prior to 2008 and, therefore, there was no cumulative effect on retained earnings as of January 1, 2008, because no ITCs were received related to the nonregulated operations prior to 2008.

The following table reflects the impacts of the change in accounting policy on Integrys Energy Group's consolidated financial statements:

	As of and for the Year Ended December 31, 2010		
(Millions, except per share data)	As Computed Under Flow-Through Method	Effect of Change	As Computed Under Deferral Method
Consolidated Balance Sheets			
Property, plant, and equipment	$5,016.4	$(3.0)	$5,013.4
Other current liabilities	262.3	0.1	262.4
Long-term deferred income taxes	865.3	(4.8)	860.5
Long-term deferred investment tax credits	36.4	8.8	45.2
Other long-term liabilities	150.0	0.6	150.6
Retained earnings	358.5	(7.7)	350.8
Consolidated Statements of Income			
Operating and maintenance expense	$1,045.7	$(0.1)	$1,045.6
Depreciation and amortization expense	266.1	(0.3)	265.8
Provision for income taxes	148.7	(0.5)	148.2
Net income (loss) from continuing operations	222.6	0.9	223.5
Net income (loss)	222.8	0.9	223.7
Net income (loss) attributed to common shareholders	220.0	0.9	220.9
Earnings (loss) per common share (basic)			
Net income (loss) from continuing operations	$2.84	$0.01	$2.85
Earnings (loss) per common share (basic)	2.84	0.01	2.85
Earnings (loss) per common share (diluted)			
Net income (loss) from continuing operations	$2.82	$0.01	$2.83
Earnings (loss) per common share (diluted)	2.82	0.01	2.83

(Millions, except per share data)	As Originally Reported		Adjustments	Retrospectively Adjusted
	As of and for the Year Ended December 31, 2009			
Consolidated Balance Sheets				
Property, plant, and equipment	$ 4,945.1		$ (3.3)	$ 4,941.8
Other current liabilities	379.9	(1)	0.1	380.0
Long-term deferred income taxes	658.2		(5.3)	652.9
Long-term deferred investment tax credits	36.2		9.8	46.0
Other long-term liabilities	147.4		0.7	148.1
Retained earnings	345.6		(8.6)	337.0
Consolidated Statements of Income				
Operating and maintenance expense	$ 1,099.9	(2)	$ (1.5)	$ 1,098.4
Depreciation and amortization expense	230.9		(0.3)	230.6
Provision for income taxes	83.2		0.5	83.7
Net income (loss) from continuing operations	(71.6)		1.3	(70.3)
Net income (loss)	(68.8)		1.3	(67.5)
Net income (loss) attributed to common shareholders	(70.9)		1.3	(69.6)
Earnings (loss) per common share (basic)				
Net income (loss) from continuing operations	$ (0.96)		$ 0.01	$ (0.95)
Earnings (loss) per common share (basic)	(0.92)		0.01	(0.91)
Earnings (loss) per common share (diluted)				
Net income (loss) from continuing operations	$ (0.96)		$ 0.01	$ (0.95)
Earnings (loss) per common share (diluted)	(0.92)		0.01	(0.91)

(Millions, except per share data)	As Originally Reported	Adjustments	Retrospectively Adjusted
	As of and for the Year Ended December 31, 2008		
Consolidated Statements of Income			
Provision for income taxes	$ 51.2	$ 9.9	$ 61.1
Net income (loss) from continuing operations	124.7	(9.9)	114.8
Net income (loss)	129.4	(9.9)	119.5
Net income (loss) attributed to common shareholders	126.4	(9.9)	116.5
Earnings (loss) per common share (basic)			
Net income (loss) from continuing operations	$ 1.59	$ (0.13)	$ 1.46
Earnings (loss) per common share (basic)	1.65	(0.13)	1.52
Earnings (loss) per common share (diluted)			

Net income (loss) from continuing operations	$ 1.58	$ (0.13)	$ 1.45
Earnings (loss) per common share (diluted)	1.64	(0.13)	1.51

(1) On the Consolidated Balance Sheet for the December 31, 2009 Annual Report on Form 10-K, accrued taxes of $81.9 million were included in the other current liabilities line item, which was originally reported as $461.8 million. Accrued taxes have been separately presented on the Consolidated Balance Sheet for the December 31, 2010 Annual Report on Form 10-K.

(2) On the Consolidated Statement of Income for the December 31, 2009 Annual Report on Form 10-K, impairment losses on property, plant, and equipment of $0.7 million were included in the operating and maintenance expense line item, which was originally reported as $1,100.6 million. Impairment losses on property, plant, and equipment have been separately presented on the Consolidated Statement of Income for the December 31, 2010 Annual Report on Form 10-K.

In the 2009 table above, the adjustments to "Other long-term liabilities" and "Operating and maintenance expense" relate to a solar project that generated an ITC in 2008, but was sold and leased back in 2009.

Prior to the change in accounting, Integrys Energy Group recognized a loss on the sale in 2009 in operating and maintenance expense. If the deferral method had been applied since 2008, the carrying amount of the project would have been reduced by the amount of the ITC received in 2008, and the sale would have instead resulted in a gain in 2009. According to the sale-leaseback guidance in the Leases Topic of the FASB ASC, this gain would have been deferred in 2009 in other long-term liabilities and recognized as a reduction of operating and maintenance expense over the lease term.

The change in accounting policy to adopt the deferral method for ITCs also impacted previously reported amounts within the Consolidated Statements of Equity and Consolidated Statements of Cash Flows. Net income (loss) attributed to common shareholders was adjusted in the Consolidated Statements of Equity to reflect the retrospectively adjusted amounts included in the table above. Although there was no overall impact on net cash provided by (used for) operating activities within the Consolidated Statements of Cash Flows, certain line items classified within this category were adjusted to reflect the retrospectively adjusted amounts included in the table above. These line items were: depreciation and amortization expense, deferred income taxes and investment tax credits, gain (loss) on sale of assets, and other.

(e) Cash and Cash Equivalents--Short-term investments with an original maturity of three months or less are reported as cash equivalents.

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

(Millions)	2010	2009	2008
Cash paid for interest	$138.7	$164.8	$156.8
Cash (received) paid for income taxes	(2.2)	19.1	100.9

Significant noncash transactions were:

(Millions)	2010	2009	2008
Construction costs funded through accounts payable	$18.3	$30.4	$34.2
Equity issued for reinvested dividends	22.6	-	-
Equity issued for stock-based compensation plans	3.0	-	-
Intangible assets (customer contracts) received in exchange for risk management assets	-	17.0	-

(f) Revenue and Customer Receivables--Revenues are recognized on the accrual basis and include estimated amounts for electric and natural gas services provided but not billed. At December 31, 2010, and 2009, Integrys Energy Group's unbilled revenues were $339.1 million and $337.0 million, respectively. At December 31, 2010, there were no customers or industries that accounted for more than 10% of Integrys Energy Group's revenues.

Prudent fuel and purchased power costs are recovered from customers under one-for-one recovery mechanisms by UPPCO and by the wholesale electric operations and Michigan retail electric operations of WPS, which provide for subsequent adjustments to rates for changes in commodity costs. There is a portion of WPS's wholesale electric business that limits cost recovery to no greater than the 2-year average rate charged to large industrial retail customers for that same period. The costs of natural gas prudently incurred by the natural gas utility subsidiaries are also recovered from customers under one-for-one recovery mechanisms.

WPS's Wisconsin retail electric operations do not have a one-for-one mechanism to recover fuel and purchased power costs. Instead, a "fuel window" mechanism is used to recover these costs. Under the fuel window, if actual fuel and purchased power costs deviate by more than 2% from costs included in the rates charged to customers, a rate review

can be triggered. Once a rate review is triggered, rates may be reset (subject to PSCW approval) for the remainder of the year to recover or refund, on an annualized basis, the projected increase or decrease in the cost of fuel and purchased power.

All of Integrys Energy Group's utility subsidiaries are required to provide service and grant credit (with applicable deposit requirements) to customers within their service territories. The companies continually review their customers' credit-worthiness and obtain or refund deposits accordingly. The utilities are generally precluded from discontinuing service to residential customers during winter moratorium months.

PGL credits proceeds from its interstate services provided by its natural gas hub against natural gas costs, resulting in a reduction to utility customers' natural gas charges.

WPS and UPPCO both sell and purchase power in the MISO market. If WPS or UPPCO is a net seller in a particular hour, the net amount is reported as revenue. If WPS or UPPCO is a net purchaser in a particular hour, the net amount is recorded as utility cost of fuel, natural gas, and purchased power on the Consolidated Statements of Income.

Integrys Energy Group presents revenues net of pass-through taxes on the Consolidated Statements of Income.

(g) Inventories--Inventories consist of natural gas in storage, liquid propane, and fossil fuels, including coal. Average cost is used to value fossil fuels, liquid propane, and natural gas in storage for the regulated utilities, excluding PGL and NSG. PGL and NSG price natural gas storage injections at the calendar year average of the costs of natural gas supply purchased. Withdrawals from storage are priced on the LIFO cost method. Inventories stated on a LIFO basis represented approximately 34% of total inventories at December 31, 2010, and 34% of total inventories at December 31, 2009. The estimated replacement cost of natural gas in inventory at December 31, 2010, and December 31, 2009, exceeded the LIFO cost by approximately $136.7 million and $220.5 million, respectively. In calculating these replacement amounts, PGL and NSG used a Chicago city-gate natural gas price per dekatherm of $4.42 at December 31, 2010, and $6.14 at December 31, 2009.

Inventories at Integrys Energy Services are valued at the lower of cost or market unless hedged pursuant to a fair value hedge, in which case changes in the fair value of inventory subsequent to the hedge designation are recorded directly to inventory. Integrys Energy Services recorded net write-downs of $0.9 million, $44.2 million, and $167.3 million in 2010, 2009, and 2008, respectively.

(h) Risk Management Activities--As part of its 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, which are described more fully in Note 2, "Risk Management Activities." Derivative instruments at the utilities are entered into in accordance with the terms of the risk management plans approved by their respective Boards of Directors and, if applicable, by their respective regulators.

All derivatives are recognized on the balance sheet at their fair value unless they are designated as and qualify for the normal purchases and sales exception. Integrys Energy Group continually assesses its contracts designated as normal and will discontinue the treatment of these contracts as normal if the required criteria are no longer met. Most energy-related physical and financial derivatives at the utilities qualify for regulatory deferral. These derivatives are marked to fair value; the resulting risk management assets are offset with regulatory liabilities or decreases to regulatory assets, and risk management liabilities are offset with regulatory assets or decreases to regulatory liabilities. Management believes any gains or losses resulting from the eventual settlement of these derivative instruments will be refunded to or collected from customers in rates.

Integrys Energy Group classifies unrealized gains and losses on derivative instruments that do not qualify for hedge accounting or regulatory deferral as a component of margins or operating and maintenance expense, depending on the nature of the transactions. Unrealized gains and losses on fair value hedges are recognized currently in revenues, as are the changes in fair value of the hedged items. To the extent they are effective, the changes in the values of contracts designated as cash flow hedges are included in other comprehensive income, net of taxes. Fair value hedge

ineffectiveness and cash flow hedge

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ineffectiveness are recorded in revenue, operating and maintenance expense, or interest expense on the Consolidated Statements of Income, based on the nature of the transactions. Cash flows from derivative activities are presented in the same category as the item being hedged within operating activities on the Consolidated Statements of Cash Flows unless the derivative contracts contain an other-than-insignificant financing element, in which case the cash flows are classified within financing activities.

Derivative accounting rules provide the option to present certain asset and liability derivative positions net on the balance sheet and to net the related cash collateral against these net derivative positions. Integrys Energy Group elected not to net these items. On the Consolidated Balance Sheets, cash collateral provided to others is shown separately as collateral on deposit, and cash collateral received from others is reflected in other current liabilities.

(i) Emission Allowances--Integrys Energy Services accounts for emission allowances as intangible assets, with cash inflows and outflows related to purchases and sales of emission allowances recorded as investing activities in the Consolidated Statements of Cash Flows. The utilities account for emission allowances as inventory at average cost by vintage year. Charges to income result when allowances are utilized in operating the utilities' generation plants. Gains on sales of allowances at the utilities are returned to ratepayers.

(j) Property, Plant, and Equipment--Utility plant is stated at original cost, including any associated AFUDC and asset retirement costs. The costs of renewals and betterments of units of property (as distinguished from minor items of property) are capitalized as additions to the utility plant accounts. Except for land, no gain or loss is recognized in connection with ordinary retirements of utility property units. The utilities charge the cost of units of property retired, sold, or otherwise disposed of to the accumulated provision for depreciation. In addition, the utilities record a regulatory liability for removal costs included in rates, with actual removal costs charged against the liability as incurred. Prior to the ICC rate orders issued January 21, 2010, PGL and NSG recorded costs of removal associated with the retirement of assets to depreciation expense as incurred. Maintenance, repair, replacement, and renewal costs associated with items not qualifying as units of property are considered operating expenses.

Integrys Energy Group records straight-line depreciation expense over the estimated useful life of utility property, using depreciation rates as approved by the applicable regulators. Annual utility composite depreciation rates are shown below.

Annual Utility Composite Depreciation Rates	2010		2009		2008	
WPS – Electric	3.05	%	3.04	%	3.09	%
WPS – Natural gas	3.28	%	3.30	%	3.39	%
UPPCO	3.18	%	3.05	%	2.98	%
MGU	3.55	%	2.66	%	2.67	%
MERC	3.08	%	3.10	%	3.32	%
PGL	3.10	%	2.29	%	2.55	%
NSG	2.35	%	1.66	%	1.80	%

Nonregulated plant is stated at cost, which includes capitalized interest. The costs of renewals, betterments, and major overhauls are capitalized as additions to plant. The gains or losses associated with ordinary retirements are recorded in the period of retirement. Maintenance, repair, and minor replacement costs are expensed as incurred.

Depreciation is computed for the majority of the nonregulated subsidiaries' assets using the straight-line method over the assets' useful lives.

Integrys Energy Group capitalizes certain costs related to software developed or obtained for internal use and amortizes those costs to operating expense over the estimated useful life of the related software, which ranges from 3

to 15 years. If software is retired prior to being fully amortized, the difference is recorded as a loss on the Consolidated Statements of Income.

See Note 5, "Property, Plant, and Equipment," for details regarding Integrys Energy Group's property, plant, and equipment balances.

(k) Capitalized Interest and AFUDC--The nonregulated subsidiaries capitalize interest for construction projects, while the utilities capitalize the cost of funds used for construction using a calculation that includes both internal equity and external debt components. The internal equity component of capitalized AFUDC is accounted for as other income, and the external debt component is accounted for as a decrease to interest expense.

Approximately 50% of WPS's retail jurisdictional construction work in progress expenditures are subject to the AFUDC calculation. For 2010, WPS's average AFUDC retail rate was 8.61%, and its average AFUDC wholesale rate was 4.73%. WPS's allowance for equity funds used during construction for 2010, 2009, and 2008 was $0.7 million, $5.1 million, and $5.2 million, respectively. WPS's allowance for borrowed funds used during construction for 2010, 2009, and 2008 was $0.3 million, $2.0 million, and $1.8 million, respectively.

The AFUDC calculation for IBS and the other utilities is determined by the respective state commissions, each with specific requirements. Based on these requirements, IBS and the other utilities did not record significant AFUDC for 2010, 2009, or 2008.

Interest capitalized at the nonregulated subsidiaries was not significant during 2010, 2009, and 2008.

(l) Regulatory Assets and Liabilities--Regulatory assets represent probable future revenue associated with certain costs or liabilities that have been deferred and are expected to be recovered from customers through the ratemaking process. Regulatory liabilities represent amounts that are expected to be refunded to customers in future rates or amounts collected in rates for future costs. If at any reporting date a previously recorded regulatory asset is no longer probable of recovery, the regulatory asset is reduced to the amount considered probable of recovery with the reduction charged to expense in the year the determination is made. See Note 7, "Regulatory Assets and Liabilities," for more information.

(m) Asset Impairment--Goodwill and other intangible assets with indefinite lives are not amortized, but are subject to an annual impairment test. Other long-lived assets require an impairment review when events or circumstances indicate that the carrying amount may not be recoverable. Integrys Energy Group bases its evaluation of other long-lived assets on the presence of impairment indicators such as the future economic benefit of the assets, any historical or future profitability measurements, and other external market conditions or factors.

Integrys Energy Group's reporting units containing goodwill perform annual goodwill impairment tests during the second quarter of each year, and interim impairment tests when impairment indicators are present. The carrying amount of the reporting unit's goodwill is considered not recoverable if it exceeds the reporting unit's fair value. An impairment loss is recorded for the excess of the carrying value of the goodwill over its implied fair value. For more information on Integrys Energy Group's goodwill and other intangible assets, see Note 9, "Goodwill and Other Intangible Assets."

The carrying amount of tangible long-lived assets held and used is considered not recoverable if it exceeds the undiscounted sum of cash flows expected to result from the use and eventual disposition of the asset. If the carrying value is not recoverable, the impairment loss is measured as the excess of the asset's carrying value over its fair value.

The carrying value of assets held for sale is not recoverable if it exceeds the fair value less estimated costs to sell the asset. An impairment loss is recorded for the excess of the asset’s carrying value over the fair value less estimated costs to sell.

The carrying values of cost and equity method investments are assessed for impairment by comparing the fair values of these investments to their carrying values, if a fair value assessment was completed, or

by reviewing for the presence of impairment indicators. If an impairment exists and it is determined to be other-than-temporary, a loss is recognized equal to the amount the carrying value exceeds the investment's fair value.

Integrys Energy Services evaluates emission allowances for impairment by comparing the expected undiscounted future cash flows to the carrying amount. When allowances are expected to be utilized for generation, the allowances are grouped with the related power plant in the impairment evaluation.

(n) Retirement of Debt--Any call premiums or unamortized expenses associated with refinancing utility debt obligations are amortized consistent with regulatory treatment of those items. Any gains or losses resulting from the retirement of nonutility debt are recorded through earnings, while gains or losses resulting from the retirement of utility debt that is not refinanced are either amortized over the remaining life of the original debt or recorded through earnings.

(o) Asset Retirement Obligations--Integrys Energy Group recognizes legal obligations at fair value associated with the retirement of tangible long-lived assets that result from the acquisition, construction or development, and/or normal operation of the assets. A liability is recorded for these obligations as long as the fair value can be reasonably estimated, even if the timing or method of settling the obligation is unknown. The asset retirement obligations are accreted using a credit-adjusted risk-free interest rate commensurate with the expected settlement dates of the asset retirement obligations; this rate is determined at the date the obligation is incurred. The associated retirement costs are capitalized as part of the related long-lived assets and are depreciated over the useful lives of the assets. Subsequent changes resulting from revisions to the timing or the amount of the original estimate of undiscounted cash flows are recognized as an increase or a decrease in the carrying amount of the liability and the associated retirement cost. See Note 13, "Asset Retirement Obligations," for more information.

(p) Income Taxes--Deferred income taxes have been recorded to recognize the expected future tax consequences of events that have been included in the financial statements by using currently enacted tax rates for the differences between the tax basis of assets and liabilities and the basis reported in the financial statements. Integrys Energy Group records valuation allowances for deferred tax assets when it is uncertain if the benefit will be realized in the future. Integrys Energy Group's regulated utilities defer certain adjustments made to income taxes that will impact future rates and record regulatory assets or liabilities related to these adjustments.

In 2010, Integrys Energy Group changed its method of accounting for ITCs from the flow-through method to the deferral method. Under the deferral method, Integrys Energy Group defers the ITCs in the year the credit is received and reduces the provision for income taxes over the useful life of the related property. See Note 1 (d), "Change in Accounting Policy," for additional information on this change in accounting policy.

Production tax credits generally reduce the provision for income taxes in the year that electricity from the qualifying facility is generated and sold. Investment tax credits and production tax credits that do not reduce income taxes payable for the current year are eligible for carryover and recognized as a deferred tax asset. A valuation allowance is established unless it is more likely than not that the credits will be realized during the carryforward period.

Integrys Energy Group files a consolidated United States income tax return that includes domestic subsidiaries of which its ownership is 80% or more. Integrys Energy Group and its consolidated subsidiaries are parties to a federal and state tax allocation arrangement under which each entity determines its provision for income taxes on a stand-alone basis. In several states, combined or consolidated filing is required for certain members of Integrys Energy Group doing business in that state. The tax allocation arrangement equitably allocates the state taxes associated with these combined or consolidated filings.

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Integrys Energy Group reports interest and penalties accrued related to income taxes as a component of provision for income taxes in the Consolidated Statements of Income, as well as regulatory assets or regulatory liabilities in the Consolidated Balance Sheets.

For more information regarding Integrys Energy Group's accounting for income taxes, see Note 14, "Income Taxes."

(q) Guarantees--Integrys Energy Group follows the guidance of the Guarantees Topic of the FASB ASC, which requires that the guarantor recognize, at the inception of the guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. For additional information on guarantees, see Note 16, "Guarantees."

(r) Employee Benefits--The costs of pension and other postretirement benefits are expensed over the periods during which employees render service. The transition obligation related to other postretirement benefit plans that existed at Integrys Energy Group prior to the PEC merger is being recognized over a 20-year period beginning in 1993. In computing the expected return on plan assets, Integrys Energy Group uses a market-related value of plan assets. Changes in fair value are recognized over the subsequent five years for plans sponsored by WPS, while differences between actual investment returns and the expected return on plan assets are recognized over a five-year period for pension plans sponsored by IBS and PEC. The benefit costs associated with employee benefit plans are allocated among Integrys Energy Group's subsidiaries based on employees' time reporting and actuarial calculations, as applicable. Integrys Energy Group's regulators allow recovery in rates for the regulated utilities' net periodic benefit cost calculated under GAAP.

Integrys Energy Group recognizes the funded status of defined benefit postretirement plans on the balance sheet, and recognizes changes in the plans' funded status in the year in which the changes occur. Integrys Energy Group's nonregulated segments record changes in the funded status in other comprehensive income, and the regulated utilities record these changes to regulatory asset or liability accounts.

For additional information on Integrys Energy Group's employee benefits, see Note 17, "Employee Benefit Plans."

(s) Fair Value--A fair value measurement is required to reflect the assumptions market participants would use in pricing an asset or liability based on the best available information. These assumptions include the risks inherent in a particular valuation technique (such as a pricing model) and the risks inherent in the inputs to the model. Also, transaction costs should not be considered in the determination of fair value. On January 1, 2008, Integrys Energy Group recognized an increase in nonregulated revenues of $11.0 million due to the exclusion of transaction costs from Integrys Energy Services' fair value estimates.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (exit price). Integrys Energy Group utilizes a mid-market pricing convention (the mid-point price between bid and ask prices) as a practical expedient for valuing certain derivative assets and liabilities.

Fair value accounting rules provide a fair value hierarchy that prioritizes the inputs used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurement) and the lowest priority to unobservable inputs (Level 3 measurement). The three levels of the fair value hierarchy are defined as follows:

Level 1 – Quoted prices are available in active markets for identical assets or liabilities as of the reporting date. Active markets are those in which transactions for the asset or liability occur in sufficient frequency and volume to provide pricing information on an ongoing basis.

Level 2 – Pricing inputs are observable, either directly or indirectly, but are not quoted prices included within Level 1. Level 2 includes those financial instruments that are valued using external inputs within models or other valuation methodologies.

Level 3 – Pricing inputs include significant inputs that are generally less observable from objective sources. These inputs may be used with internally developed methodologies that result in management's best estimate of fair value. Level 3 instruments include those that may be more structured or otherwise tailored to customers' needs.

Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

Integrys Energy Group determines fair value 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.

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 the use of historically settled data or 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.

See Note 22, "Fair Value," for additional information.

NOTE 2--RISK MANAGEMENT ACTIVITIES

The following table shows Integrys Energy Group's assets and liabilities from risk management activities:

		December 31, 2010	
(Millions)	Balance Sheet Presentation *	Risk Management Assets	Risk Management Liabilities
Utility Segments			
Non-hedge derivatives			
Natural gas contracts	Current	$2.2	$ 23.6
Natural gas contracts	Long-term	1.6	1.4
Financial transmission rights (FTRs)	Current	3.1	0.2
Petroleum product contracts	Current	0.6	-
Coal contract	Current	-	1.2
Coal contract	Long-term	3.7	-
Total commodity contracts	Current	5.9	25.0
Total commodity contracts	Long-term	5.3	1.4
Cash flow hedges			
Natural gas contracts	Current	-	1.0
Nonregulated Segments			
Non-hedge derivatives			
Natural gas contracts	Current	132.0	113.8
Natural gas contracts	Long-term	62.3	57.7
Electric contracts	Current	85.7	122.0
Electric contracts	Long-term	16.5	30.3
Total commodity contracts	Current	217.7	235.8
Total commodity contracts	Long-term	78.8	88.0
Foreign exchange contracts	Current	1.2	1.2
Foreign exchange contracts	Long-term	0.3	0.3
Fair value hedges			
Interest rate swaps	Current	0.9	-
Cash flow hedges			
Natural gas contracts	Current	1.6	9.2
Natural gas contracts	Long-term	0.1	0.9
Electric contracts	Current	9.6	17.4
Electric contracts	Long-term	4.9	9.1
Total commodity contracts	Current	11.2	26.6
Total commodity contracts	Long-term	5.0	10.0
	Current	236.9	289.6
	Long-term	89.4	99.7
Total		$326.3	$ 389.3

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

(Millions)	Balance Sheet Presentation *	December 31, 2009 Risk Management Assets	December 31, 2009 Risk Management Liabilities
Utility Segments			
Non-hedge derivatives			
Commodity contracts	Current	$10.8	$ 24.7
Commodity contracts	Long-term	2.0	1.5
Cash flow hedges			
Commodity contracts	Current	-	0.2
Commodity contracts	Long-term	-	0.1
Nonregulated Segments			
Non-hedge derivatives			
Commodity contracts	Current	1,503.9	1,548.4
Commodity contracts	Long-term	787.2	769.5
Interest rate swaps	Current	-	1.0
Interest rate swaps	Long-term	-	2.5
Foreign exchange contracts	Current	1.0	0.9
Foreign exchange contracts	Long-term	0.9	0.9
Fair value hedges			
Interest rate swaps	Current	1.8	-
Interest rate swaps	Long-term	0.8	-
Cash flow hedges			
Commodity contracts	Current	4.6	30.1
Commodity contracts	Long-term	4.5	8.6
Interest rate swaps	Current	-	1.8
	Current	1,522.1	1,607.1
	Long-term	795.4	783.1
Total		$2,317.5	$ 2,390.2

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

The following table shows Integrys Energy Group's cash collateral positions:

(Millions)	December 31, 2010	December 31, 2009
Cash collateral provided to others	$ 33.3	$ 184.9
Cash collateral received from others	4.5	55.2

Certain of Integrys Energy Group's derivative and nonderivative commodity instruments contain provisions that could require "adequate assurance" in the event of a material adverse change in Integrys Energy Group's creditworthiness, or the posting of additional collateral for instruments in net liability positions, if triggered by a decrease in credit ratings. The following table shows the aggregate fair value of all derivative instruments with specific credit-risk related contingent features that were in a liability position:

(Millions)

	December 31, 2010	December 31, 2009
Integrys Energy Services	$ 219.5	$ 555.6
Utility segments	22.1	24.0

If all of the credit-risk related contingent features contained in commodity instruments (including derivatives, nonderivatives, normal purchase and normal sales contracts, and applicable payables and receivables) had been triggered, Integrys Energy Group's collateral requirement would have been as follows:

(Millions)	December 31, 2010	December 31, 2009
Collateral that would have been required:		
Integrys Energy Services	$ 295.7	$ 549.3
Utility segments	14.1	17.0
Collateral already satisfied:		
Integrys Energy Services		
Letters of credit	56.9	51.9
Cash	-	-
Utility segments		
Letters of credit	-	-
Cash	-	-
Collateral remaining:		
Integrys Energy Services	238.8	497.4
Utility segments	14.1	17.0

Utility Segments

Non-Hedge Derivatives

Utility derivatives include a limited number of natural gas purchase contracts, a coal purchase contract, financial derivative contracts (futures, options, and swaps), and FTRs used to manage electric transmission congestion costs. The futures, options, and swaps were used by both the electric and natural gas utility segments to mitigate the risks associated with the market price volatility of natural gas supply costs, the costs of gasoline and diesel fuel used by utility vehicles, and the cost of coal transportation.

The tables below show the unrealized gains (losses) recorded related to non-hedge derivatives at the utilities.

(Millions)	Financial Statement Presentation	2010
Natural gas contracts	Balance Sheet – Regulatory assets (current)	$(1.7)
Natural gas contracts	Balance Sheet – Regulatory assets (long-term)	0.1
FTRs	Balance Sheet – Regulatory assets (current)	1.0
FTRs	Balance Sheet – Regulatory liabilities (current)	(2.1)
Petroleum product contracts	Balance Sheet – Regulatory liabilities (current)	0.1
Petroleum product contracts	Income Statement – Operating and maintenance expense	0.1
Coal contract	Balance Sheet – Regulatory assets (current)	(1.2)
Coal contract	Balance Sheet – Regulatory liabilities (long-term)	3.7

(Millions)	Financial Statement Presentation	2009
Commodity contracts	Balance Sheet – Regulatory assets (current)	$122.5
Commodity contracts	Balance Sheet – Regulatory assets (long-term)	7.3
Commodity contracts	Balance Sheet – Regulatory liabilities (current)	(1.0)
Commodity contracts	Balance Sheet – Regulatory liabilities (long-term)	-
Commodity contracts	Income Statement – Utility cost of fuel, natural gas, and purchased power	0.1

The utilities had the following notional volumes of outstanding non-hedge derivative contracts:

	December 31, 2010		December 31, 2009	
	Purchases	Other Transactions	Purchases	Other Transactions
Natural gas (millions of therms)	979.9	N/A	833.2	N/A
FTRs (millions of kilowatt-hours)	N/A	5,882.5	N/A	4,546.6
Petroleum products (barrels)	71,827.0	N/A	42,823.0	N/A
Coal contract (millions of tons)	4.9	N/A	N/A	N/A

Cash Flow Hedges

PGL uses natural gas contracts designated as cash flow hedges to hedge changes in the price of natural gas used to support operations. The natural gas used to support operations is not a component of the natural gas recovered from customers on a one-for-one basis. These contracts extend through January 2012. PGL had the following notional volumes of outstanding contracts that were designated as cash flow hedges:

	Purchases	
	December 31, 2010	December 31, 2009
Natural gas (millions of therms)	5.4	9.6

Changes in the fair values of the effective portions of these contracts are included in OCI, net of taxes. Amounts recorded in OCI related to these cash flow hedges will be recognized in earnings when the hedged transactions occur, or if it is probable that the hedged transaction will not occur. The tables below show the amounts related to cash flow hedges recorded in OCI and in earnings.

Unrealized Loss Recognized in OCI on Derivative Instruments (Effective Portion)

(Millions)	2010	2009
Natural gas contracts	$(1.6)	$(1.4)

Loss Reclassified from Accumulated OCI into Income (Effective Portion)

(Millions)	Income Statement Presentation	2010	2009
Settled natural gas contracts	Operating and maintenance expense	$(0.9)	$(2.6)

The amount reclassified from accumulated OCI into earnings as a result of the discontinuance of cash flow hedge accounting related to these natural gas contracts was not significant during 2010 and 2009, and was a pre-tax loss of $2.7 million during 2008. Cash flow hedge ineffectiveness related to these natural gas contracts was not significant during 2010, 2009 and 2008. When testing for effectiveness, no portion of these derivative instruments was excluded. In the next 12 months, an insignificant pre-tax loss is expected to be recognized in earnings as the hedged transactions occur.

Nonregulated Segments

Non-Hedge Derivatives

Integrys Energy Group's nonregulated segments enter into derivative contracts such as futures, forwards, options, and swaps that are not designated as accounting hedges under GAAP. These contracts are used to manage commodity price risk associated with customer-related contracts.

The nonregulated segments had the following notional volumes of outstanding non-hedge derivative contracts:

	December 31, 2010			December 31, 2009		
(Millions)	Purchases	Sales	Other Transactions	Purchases	Sales	Other Transactions
Commodity contracts						
Natural gas (therms)	940.6	1,048.4	N/A	2,990.4	2,917.1	N/A
Electric (kilowatt-hours)	22,149.4	19,707.0	N/A	132,200.4	125,983.1	N/A
Interest rate swaps	N/A	N/A	$ -	N/A	N/A	$ 219.2

Foreign exchange contracts	$15.5	$15.5	N/A	$35.1	$35.1	N/A

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Gains (losses) related to non-hedge derivatives are recognized currently in earnings, as shown in the tables below.

(Millions)	Income Statement Presentation	2010
Natural gas contracts	Nonregulated revenue	$30.9
Natural gas contracts	Nonregulated revenue (reclassified from accumulated OCI)	(1.6) *
Electric contracts	Nonregulated revenue	(92.7)
Electric contracts	Nonregulated revenue (reclassified from accumulated OCI)	(3.7) *
Interest rate swaps	Interest expense	0.4
Total		$(66.7)

* Represents amounts reclassified from accumulated OCI related to cash flow hedges that were dedesignated and retained in accumulated OCI in the current and/or prior periods.

(Millions)	Income Statement Presentation	2009
Commodity contracts	Nonregulated revenue	$(5.1)
Commodity contracts	Nonregulated revenue (reclassified from accumulated OCI)	(3.2) *
Interest rate swaps	Interest expense	(1.7)
Foreign exchange contracts	Nonregulated revenue	(1.8)
Total		$(11.8)

* Represents amounts reclassified from accumulated OCI related to cash flow hedges that were dedesignated and retained in accumulated OCI in the current and/or prior periods.

Fair Value Hedges

At PEC, an interest rate swap designated as a fair value hedge was used to hedge changes in the fair value of $50.0 million of the $325.0 million PEC Series A 6.9% notes due January 15, 2011. The interest rate swap and related debt were settled in January 2011. The changes in the fair value of this hedge were recognized in earnings, as were the changes in fair value of the hedged item. Unrealized gains (losses) related to the fair value hedge and the related hedged item are shown in the table below.

(Millions)	Income Statement Presentation	2010	2009
Interest rate swap	Interest expense	$(1.7)	$(0.6)
Debt hedged by swap	Interest expense	1.7	0.6
Total		$-	$-

Fair value hedge ineffectiveness recorded in interest expense on the Consolidated Statements of Income was not significant in 2010, 2009, and 2008. No amounts were excluded from effectiveness testing related to the interest rate swap during 2010, 2009, and 2008.

During the years ended December 31, 2010 and 2009, Integrys Energy Services did not have any commodity derivative contracts designated as fair value hedges. During the year ended December 31, 2008, Integrys Energy Services had commodity derivative contracts designated as fair value hedges to mitigate the risk of changes in the price of natural gas held in storage. Fair value hedge ineffectiveness recorded in nonregulated revenue on the Consolidated Statements of Income was not significant in 2008. 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 $5.5 million during 2008.

Cash Flow Hedges

Natural gas futures, forwards, and swaps that are designated as cash flow hedges extend through December 2013, while electric futures, forwards, and swaps designated as cash flow hedges extend through May 2017. These contracts are used to mitigate the risk of cash flow variability associated with future purchases and sales of natural gas and electricity. In the second quarter of 2010, Integrys Energy Group entered into two interest rate swaps designated as cash flow hedges to hedge the variability in forecasted interest payments associated with the first $100 million of a planned debt issuance in the fourth quarter of 2010. In November 2010, both swaps were terminated in conjunction with the issuance

of the $250.0 million Series 4.170% senior notes due November 2020. Amounts remaining in accumulated OCI are being reclassified to interest expense over a ten-year period beginning in November 2010 to correspond with the ten years of interest expense on the related debt.

The nonregulated segments had the following notional volumes of outstanding contracts that were designated as cash flow hedges:

	December 31, 2010			December 31, 2009		
(Millions)	Purchases	Sales	Other Transactions	Purchases	Sales	Other Transactions
Commodity contracts						
Natural gas (therms)	265.6	-	N/A	5.9	8.6	N/A
Electric (kilowatt-hours)	11,569.0	29.8	N/A	7,116.2	-	N/A
Interest rate swaps	N/A	N/A	$ -	N/A	N/A	$ 65.6 *

* Notional amount of two interest rate swaps designated as cash flow hedges to hedge the variability in interest payments on an unsecured term loan through June 2010. These interest rate swaps settled in the second quarter of 2010.

Changes in the fair values of the effective portions of contracts designated as cash flow hedges are included in OCI, net of taxes. Amounts recorded in OCI related to cash flow hedges will be recognized in earnings when the hedged transactions occur, or when it is probable that the hedged transaction will not occur. The tables below show the amounts related to cash flow hedges recorded in OCI and in earnings.

Unrealized Loss Recognized in OCI on Derivative Instruments (Effective Portion)

(Millions)	2010
Natural gas contracts	$(15.2)
Electric contracts	(13.6)
Interest rate swaps	(6.0)
Total	$(34.8)

Unrealized Gain (Loss) Recognized in OCI on Derivative Instruments (Effective Portion)

(Millions)	2009
Commodity contracts	$(60.0)
Interest rate swaps	3.2
Total	$(56.8)

Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)

(Millions)	Income Statement Presentation	2010
Settled/Realized		
Natural gas contracts	Nonregulated revenue	$(16.4)
Electric contracts	Nonregulated revenue	(21.6)
Interest rate swaps	Interest expense	0.2
Hedge Designation Discontinued		
Natural gas contracts	Nonregulated revenue	0.2
Electric contracts	Nonregulated revenue	(9.9)
Total		$(47.5)

Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)

(Millions)	Income Statement Presentation	2009
Settled/Realized		
Commodity contracts	Nonregulated revenue	$(107.3)
Interest rate swaps	Interest expense	1.2
Hedge Designation Discontinued		
Commodity contracts	Nonregulated revenue	2.7
Total		$(103.4)

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Loss Recognized in Income on Derivative Instruments (Ineffective Portion and Amount Excluded from Effectiveness Testing)

(Millions)	Income Statement Presentation	2010
Natural gas contracts	Nonregulated revenue	$(1.1)
Electric contracts	Nonregulated revenue	(0.5)
Total		$(1.6)

Loss Recognized in Income on Derivative Instruments (Ineffective Portion and Amount Excluded from Effectiveness Testing)

(Millions)	Income Statement Presentation	2009
Commodity contracts	Nonregulated revenue	$(1.1)

In the next 12 months, subject to changes in market prices of natural gas and electricity, pre-tax losses of $8.0 million and $7.9 million related to cash flow hedges of natural gas contracts and electric contracts, respectively, are expected to be recognized in earnings as the hedged transactions occur. This amount is expected to be substantially offset by the settlement of the related nonderivative hedged contracts.

NOTE 3--RESTRUCTURING EXPENSE

Reductions in Workforce

In an effort to permanently remove costs from its operations, Integrys Energy Group developed a plan at the end of 2009 that included reductions in its workforce. In connection with this plan, employee-related and consulting costs were included in the restructuring expense line item on the Consolidated Statements of Income. The restructuring costs were distributed across Integrys Energy Group's segments as follows:

(Millions)	2010	2009
Electric utility	$(0.3)	$8.6
Natural gas utility	(0.2)	6.9
Integrys Energy Services	-	1.7
Holding company and other	0.1	0.8
Total restructuring expense	$(0.4)	$18.0

The following table summarizes the activity related to these restructuring costs:

(Millions)	2010	2009
Accrued restructuring costs at beginning of period	$18.0	$-
Add: Adjustments to accrual during the period	(0.1) *	18.0
Deduct: Cash payments	17.7	-
Accrued restructuring costs at end of period	$0.2	$18.0

* Restructuring costs of $0.3 million were billed to certain companies in accordance with provisions in the operating agreements with these companies that allow Integrys Energy Group to recover a portion of its administrative and general expenses.

Integrys Energy Services Strategy Change

As part of Integrys Energy Group's decision to reposition its nonregulated energy services business to focus on selected retail markets in the northeast quadrant of the United States and investments in energy assets with renewable attributes, the following restructuring costs were expensed:

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(Millions)	2010	2009
Employee-related costs	$1.1	$10.1
Professional fees	6.4	9.2
Software write-offs and accelerated depreciation	0.4	5.9
Miscellaneous	0.4	0.3
Total restructuring expense	$8.3	$25.5

All of the above costs were related to the Integrys Energy Services segment and were included in the restructuring expense line item on the Consolidated Statements of Income.

The following table summarizes the activity related to employee-related restructuring expense:

(Millions)	2010	2009
Accrued employee-related costs at beginning of period	$8.2	$-
Add: Employee-related costs expensed	1.1	10.1
Deduct: Cash payments	9.0	1.9
Accrued employee-related costs at end of period	$0.3	$8.2

Integrys Energy Group expects to recognize an insignificant amount of additional employee-related restructuring expense related to the Integrys Energy Services strategy change in the first half of 2011.

NOTE 4--DISPOSITIONS

Integrys Energy Services Strategy Change

As part of Integrys Energy Group's decision to reposition its nonregulated energy services business to focus on selected retail markets in the northeast quadrant of the United States and investments in energy assets with renewable attributes, Integrys Energy Services completed the following sales.

Sale of Integrys Energy Services of Texas, LP

In June 2010, Integrys Energy Services sold its Texas retail electric marketing business. The pre-tax gain on the sale of Integrys Energy Services of Texas, LP was $25.5 million and was reported as a component of net loss on Integrys Energy Services' dispositions related to strategy change in the Consolidated Statements of Income.

The following table shows the carrying values of the major classes of assets and liabilities included in the sale at the closing date:

(Millions)	
Current assets from risk management activities	$14.0
Other current assets	2.2
Long-term assets from risk management activities	13.8
Other long-term assets	1.9
Total assets	$31.9
Current liabilities from risk management activities	$35.2
Long-term liabilities from risk management activities	27.3
Total liabilities	$62.5

In addition to the above recognized assets and liabilities, commodity contracts not accounted for as derivative instruments were also transferred to the buyer.

Sale of Canadian Natural Gas and Wholesale Electric Marketing and Trading Portfolio

In September 2009, Integrys Energy Services of Canada, a subsidiary of Integrys Energy Services, sold nearly all of its Canadian natural gas and electric power contract portfolio. In a separate transaction, Integrys Energy Services of Canada sold a 2 billion cubic foot (bcf) natural gas storage contract. With these two transactions, Integrys Energy Services exited the majority of its electric and natural gas marketing business in Canada.

The following table shows the carrying values of the major classes of assets and liabilities included in the transactions at the closing dates.

(Millions)	
Inventories	$5.3
Current assets from risk management activities	134.7
Long-term assets from risk management activities	48.6
Total assets	$188.6
Current liabilities from risk management activities	$119.8
Long-term liabilities from risk management activities	32.3
Total liabilities	$152.1

In conjunction with the first transaction, Integrys Energy Services entered into derivative contracts with the buyer to reestablish the economic hedges for the retained United States retail business, at the same prices and other terms originally executed through Integrys Energy Services' Canadian natural gas and electric power portfolio. The execution of these third-party derivative contracts resulted in assets and liabilities from risk management activities as follows at the closing date:

(Millions)	
Current assets from risk management activities	$21.8
Long-term assets from risk management activities	8.8
Total assets	$30.6
Current liabilities from risk management activities	$14.2
Long-term liabilities from risk management activities	6.3
Total liabilities	$20.5

In May 2010, Integrys Energy Services completed the sale of its remaining Canadian wholesale electric marketing and trading portfolio. The following table shows the carrying values of the major classes of assets and liabilities included in the sale at the May 2010 closing date:

(Millions)	
Current assets from risk management activities	$13.8
Long-term assets from risk management activities	10.5
Total assets	$24.3
Current liabilities from risk management activities	$15.2
Long-term liabilities from risk management activities	9.5

Total liabilities	$24.7

The pre-tax losses on the sales of the Canadian natural gas and wholesale electric marketing and trading portfolio were $0.4 million in both 2010 and 2009 and were reported as a component of net loss on

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Integrys Energy Services' dispositions related to strategy change in the Consolidated Statements of Income.

Sale of Renewable Energy Certificates Portfolio

In March 2010, Integrys Energy Services sold its environmental markets business, which consisted of a portfolio of long-term renewable energy certificate contracts with generators, wholesalers, municipalities, cooperatives, and large industrial companies. The pre-tax gain on the sale of the renewable energy certificate contracts was $2.8 million and was reported as a component of net loss on Integrys Energy Services' dispositions related to strategy change in the Consolidated Statements of Income.

Sale of United States Wholesale Electric Marketing and Trading Business

In March 2010, Integrys Energy Services closed on the sale of substantially all of its United States wholesale electric marketing and trading business.

The following table shows the carrying values of the major classes of assets and liabilities included in the sale at the closing date:

(Millions)	
Current assets from risk management activities	$1,375.5
Long-term assets from risk management activities	683.3
Total assets	$2,058.8
Current liabilities from risk management activities	$1,389.8
Long-term liabilities from risk management activities	654.3
Total liabilities	$2,044.1

In addition to the above recognized assets and liabilities, commodity contracts not accounted for as derivative instruments were also transferred to the buyer.

In conjunction with the sale, Integrys Energy Services entered into derivative contracts with the buyer to reestablish the economic hedges for the retained United States retail electric business, with the same prices and terms originally executed through Integrys Energy Services' United States wholesale electric marketing and trading business. For a two-year period following the closing, Integrys Energy Services will retain counterparty default risk with approximately 50% of the counterparties to the commodity contracts novated. The fair value of the counterparty payment default risk at the date of the sale was $0.8 million and was reported as a component of other long-term liabilities. As of December 31, 2010, the carrying value of the default risk decreased to $0.3 million, resulting in a $0.5 million pre-tax positive impact on net income.

On February 1, 2010, Integrys Energy Services transferred substantially all of the market risk associated with this business by entering into trades with the buyer that mirrored Integrys Energy Services' underlying wholesale electric contracts. On March 31, 2010, Integrys Energy Services transferred title to the majority of the underlying commodity contracts, upon which time the corresponding mirror transactions terminated. As of December 31, 2010, approximately 95% of the commodity contracts had been novated, and the corresponding mirror transactions had been terminated. The remaining underlying commodity contracts that had not been novated as of December 31, 2010 will be settled through the normal course of business, at which time the corresponding mirror transactions will terminate.

The following table shows the carrying values of the remaining underlying commodity contracts that had not been novated at December 31, 2010:

(Millions)	
Current assets from risk management activities	$22.3
Current liabilities from risk management activities	7.9

The following table shows the carrying values of the remaining mirror transactions associated with the underlying commodity contracts referenced above that had not been novated at December 31, 2010:

(Millions)	
Current assets from risk management activities	$7.9
Current liabilities from risk management activities	22.3

Integrys Energy Services closed on the sale of its only remaining significant wholesale electric commodity contract with another buyer in March 2010.

The total of the pre-tax net loss on the sale of the United States wholesale electric marketing and trading business and the remaining commodity contract, net of the gain resulting from the fair value adjustment, was $55.7 million for 2010 and was reported as a component of net loss on Integrys Energy Services' dispositions related to strategy change in the Consolidated Statements of Income.

Sale of Generation Businesses in New Brunswick, Canada and Northern Maine, and Associated Retail Electric Contracts

In January 2010, Integrys Energy Services closed on the sale of two of its power generation businesses, which owned generation assets in New Brunswick, Canada and Northern Maine, and subsequently closed on the sale of the associated retail electric contracts and standard offer service contracts in Northern Maine in February 2010. The proceeds from the sale of the generation companies and associated retail electric contracts were $38.5 million. The pre-tax gain on the sales was $15.7 million for 2010 and was reported as a component of net loss on Integrys Energy Services' dispositions related to strategy change in the Consolidated Statements of Income.

The carrying values of the major classes of assets and liabilities included in the sales as of the closing dates and classified as held for sale on the Consolidated Balance Sheets at December 31, 2009, were as follows:

(Millions)	As of the Closing Dates in 2010	December 31, 2009
Inventories	$0.1	$ 0.1
Property, plant, and equipment, net	25.1	25.1
Other long-term assets	1.3	1.3
Total assets	$26.5	$ 26.5
Other current liabilities	$0.1	$ -
Asset retirement obligations	0.3	0.3

Total liabilities	$0.4	$ 0.3

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In conjunction with the sale, Integrys Energy Services entered into derivative contracts with the buyer of the Northern Maine retail electric sales contracts to offset the retained economic hedges associated with the customer contracts sold.

Sale of United States Wholesale Natural Gas Marketing and Trading Business and Other Wholesale Natural Gas Storage Contracts

In October 2009, Integrys Energy Services entered into definitive agreements to sell the majority of its United States wholesale natural gas marketing and trading business in a two-part transaction. In December 2009, Integrys Energy Services closed the first part of the transaction by selling substantially all of its United States wholesale natural gas marketing and trading business. The second part of the transaction included the sale of its remaining natural gas storage and related transportation contracts through multiple transactions which closed during the first half of 2010. The carrying value of inventories included in the 2010 sales was $1.8 million as of the closing date.

The pre-tax losses on the sale of the United States wholesale natural gas marketing and trading business and natural gas storage and related transportation contracts as of 2010 and 2009 was $2.0 million and $28.5 million, respectively, and were reported as a component of net loss on Integrys Energy Services' dispositions related to strategy change in the Consolidated Statements of Income.

Discontinued Operations Resulting from Integrys Energy Services’ Strategy Change

Energy Management Consulting Business

During 2010, Integrys Energy Services recorded a $0.2 million after-tax gain in discontinued operations when contingent payments were earned related to the sale of its energy management consulting business.

During 2009, Integrys Energy Services completed the sale of its energy management consulting business and received proceeds of $4.7 million. This business provided consulting services relating to long-term strategies for managing energy costs for its customers. The historical results of this business were not significant. The gain on the sale of this business reported in discontinued operations during the third quarter of 2009 was $3.9 million ($2.4 million after tax).

Other Discontinued Operations

WPS Niagara Generation, LLC

During 2009, Integrys Energy Services recorded a $0.4 million after-tax gain in discontinued operations related to a refund received in connection with the overpayment for auxiliary power service in prior years.

During 2008, Integrys Energy Services recorded a $0.1 million after-tax gain in discontinued operations related to amortization of an environmental indemnification guarantee included as part of the 2007 sale agreement of WPS Niagara Generation.

Stoneman

During 2008, Integrys Energy Services sold its subsidiary Mid-American Power, LLC, which owned the Stoneman generation facility, located in Wisconsin. The historical financial results of this business were not significant. In the fourth quarter of 2008, Integrys Energy Services recognized a $6.3 million ($3.8 million after tax) gain on the sale of this business in discontinued operations when a contingent payment was earned.

PEP

In 2008, $0.8 million of tax adjustments related to the sale of PEP in 2007 was recorded as income from discontinued operations.

NOTE 5--PROPERTY, PLANT, AND EQUIPMENT

Property, plant, and equipment at December 31 consisted of the following utility, nonutility, and nonregulated assets:

(Millions)	2010	2009
Electric utility	$3,095.5	$3,066.7
Natural gas utility	4,506.3	4,338.3
Total utility plant	7,601.8	7,405.0
Less: Accumulated depreciation	2,794.2	2,726.0
Net	4,807.6	4,679.0
Construction work in progress	39.5	40.7
Net utility plant	4,847.1	4,719.7
Nonutility plant – utility segments	143.9	100.7
Less: Accumulated depreciation	70.2	59.1
Net	73.7	41.6
Construction work in progress	1.6	34.6
Net nonutility plant – utility segments	75.3	76.2
Electric nonregulated	87.5	163.2
Natural gas nonregulated	18.0	18.1
Other nonregulated	20.5	23.5
Total nonregulated property, plant, and equipment	126.0	204.8
Less: Accumulated depreciation	35.8	61.8
Net	90.2	143.0
Construction work in progress	0.8	2.9
Net nonregulated property, plant, and equipment	91.0	145.9
Total property, plant, and equipment	$5,013.4	$4,941.8

Integrys Energy Group evaluates property, plant, and equipment for impairment whenever indicators of impairment exist. During the third quarter of 2010, Integrys Energy Services recorded a pre-tax noncash impairment loss of $43.2 million related to its three natural gas-fired generation plants (Beaver Falls Generation, Syracuse Generation, and Combined Locks Energy Center). The impairment charge resulted from lower estimated future cash flows for these plants and was primarily driven by reduced expectations for forward capacity prices. The impairment charge is shown under impairment losses in property, plant, and equipment in the Consolidated Statements of Income.

The fair value of the natural gas plants was determined primarily using the income approach, which was based on discounted cash flows that were derived from internal forecasts and economic expectations. The key assumptions used to determine fair value under the income approach over the cash flow period were forward energy and capacity curves. Other assumptions included forecasted operating expenses, forecasted capital additions, anticipated working capital requirements, and the discount rate. The discount rate represents the estimated cost of capital appropriate for the nonregulated generation plants. The discount rate used for the impairment analysis was 10%.

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NOTE 6--JOINTLY OWNED UTILITY FACILITIES

WPS holds a joint ownership interest in certain electric generating facilities. WPS is entitled to its share of generating capability and output of each facility equal to its respective ownership interest. WPS also pays its ownership share of additional construction costs, fuel inventory purchases, and operating expenses, unless specific agreements have been executed to limit its maximum exposure to additional costs. WPS's share of significant jointly owned electric generating facilities as of December 31, 2010, was as follows:

(Millions, except for percentages and megawatts)	Weston 4	West Marinette Unit No. 33 *	Columbia Energy Center Units 1 and 2	Edgewater Unit No. 4
Ownership	70.0 %	68.0 %	31.8 %	31.8 %
WPS's share of rated capacity (megawatts)	374.5	65.8	335.2	105.0
Utility plant in service	$614.7	$18.3	$165.3	$38.5
Accumulated depreciation	$75.9	$10.2	$103.4	$24.4
In-service date	2008	1993	1975 and 1978	1969

* On February 1, 2011, the joint owner of this facility sold all of its ownership interest to WPS, making WPS the sole owner.

WPS's share of direct expenses for these plants is recorded in operating expenses in the Consolidated Statements of Income. WPS has supplied its own financing for all jointly owned projects.

NOTE 7--REGULATORY ASSETS AND LIABILITIES

Integrys Energy Group's utility subsidiaries expect to recover their regulatory assets and incur future costs or refund their regulatory liabilities through rates charged to customers based on specific ratemaking decisions over periods specified by the regulators or over the normal operating period of the assets and liabilities to which they relate. Based on prior and current rate treatment for such costs, Integrys Energy Group believes it is probable that its utility subsidiaries will continue to recover from customers the regulatory assets described below.

The following regulatory assets and liabilities were reflected in Integrys Energy Group's Consolidated Balance Sheets as of December 31:

(Millions)	2010	2009	See Note	
Regulatory assets				
Environmental remediation costs (net of insurance recoveries) (1) (2)	$653.0	$674.9	15	
Unrecognized pension and other postretirement benefit costs	544.5	570.2	17	
Merger and acquisition related pension and other postretirement benefit costs (3)	133.8	35.3		
Decoupling	50.5	28.9	24	
Asset retirement obligations	47.6	39.4	13	
Derivatives	34.1	32.3	1	(h)
De Pere Energy Center (4)	31.0	33.4		
Income tax related items	28.1	29.0	14	
Energy costs receivable through rate adjustments	15.5	12.3	24	
Conservation program costs (5)	15.3	17.4		
Unamortized loss on reacquired debt (1) (6)	14.6	12.5		
Weston 3 lightning strike (1) (7)	14.5	18.1		
Other	30.5	52.3		
Total	$1,613.0	$1,556.0		
Balance Sheet Presentation				
Current	$117.9	$121.1		
Long-term	1,495.1	1,434.9		
Total	$1,613.0	$1,556.0		
Regulatory liabilities				
Removal costs (8)	$278.1	$246.6		
Energy costs refundable through rate adjustments	51.8	79.6	24	
Unrecognized pension and other postretirement benefit costs	20.0	23.5	17	
Uncollectible expense	8.3	3.2	24	
Decoupling	8.1	1.4	24	
EEP (5)	7.2	6.1		
Derivatives	6.0	4.3	1	(h)
Other	12.4	13.3		
Total	$391.9	$378.0		
Balance Sheet Presentation				
Current	$75.7	$100.4		
Long-term	316.2	277.6		
Total	$391.9	$378.0		

(1) Amounts related to the Weston 3 lightning strike, WPS environmental remediation, and unamortized loss on reacquired debt at PGL and NSG are not earning a return. The carrying costs of these regulatory assets are borne by Integrys Energy Group's shareholders.

(2) As of December 31, 2010, Integrys Energy Group had not yet made cash expenditures for $643.9 million of these environmental remediation costs.

(3)

Composed of unrecognized benefit costs that existed prior to the PEC merger and the MERC and MGU acquisitions.

(4) Prior to WPS purchasing the De Pere Energy Center, WPS had a long-term power purchase contract with the De Pere Energy Center that was accounted for as a capital lease. As a result of the purchase, the capital lease obligation was reversed and the difference between the capital lease asset and the purchase price was recorded as a regulatory asset. WPS is authorized recovery of this regulatory asset over a 20-year period.

(5) Represents amounts recoverable from and/or refundable to customers related to programs designed to meet energy efficiency standards.

(6) Amounts for PGL and NSG are recovered over the term of the replacement debt as authorized by the ICC.

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(7) In 2007, a lightning strike caused significant damage to the Weston 3 generating facility. The PSCW approved the deferral of the incremental fuel and purchased power expenses, as well as the non-fuel operating and maintenance expenditures incurred as a result of the outage that were not covered by insurance. WPS is authorized recovery of this regulatory asset over a six-year period.

(8) Represents amounts collected from customers to cover the future removal of property, plant, and equipment.

NOTE 8--INVESTMENTS IN AFFILIATES, AT EQUITY METHOD

Investments in corporate joint ventures and other companies accounted for under the equity method at December 31, 2010, and 2009 were as follows:

(Millions)	2010	2009
ATC	$416.3	$395.9
WRPC	8.1	8.5
Other	1.1	1.4
Investments in affiliates, at equity method	$425.5	$405.8

Investments in affiliates accounted for under the equity method are included in other long-term assets on the Consolidated Balance Sheets, and the equity income is recorded in miscellaneous income on the Consolidated Statements of Income. Integrys Energy Group is taxed on ATC's equity income, due to the tax flow-through nature of ATC's business structure. Accordingly, Integrys Energy Group's provision for income taxes includes taxes on ATC's equity income.

ATC

Integrys Energy Group’s electric transmission investment segment consists of WPS Investments LLC’s ownership interest in ATC, which was approximately 34% at December 31, 2010. ATC is a for-profit, transmission-only company regulated by FERC. ATC owns, maintains, monitors, and operates electric transmission assets in portions of Wisconsin, Michigan, Minnesota, and Illinois.

The following table shows changes to Integrys Energy Group's investment in ATC during the years ended December 31.

(Millions)	2010	2009	2008
Balance at the beginning of period	$395.9	$346.9	$296.6
Add: equity in net income	77.6	75.3	66.1
Add: capital contributions	6.8	34.1	34.6
Less: dividends received	64.0	60.4	50.4
Balance at the end of period	$416.3	$395.9	$346.9

The regulated electric utilities provide construction and other services to, and receive network transmission services from, ATC. The related party transactions recorded by the regulated electric utilities in the years ended December 31 were as follows:

(Millions)	2010	2009	2008
Total charges to ATC for services and construction	$14.0	$10.1	$12.8
Total costs for network transmission service provided by ATC	103.0	90.7	87.8
Net amounts received from (advanced to) ATC for	-	-	82.3

transmission interconnection

WRPC

WPS owns 50% of the stock of WRPC, which operates two hydroelectric plants and an oil-fired combustion turbine. Two-thirds of the energy output of the hydroelectric plants is sold to WPS, and the remaining one-third is sold to Wisconsin Power and Light. The electric power from the combustion turbine is sold in equal parts to WPS and Wisconsin Power and Light.

WPS provides services to WRPC, purchases energy from WRPC, and receives net proceeds from sales of energy into the MISO market from WRPC. The related party transactions recorded and net proceeds and dividends received during the years ended December 31 were as follows:

(Millions)	2010	2009	2008
Revenues from services provided to WRPC	$0.6	$0.6	$0.8
Purchases of energy from WRPC	4.7	4.6	4.7
Net proceeds from WRPC sales of energy to MISO	4.5	2.6	5.8
Dividends received from WRPC	1.4	0.9	3.5

Of Integrys Energy Group's equity in net income disclosed below, $1.0 million, $1.0 million, and $2.2 million is the pre-tax income related to WPS's investment in WRPC in 2010, 2009, and 2008, respectively.

Financial Data

Combined financial data of Integrys Energy Group's significant equity method investments, ATC and WRPC, is included in the table below.

(Millions)	2010	2009	2008
Income statement data			
Revenues	$564.1	$528.7	$474.0
Operating expenses	256.8	235.7	214.6
Other expense	85.7	77.7	67.1
Net income	$221.6	$215.3	$192.3
Integrys Energy Group's equity in net income	$78.6	$76.3	$68.3
Balance sheet data			
Current assets	$62.5	$54.0	$52.5
Noncurrent assets	2,906.2	2,785.5	2,494.8
Total assets	$2,968.7	$2,839.5	$2,547.3
Current liabilities	$429.0	$286.3	$252.4
Long-term debt	1,175.0	1,259.6	1,109.4
Other noncurrent liabilities	88.5	80.1	119.3
Shareholders' equity	1,276.2	1,213.5	1,066.2
Total liabilities and shareholders' equity	$2,968.7	$2,839.5	$2,547.3

NOTE 9--GOODWILL AND OTHER INTANGIBLE ASSETS

Integrys Energy Group had no changes to the carrying amount of goodwill for the year ended

December 31, 2010. Annual impairment tests were completed at all of Integrys Energy Group's reporting units that carry a goodwill balance in the second quarter of 2010, and no impairments resulted from these tests.

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The following table shows goodwill by business segment as of January 1, 2009:

(Millions)	Natural Gas Utility Segment	Integrys Energy Services	Total
Gross goodwill balance	$933.5	$6.9	$940.4
Accumulated impairment loss	(6.5)	-	(6.5)
Net goodwill balance	$927.0	$6.9	$933.9

Integrys Energy Group had the following changes to the carrying amount of goodwill for the year ended December 31, 2009:

(Millions)	Natural Gas Utility Segment	Integrys Energy Services	Total
Net goodwill recorded at December 31, 2008	$927.0	$6.9	$933.9
Impairment loss	(291.1)	-	(291.1)
Goodwill allocated to businesses sold	-	(0.3)	(0.3)
Net goodwill recorded at December 31, 2009	$635.9	$6.6	$642.5

The following table shows goodwill by business segment as of December 31:

	2010			2009		
(Millions)	Natural Gas Utility Segment	Integrys Energy Services	Total	Natural Gas Utility Segment	Integrys Energy Services	Total
Gross goodwill balance	$933.5	$6.6	$940.1	$933.5	$6.6	$940.1
Accumulated impairment loss	(297.6)	-	(297.6)	(297.6)	-	(297.6)
Net goodwill balance	$635.9	$6.6	$642.5	$635.9	$6.6	$642.5

In the first quarter of 2009, the combination of the decline in equity markets as well as the increase in the expected weighted-average cost of capital triggered an interim goodwill impairment analysis. Based upon the results of this analysis, Integrys Energy Group recorded a noncash goodwill impairment loss of $291.1 million ($248.8 million after tax) in the first quarter of 2009, all within the natural gas utility segment. A combination of the income approach and the market approach were used to estimate the fair values of PGL, NSG, MERC, and MGU. The income approach was used to estimate the fair value of Integrys Energy Services. Key factors contributing to the impairment charge included disruptions in the global credit and equity markets and the resulting increase in the weighted-average cost of capital used to value the natural gas utility operations, and the negative impact that the global decline in equity markets had on the valuation of natural gas distribution companies in general.

A goodwill impairment loss in the amount of $6.5 million, after tax, was recognized for NSG in the second quarter of 2008. The income approach was used to estimate the fair value of NSG at April 1, 2008. The goodwill impairment recognized for NSG was due to a decline in the estimated fair value of NSG, caused primarily by a decrease in forecasted results as compared to the forecast at the time of the acquisition. Worsening economic factors also contributed to the decline in fair value.

Identifiable intangible assets other than goodwill are included as a component of other current and long-term assets and other current and long-term liabilities within the Consolidated Balance Sheets as listed below.

(Millions)	December 31, 2010			December 31, 2009		
	Gross Carrying Amount	Accumulated Amortization	Net	Gross Carrying Amount	Accumulated Amortization	Net
Amortized intangible assets (liabilities)						
Customer-related (1)	$32.6	$ (21.8)	$10.8	$32.6	$ (18.3)	$14.3
Natural gas and electric contract assets (2) (3)	57.1	(55.0)	2.1	71.4	(60.5)	10.9
Natural gas and electric contract liabilities (2)	(10.5)	10.5	-	(10.5)	10.4	(0.1)
Renewable energy credits (4)	2.5	-	2.5	3.4	(2.1)	1.3
Nonregulated easements (5)	3.8	(0.4)	3.4	3.6	(0.1)	3.5
Emission allowances (6)	1.9	(0.2)	1.7	2.1	(0.2)	1.9
Other	2.4	(0.4)	2.0	2.5	(0.5)	2.0
Total	$89.8	$ (67.3)	$22.5	$105.1	$ (71.3)	$33.8
Unamortized intangible assets						
MGU trade name	5.2	-	5.2	5.2	-	5.2
Total intangible assets	$95.0	$ (67.3)	$27.7	$110.3	$ (71.3)	$39.0

(1) Includes customer relationship assets associated with both PEC's former nonregulated retail natural gas and electric operations and MERC's nonutility ServiceChoice business. The remaining weighted-average amortization period for customer-related intangible assets at December 31, 2010, was approximately 7 years.

(2) Represents the fair value of certain PEC natural gas and electric customer contracts acquired in the February 2007 PEC merger that were not considered to be derivative instruments, as well as other electric customer contracts acquired in exchange for risk management assets.

(3) Includes both short-term and long-term intangible assets related to customer contracts in the amount of $0.9 million and $1.2 million, respectively, at December 31, 2010, and $6.2 million and $4.7 million, respectively, at December 31, 2009. The remaining weighted-average amortization period for these intangible assets at December 31, 2010, was approximately 3 years.

(4) Used at Integrys Energy Services to comply with state Renewable Portfolio Standards and to support customer commitments.

(5) Relates to easements supporting a natural gas pipeline at Integrys Energy Services. The easements are amortized on a straight-line basis, with a remaining amortization period of approximately 13 years.

(6) Emission allowances do not have a contractual term or expiration date.

Intangible asset amortization expense was recorded as a component of depreciation and amortization expense in the Consolidated Statements of Income. This intangible asset amortization expense excludes amortization related to natural gas contracts, electric contracts, renewable energy credits, and emission allowances, which are recorded as a component of nonregulated cost of fuel, natural gas, and purchased power in the Consolidated Statements of Income. Amortization for the years ended December 31, 2010, 2009, and 2008, was $3.9 million, $6.3 million, and $7.9 million, respectively.

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

(Millions)	
For year ending December 31, 2011	$3.3
For year ending December 31, 2012	2.4
For year ending December 31, 2013	1.6
For year ending December 31, 2014	1.4
For year ending December 31, 2015	1.3

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Amortization related to the natural gas and electric contract intangible assets and liabilities, renewable energy credits, and emission allowances for the years ended December 31, 2010, 2009, and 2008, was $4.9 million, $8.9 million, and $34.4 million, respectively.

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

(Millions)	
For year ending December 31, 2011	$3.6
For year ending December 31, 2012	0.7
For year ending December 31, 2013	0.6
For year ending December 31, 2014	0.5
For year ending December 31, 2015	0.2

NOTE 10--LEASES

Integrys Energy Group leases various property, plant, and equipment. Terms of the operating leases vary, but generally require Integrys Energy Group to pay property taxes, insurance premiums, and maintenance costs associated with the leased property. Many of Integrys Energy Group's leases contain one of the following options upon the end of the lease term: (a) purchase the property at the current fair market value or (b) exercise a renewal option, as set forth in the lease agreement. Rental expense attributable to operating leases was $15.2 million, $16.9 million, and $17.0 million in 2010, 2009 and 2008, respectively. Future minimum rental obligations under non-cancelable operating leases are payable as follows:

Year ending December 31 (Millions)	
2011	$9.8
2012	8.9
2013	8.8
2014	4.9
2015	2.9
Later years	21.1
Total payments	$56.4

NOTE 11--SHORT-TERM DEBT AND LINES OF CREDIT

Integrys Energy Group's short-term borrowings consist of sales of commercial paper, borrowings under revolving credit facilities, and short-term notes. Amounts shown are as of December 31:

(Millions, except percentages)	2010		2009		2008	
Commercial paper outstanding	-		$212.1		$552.9	
Average discount rate on outstanding commercial paper	-		0.52	%	4.78	%
Borrowings outstanding under revolving credit facilities	-		-		$475.0	
Average interest rate on borrowings outstanding under revolving credit facilities	-		-		2.41	%
Short-term notes payable outstanding	$10.0		$10.0		$181.1	
Average interest rate on short-term notes payable outstanding	0.32	%	0.18	%	3.40	%

The table below presents Integrys Energy Group's average amount of short-term borrowings outstanding based on daily outstanding balances during the years ended December 31:

(Millions)	2010	2009	2008
Average amount of commercial paper outstanding	$66.9	$193.8	$305.7
Average amount of borrowings outstanding under revolving credit facilities	-	114.5	166.8
Average amount of short-term notes payable outstanding	10.0	48.0	34.3

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Integrys Energy Group manages its liquidity by maintaining adequate external financing commitments. The information in the table below relates to Integrys Energy Group's short-term debt, lines of credit, and remaining available capacity as of December 31:

(Millions)	Maturity	2010	2009
Revolving credit facility (Integrys Energy Group) (1)	04/23/13	$735.0	$-
Revolving credit facility (Integrys Energy Group) (2)	06/09/11	500.0	500.0
Revolving credit facility (Integrys Energy Group) (3)	06/02/10	-	500.0
Revolving credit facility (Integrys Energy Group) (3)	05/26/10	-	425.0
Revolving credit facility (Integrys Energy Group) (3)	06/04/10	-	35.0
Revolving credit facility (WPS) (4)	04/23/13	115.0	-
Revolving credit facility (WPS) (3)	06/02/10	-	115.0
Revolving credit facility (PEC) (2) (5)	06/13/11	400.0	400.0
Revolving credit facility (PGL) (6)	04/23/13	250.0	-
Revolving credit facility (PGL) (3)	07/12/10	-	250.0
Revolving short-term notes payable (WPS) (7)	05/13/11	10.0	10.0
Total short-term credit capacity		2,010.0	2,235.0
Less:			
Letters of credit issued inside credit facilities		64.9	130.4
Loans outstanding under credit agreements and notes payable		10.0	10.0
Commercial paper outstanding		-	212.1
Available capacity under existing agreements		$1,935.1	$1,882.5

(1) In April 2010, Integrys Energy Group entered into a new revolving credit agreement to provide support for its commercial paper borrowing program.

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

(3) These facilities were replaced with new revolving credit agreements in April 2010. Upon entering into the new agreements, the maturing facilities were terminated.

(4) In April 2010, WPS entered into a new revolving credit agreement to provide support for its commercial paper borrowing program.

(5) Borrowings under this agreement are guaranteed by Integrys Energy Group.

(6) In April 2010, PGL entered into a new revolving credit agreement to provide support for its commercial paper borrowing program.

(7) This Note is renewed every six months and is used for general corporate purposes.

At December 31, 2010, Integrys Energy Group and its subsidiaries were in compliance with all financial covenants related to outstanding short-term debt. Integrys Energy Group's and certain subsidiaries' revolving credit agreements contain financial and other covenants, including but not limited to, a requirement to maintain a debt to total capitalization ratio not to exceed 65%, excluding non-recourse debt. Failure to meet these covenants beyond applicable grace periods could result in accelerated due dates and/or termination of the agreements.

NOTE 12--LONG-TERM DEBT

(Millions)				December 31 2010	2009
WPS First Mortgage Bonds (1)					
Series		Year Due			
7.125	%	2023		$0.1	$0.1
WPS Senior Notes (1)					
Series		Year Due			
6.125	%	2011		150.0	150.0
4.875	%	2012		150.0	150.0
4.80	%	2013		125.0	125.0
3.95	%	2013		22.0	22.0
6.375	%	2015		125.0	125.0
5.65	%	2017		125.0	125.0
6.08	%	2028		50.0	50.0
5.55	%	2036		125.0	125.0
UPPCO First Mortgage Bonds (2)					
Series		Year Due			
9.32	%	2021		9.4	10.8
PEC Unsecured Senior Note (3)					
Series		Year Due			
A, 6.90	%	2011		325.0	325.0
Fair value hedge adjustment				0.9	2.6
PGL Fixed First and Refunding Mortgage Bonds (4) (5)					
Series		Year Due			
HH, 4.75%		2030		-	50.0
KK, 5.00%		2033		50.0	50.0
LL, 3.75%		2033		-	50.0
MM-2, 4.00%		2010		-	50.0
NN-2, 4.625%		2013		75.0	75.0
QQ, 4.875%		2038	Adjustable after November 1, 2018	75.0	75.0
RR, 4.30%		2035	Adjustable after June 1, 2016	50.0	50.0
SS, 7.00%		2013		45.0	45.0
TT, 8.00%		2018		5.0	5.0
UU, 4.63%		2019		75.0	75.0

VV, 2.125%	2030	Mandatory interest reset date on July 1, 2014	50.0	-
WW, 2.625%	2033	Mandatory interest reset date on August 1, 2015	50.0	-
PGL Adjustable First and Refunding Mortgage Bonds (5) (6)				
Series	Year Due			
OO	2037		51.0	51.0
NSG First Mortgage Bonds (7)				
Series	Year Due		28.3	28.5
M, 5.00 %	2028		40.0	40.0
N-2, 4.625 %	2013		6.5	6.5
O, 7.00 %	2013			
Integrys Energy Group Unsecured Senior Notes (8)				
Series	Year Due			
5.375 %	2012		100.0	100.0
7.27 %	2014		100.0	100.0
8.00 %	2016		55.0	55.0
4.17 %	2020		250.0	-
Integrys Energy Group Unsecured Junior Subordinated Notes (9)				
Series	Year Due			
6.11 %	2066		300.0	300.0
Unsecured term loan due 2010 – Integrys Energy Group (10)			-	65.6
Other term loan (11)			27.0	27.0
Total			2,640.2	2,509.1
Unamortized discount and premium on bonds and debt			(1.7)	2.1
Total debt			2,638.5	2,511.2
Less current portion			(476.9)	(116.5)
Total long-term debt			$2,161.6	$2,394.7

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(1) In August 2011, WPS's 6.125% Senior Notes will mature. As a result, the $150.0 million balance of these notes was included in current portion of long-term debt on Integrys Energy Group's Consolidated Balance Sheets at December 31, 2010.

WPS's First Mortgage Bonds and Senior Notes are subject to the terms and conditions of WPS's First Mortgage Indenture. Under the terms of the Indenture, substantially all property owned by WPS is pledged as collateral for these outstanding debt securities. All of these debt securities require semi-annual payments of interest. WPS Senior Notes become non-collateralized if WPS retires all of its outstanding First Mortgage Bonds and no new mortgage indenture is put in place.

(2) Under the terms of UPPCO's First Mortgage Indenture, substantially all property owned by UPPCO is pledged as collateral for its 9.32% First Mortgage Bonds. Interest payments are due semi-annually with a sinking fund payment of $0.9 million due each November 1. As a result, this payment is included in the current portion of long-term debt on Integrys Energy Group's Consolidated Balance Sheet at December 31, 2010. On May 3, 2010, UPPCO repaid an additional $0.5 million of this debt. The final sinking fund payment due November 1, 2021, will completely retire the series.

(3) In January 2011, PEC's 6.9% unsecured Senior Notes matured, and the outstanding principal balance was repaid. As a result, the $325.0 million balance of these notes and the related fair value adjustment and unamortized premium of $1.0 million were included in current portion of long-term debt on Integrys Energy Group's Consolidated Balance Sheets at December 31, 2010. Under a First Supplemental Indenture, Integrys Energy Group fully and unconditionally guaranteed, on a senior unsecured basis, PEC's obligations under these notes. In January 2011, Integrys Energy Group settled the interest rate swap designated as a fair value hedge associated with $50.0 million of the senior notes. See Note 2, "Risk Management Activities," for more information.

(4) In October 2010, PGL issued $50.0 million of Series WW, 2.625%, First Mortgage Bonds due February 1, 2033. The bonds are subject to a mandatory interest reset date on August 1, 2015. The net proceeds from the issuance of these bonds were used to redeem PGL’s $50 million, 3.75%, Series LL, First and Refunding Mortgage Bonds.

In August 2010, PGL issued $50.0 million of Series VV, 2.125%, First Mortgage Bonds due March 1, 2030. The bonds are subject to a mandatory interest reset date on July 1, 2014. The net proceeds from the issuance of these bonds were used to redeem PGL’s $50 million, 4.75%, Series HH, First and Refunding Mortgage Bonds.

On March 1, 2010, $50.0 million of PGL's Series MM-2 First and Refunding Mortgage Bonds matured. PGL repaid the outstanding principal balance on these 4.00% bonds.

(5) PGL's First Mortgage Bonds are subject to the terms and conditions of PGL's First Mortgage Indenture dated January 2, 1926, as supplemented. Under the terms of the Indenture, substantially all property owned by PGL is pledged as collateral for these outstanding debt securities.

PGL has utilized certain First Mortgage Bonds to secure tax exempt interest rates. The Illinois Finance Authority and the City of Chicago have issued Tax Exempt Bonds, and the proceeds from the sale of these bonds were loaned to PGL. In return, PGL issued equal principal amounts of certain collateralized First Mortgage Bonds.

(6) PGL has outstanding $51.0 million of Adjustable Rate, Series OO bonds, due October 1, 2037, which are currently in a 35-day Auction Rate mode (the interest rate is reset every 35 days through an auction process). Since 2008, auctions have failed to receive sufficient clearing bids. As a result, these bonds are priced each 35 days at the maximum auction rate, until such time a successful auction occurs. The maximum auction rate

is determined based on the lesser of the London Interbank Offered Rate or the Securities Industry and Financial Markets Association Municipal Swap Index rate plus a defined premium. The year-to-date weighted-average interest rate at December 31, 2010, was 0.501% for these bonds.

(7) NSG's First Mortgage Bonds are subject to the terms and conditions of NSG's First Mortgage Indenture dated April 1, 1955, as supplemented. Under the terms of the Indenture, substantially all property owned by NSG is pledged as collateral for these outstanding debt securities.

NSG has utilized First Mortgage Bonds to secure tax exempt interest rates. The Illinois Finance Authority has issued Tax Exempt Bonds, and the proceeds from the sale of these bonds were loaned to NSG. In return, NSG issued equal principal amounts of certain collateralized First Mortgage Bonds.

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(8) In November 2010, Integrys Energy Group issued $250.0 million of 4.17%, 10-year Unsecured Senior Notes due November 1, 2020. The net proceeds from the issuance of the Senior Notes were used to repay short-term debt and a portion of long-term debt maturing in January 2011, as well as for general corporate purposes. Integrys Energy Group also terminated two interest rate swaps that had been designated as cash flow hedges associated with the anticipated issuance of $100.0 million of the senior notes that were issued in November 2010. See Note 2, "Risk Management Activities," for more information.

(9) These Integrys Energy Group Junior Subordinated Notes are considered hybrid instruments with a combination of debt and equity characteristics. Integrys Energy Group has agreed in a replacement capital covenant, dated as of December 1, 2010, with the holders of Integrys Energy Group's 4.17% Unsecured Senior Notes due November 1, 2020, that it will not redeem or repurchase more than 10% of the Junior Subordinated Notes on or prior to December 1, 2036, unless, subject to certain limitations, during the 360 days prior to the date of that redemption or repurchase, Integrys Energy Group has received a specified amount of proceeds from the sale of qualifying securities that have equity-like characteristics that are the same as, or more equity-like than, the applicable characteristics of the Junior Subordinated Notes.

(10) On May 13, 2010, Integrys Energy Group repaid the outstanding principal balance of its maturing $65.6 million unsecured term loan.

(11) In April 2001, the Schuylkill County Industrial Development Authority issued $27.0 million of Refunding Tax Exempt Bonds. The proceeds from the bonds were loaned to WPS Westwood Generation, LLC, a subsidiary of Integrys Energy Services. This loan is repaid by WPS Westwood Generation to Schuylkill County Industrial Development Authority with monthly interest only payments and has a floating interest rate that is reset weekly. At December 31, 2010, the interest rate was 4.33%. The loan is to be repaid by April 2021. In January 2011, Integrys Energy Group replaced its guarantee to provide sufficient funds to pay the loan and the related obligations and indemnities on WPS Westwood Generation's obligation with a new standby letter of credit. See Note 16, "Guarantees," for additional information.

At December 31, 2010, Integrys Energy Group and each of its subsidiaries were in compliance with all respective financial covenants related to outstanding long-term debt. Integrys Energy Group's and certain subsidiaries' long-term debt obligations contain covenants related to payment of principal and interest when due and various financial reporting obligations. In addition, certain long-term debt obligations contain financial and other covenants, including but not limited to, a requirement to maintain a debt to total capitalization ratio not to exceed 65%. Failure to comply with these covenants could result in an event of default which, if not cured or waived, could result in the acceleration of outstanding debt obligations.

A schedule of all principal debt payment amounts related to bond maturities is as follows:

Year ending December 31 (Millions)	
2011	$476.9
2012	250.9
2013	314.4
2014	100.9
2015	125.9
Later years	1,371.2
Total payments	$2,640.2

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NOTE 13--ASSET RETIREMENT OBLIGATIONS

The utility segments have asset retirement obligations primarily related to removal of natural gas distribution pipe (including asbestos and PCBs); asbestos abatement at certain generation facilities, office buildings, and service centers; dismantling wind generation projects; disposal of PCB-contaminated transformers; and closure of fly-ash landfills at certain generation facilities. The utilities establish regulatory assets and liabilities to record the differences between ongoing expense recognition under the Asset Retirement and Environmental Obligations accounting rules, and the ratemaking practices for retirement costs authorized by the applicable regulators.

The following table shows changes to Integrys Energy Group's asset retirement obligations through December 31, 2010.

(Millions)	Utilities		Integrys Energy Services		Total
Asset retirement obligations at December 31, 2007	$139.5		$0.7		$140.2
Accretion	7.8		-		7.8
Additions and revisions to estimated cash flows	31.7		-		31.7
Asset retirement obligations transferred in sales	(0.1)		(0.5)		(0.6)
Asset retirement obligations at December 31, 2008	178.9		0.2	(2)	179.1
Accretion	9.6		0.1		9.7
Additions and revisions to estimated cash flows	6.3	(1)	-		6.3
Asset retirement obligations at December 31, 2009	194.8		0.3	(2)	195.1
Accretion	11.7		-		11.7
Asset retirement obligations transferred in sale	-		(0.3)		(0.3)
Revisions to estimated cash flows	120.5	(3)	-		120.5
Settlements	(6.1)		-		(6.1)
Asset retirement obligations at December 31, 2010	$320.9		$-		$320.9

(1) This amount includes a $6.3 million asset retirement obligation related to the WPS 99-megawatt Crane Creek wind generation project that became operational in the fourth quarter of 2009. All other adjustments netted to an insignificant amount.

(2) These amounts were classified as held for sale, as they related to the sale of generation assets in Northern Maine, which closed in the first quarter of 2010.

(3) Revisions were made to estimated cash flows related to asset retirement obligations for natural gas distribution pipes at PGL due to changes in the average remaining service life of distribution pipe based upon an updated depreciation study, as well as an increase in estimated costs.

NOTE 14--INCOME TAXES

Deferred Income Tax Assets and Liabilities

Certain temporary book to tax differences, for which the offsetting amount is recorded as a regulatory asset or liability, are presented in the table below as net amounts, consistent with regulatory treatment. The principal components of deferred income tax assets and liabilities recognized in the Consolidated Balance Sheets as of December 31 were as follows:

(Millions)	2010	2009*
Deferred income tax assets		
Tax credit carryforwards	$108.6	$90.7
Employee benefits	40.2	96.0
Price risk management	32.3	55.4
State capital and operating loss carryforwards	14.7	16.0
Other	54.5	32.4
Total deferred income tax assets	$250.3	$290.5
Valuation allowance	(8.2)	(7.4)
Net deferred income tax assets	$242.1	$283.1
Deferred income tax liabilities		
Plant-related	$955.0	$751.4
Regulatory deferrals	64.3	76.1
Deferred income	15.6	15.6
Total deferred income tax liabilities	$1,034.9	$843.1
Consolidated Balance Sheet presentation		
Current deferred income tax assets	$67.7	$92.9
Long-term deferred income tax liabilities	860.5	652.9
Net deferred income tax liabilities	$792.8	$560.0

* Certain amounts have been retrospectively adjusted due to a change in accounting policy in 2010. See Note 1(d), "Change in Accounting Policy," for more information.

In December 2010, Integrys Energy Group received consent from the IRS to change its tax accounting method related to capitalization of overhead costs. This allows Integrys Energy Group to currently deduct overhead costs that were previously capitalized to the basis of certain assets for tax purposes. Also during 2010, the federal government passed legislation providing for bonus tax depreciation. Both of these items generated significant additional tax deductions, which drove the $232.8 million increase in net deferred income tax liabilities.

Deferred tax credit carryforwards at December 31, 2010, included $77.3 million of alternative minimum tax credits related to tax credits available under Section 45K (formerly Section 29) of the Internal Revenue Code, which can be carried forward indefinitely. Other deferred tax credit carryforwards include $17.1 million of general business credits, which have a carryforward period of 20 years, with the majority of the general business credits to expire in 2028, and $14.2 million of foreign tax credits, which have a carryforward period of 10 years, with the majority of the foreign tax credits to expire in 2020.

Carryforward periods for state capital and operating losses vary. In the majority of states in which Integrys Energy Group operates, the carryforward period is 15 years or more, with the majority of the state capital and operating losses beginning to expire in 2013. Valuation allowances are established for

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certain state operating losses, capital loss carryforwards, and federal tax credits based on the projected ability of Integrys Energy Group to realize the benefit of these losses in the future.

Federal Income Tax Expense

The following table presents a reconciliation of federal income taxes to the provision for income taxes reported in the Consolidated Statements of Income for the periods ended December 31, which is calculated by multiplying the statutory federal income tax rate by book income before federal income tax.

(Millions, except for percentages)	2010 Rate	2010 Amount	2009* Rate	2009* Amount	2008* Rate	2008* Amount
Statutory federal income tax	35.0 %	$130.1	35.0 %	$4.7	35.0 %	$61.6
State income taxes, net	5.1	19.1	105.2	14.1	6.8	12.0
Benefits and compensation	1.3	5.0	(26.9)	(3.6)	(2.8)	(4.9)
Plant-related	-	0.1	(12.7)	(1.7)	-	-
Goodwill	-	-	486.6	65.2	1.3	2.3
Unrecognized tax benefits and interest	(0.2)	(0.9)	12.7	1.7	-	0.1
Investment tax credit – amortization	(0.5)	(1.8)	(19.4)	(2.6)	(1.0)	(1.8)
Federal tax credits	(1.8)	(6.7)	8.2	1.1	(0.3)	(0.6)
Other differences, net	1.0	3.3	35.9	4.8	(4.3)	(7.6)
Effective income tax	39.9 %	$148.2	624.6 %	$83.7	34.7 %	$61.1
Current provision						
Federal		$(83.7)		$1.9		$(10.5)
State		(10.8)		14.1		(3.1)
Foreign		6.8		7.1		1.9
Total current provision		(87.7)		23.1		(11.7)
Deferred provision		237.1		53.5		63.6
Valuation allowance		0.8		5.1		-
Net operating loss carryforwards		(0.2)		1.4		(1.8)
Interest		(0.3)		3.7		(0.1)
Unrecognized tax benefits		(0.6)		(2.0)		0.2
Investment tax credit, net		(0.9)		(1.1)		10.5
Penalties		-		-		0.4
Total provision for income taxes		$148.2		$83.7		$61.1

* Certain amounts have been retrospectively adjusted due to a change in accounting policy in 2010. See Note 1(d), "Change in Accounting Policy," for more information.

Foreign income before taxes was $10.6 million in 2010, $0.3 million in 2009, and $12.0 million in 2008.

As the related temporary differences reverse, the regulated utilities are prospectively refunding taxes to or collecting taxes from customers for which deferred taxes were recorded in prior years at rates different than current rates. The net regulatory asset for these and other regulatory tax effects totaled $16.2 million and $19.3 million at December 31, 2010, and 2009, respectively.

Integrys Energy Group had accrued interest of $6.9 million and accrued penalties of $3.0 million related to unrecognized tax benefits at December 31, 2010. Integrys Energy Group had accrued interest of $8.0 million and accrued penalties of $3.0 million related to unrecognized tax benefits at December 31, 2009.

Unrecognized Tax Benefits

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

(Millions)	2010	2009	2008
Balance at January 1	$31.8	$22.4	$10.0
Increase related to tax positions taken in prior years	9.2	10.2	23.8
Decrease related to tax positions taken in prior years	(10.6)	(0.2)	(7.7)
Increase related to tax positions taken in current year	-	-	-
Decrease related to tax positions taken in current year	-	(0.1)	-
Decrease related to settlements	-	(0.3)	(3.7)
Decrease related to lapse of statutes	-	(0.2)	-
Balance at December 31	$30.4	$31.8	$22.4

At December 31, 2010, recognition in subsequent periods of $6.9 million of unrecognized tax benefits related to continuing operations could affect Integrys Energy Group's effective tax rate. Also, recognition in subsequent periods of $9.5 million of unrecognized tax benefits related to discontinued operations could affect Integrys Energy Group's effective tax rate.

Subsidiaries of Integrys Energy Group file income tax returns in the United States federal jurisdiction, in various United States state and local jurisdictions, and in Canada. Subject to the major exceptions listed below, Integrys Energy Group is no longer subject to United States federal, state and local, or foreign income tax examinations by tax authorities for years prior to 2005.

IRS – PEC and consolidated subsidiaries have open examinations for the September 30, 2004 tax year.
Illinois Department of Revenue – PEC and consolidated subsidiaries have open examinations for the September 30, 2003 and September 30, 2004 tax years.
Oregon Department of Revenue – WPS Power Development has open examinations for the 2002, 2003, and 2004 tax years.

In 2010, Integrys Energy Group closed the following examinations:

IRS – Integrys Energy Services' subsidiary Synfuel Solutions, LLC for the tax years 2005 and 2006.

Integrys Energy Group has the following open examinations:

IRS – PEC and consolidated subsidiaries have open examinations for the September 30, 2004 through December 31, 2006 tax years.
IRS – Integrys Energy Group and consolidated subsidiaries have open examinations for the 2006 through 2008 tax years along with the February 21, 2007 PEC short year.
IRS – An Integrys Energy Services' subsidiary, Soltage-ADC 360 Jamesburg LLC has an open examination for the 2008 tax year.
Illinois Department of Revenue – PEC and consolidated subsidiaries have open examinations for the September 30, 2003 through December 31, 2006 tax years.
Illinois Department of Revenue – Integrys Energy Group and consolidated subsidiaries have an open examination for the 2007 tax year.

Kentucky Department of Revenue – Integrys Energy Group has open examinations for the 2005 through 2008 tax years.
Mississippi Department of Revenue – PEC, PEP, and PEP Holdings LLC have open examinations for the September 30, 2006, December 31, 2006, and December 31, 2007 tax years.
New Hampshire Department of Revenue – Integrys Energy Group has open examinations for the 2007 and 2008 tax years.

New York State Department of Revenue – Integrys Energy Services and WPS Power Development have open examinations for the 2004 and 2005 tax years; Integrys Energy Group and Integrys Energy Services have open examinations for the 2007 and 2008 tax years.
Oregon Department of Revenue – Integrys Energy Services has an open examination for the 2005 tax year; WPS Power Development has open examinations for the 2002, 2003, and 2004 tax years.
Pennsylvania Department of Revenue – Integrys Energy Services has open examinations for the 2006 and 2007 tax years.
Texas Comptroller – Integrys Energy Group has an open examination for the 2008 tax year.

In the next 12 months, it is reasonably possible that Integrys Energy Group and its subsidiaries will settle their open examinations in multiple taxing jurisdictions related to tax years prior to 2009, resulting in a decrease in unrecognized tax benefits of as much as $17.5 million.

NOTE 15--COMMITMENTS AND CONTINGENCIES

Commodity Purchase Obligations and Purchase Order Commitments

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

The obligations described below were as of December 31, 2010.

The electric utility segment had obligations of $185.0 million related to coal supply and transportation that extend through 2016, obligations of $1,166.8 million for either capacity or energy related to purchased power that extend through 2030, and obligations of $9.8 million for other commodities that extend through 2013.
The natural gas utility segment had obligations of $1,110.9 million related to natural gas supply and transportation contracts that extend through 2028.
Integrys Energy Services had obligations of $356.3 million related to energy and natural gas supply contracts that extend through 2019. The majority of these obligations end by 2013, with obligations of $10.4 million extending beyond 2013.
Integrys Energy Group also had commitments of $233.1 million in the form of purchase orders issued to various vendors that relate to normal business operations, including construction projects.

Environmental

Clean Air Act New Source Review Issues

Weston and Pulliam Plants:
In 2009, the EPA issued a Notice of Violation (NOV) to WPS alleging violations of the CAA's New Source Review requirements pertaining to certain projects undertaken at the Weston and Pulliam generation stations from 1994 to

2009. WPS met with the EPA and exchanged proposals related to a possible resolution. Integrys Energy Group continues to review the allegations but is currently unable to predict the impact on its consolidated financial statements.

On May 20, 2010, WPS received from the Sierra Club a Notice of Intent (NOI) to file a civil lawsuit based on allegations and violations of the CAA at Weston and Pulliam. WPS entered into a Standstill Agreement with the Sierra Club and has had discussions related to a possible resolution with the Sierra Club in conjunction with the EPA. However, Integrys Energy Group is currently unable to predict the impact on its consolidated financial statements.

Columbia Plant:
In 2009, WPS, along with its co-owners, received from the Sierra Club an NOI to file a civil lawsuit based on allegations that major modifications were made at the Columbia generation station without complying with the CAA. The allegations suggest that Prevention of Significant Deterioration (PSD) permits that imposed BACT limits on emissions from the facility should have been obtained for Columbia.

In September 2010, the Sierra Club filed suit against Wisconsin Power and Light (WP&L), the operator of the Columbia plant, in the Federal District Court for the Western District of Wisconsin, alleging that WP&L violated the CAA with respect to its operation of the Columbia generation station and the Nelson E. Dewey generation station. The parties have entered into a confidentiality agreement to allow the Sierra Club to participate in settlement negotiations with the EPA, WP&L, and the other co-owners of the Columbia and Edgewater plants, as discussed below. Integrys Energy Group is currently unable to predict the impact on its consolidated financial statements.

Edgewater Plant:
In 2009, WPS, along with its co-owners, received from the Sierra Club a copy of an NOI to file a civil lawsuit against the EPA due to the EPA's failure to take actions against the co-owners and operator of the Edgewater generation station based upon allegations of failure to comply with the CAA. The allegations suggest that PSD permits that imposed BACT limits on emissions from the facility should have been obtained for Edgewater. WP&L is the operator of Edgewater. Integrys Energy Group is currently unable to predict the impact on its consolidated financial statements.

Also in 2009, WPS, along with its co-owners, received from the Sierra Club an NOI to file a civil lawsuit based on allegations that major modifications were made at the Edgewater generation station without complying with the CAA. The allegations suggest that PSD permits that imposed BACT limits on emissions from the facility should have been obtained for Edgewater.

In September 2010, the Sierra Club filed suit against WP&L in the Federal District Court for the Eastern District of Wisconsin, alleging that WP&L violated the CAA with respect to its operation of the Edgewater generation station. The complaint was not served on WP&L until December 2010. The parties have entered into a confidentiality agreement to allow Sierra Club to participate in settlement negotiations with the EPA, WP&L, and the other co-owners of the Columbia and Edgewater plants, as discussed below. Integrys Energy Group is currently unable to predict the impact on its consolidated financial statements.

Columbia and Edgewater Plants:
In 2009, the EPA issued an NOV to WP&L relative to its Nelson E. Dewey Plant and to WP&L and the other joint owners of the Columbia and Edgewater generation stations alleging violations of the CAA’s New Source Review requirements pertaining to certain projects undertaken at those plants. WP&L is the operator of these plants and, along with the joint owners, exchanged proposals with the EPA related to a possible resolution. Integrys Energy Group is currently unable to predict the impact on its consolidated financial statements.

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

If it were determined that historic projects at the Weston, Pulliam, Columbia, and Edgewater generation stations required either a state or federal CAA permit, WPS may, under the applicable statutes, be required to:

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

In addition, under the CAA, citizen groups may pursue a claim.

Weston Air Permits

Sierra Club Weston 4 Construction Permit Petitions:
From 2004 to 2009, the Sierra Club filed various petitions related to the construction permit issued for the Weston 4 generation station, all of which were denied. On June 24, 2010, the Wisconsin Court of Appeals affirmed the Weston 4 air permit, but directed the WDNR to reopen the permit to establish specific visibility limits. In July 2010, the WDNR, WPS, and the Sierra Club filed Petitions for Review with the Wisconsin Supreme Court. WPS and the WDNR objected to the Sierra Club's Petition. To date, no action has been taken by the Wisconsin Supreme Court. Integrys Energy Group is currently unsure how the Wisconsin Supreme Court will respond. WPS believes that it has substantial defenses to the Sierra Club's challenges. Until the Sierra Club's challenges are resolved and the revised permit is finalized, Integrys Energy Group will not be able to make a final determination of the probable impact on future costs, if any, of compliance with any changes to the air permit.

Weston Title V Permit:
On November 29, 2010, the WDNR provided a draft revised permit. WPS objected to proposed changes in the mercury limits and the requirements on the boiler as beyond the authority of the WDNR, and provided technical comments. WPS and the WDNR continue to meet to resolve these issues.

WDNR Issued NOV's:
Since 2008, WPS has received three NOVs from the WDNR alleging various violations of the air permits for Weston 4, Weston 1 and Weston 2, and one NOV for a clerical error involving pages missing from a quarterly report for Weston. Corrective actions have been taken for the events in the four NOVs. Discussions with the WDNR on the severity classification of the events continue. While management believes it is 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 consolidated financial statements of Integrys Energy Group.

Other:
In 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 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 generation station was issued by the WDNR in April 2009. On June 28, 2010, the EPA issued an order directing the WDNR to respond to the comments raised by the Sierra Club in its Petition objecting to the Title V permit, which was filed in June 2009. Integrys Energy Group has been working with the WDNR to address the order.

WPS also challenged the Title V permit in a contested case proceeding and Petition for Judicial Review. The Petition was dismissed in an order remanding the matter to the WDNR and on February 11, 2011, the WDNR granted a contested case proceeding on the issues raised by WPS, which included averaging times in the emission limits in the permit. WPS will participate in the contested case proceeding.

On October 22, 2010, WPS received from the Sierra Club a copy of an NOI to file a civil lawsuit against the EPA based on what the Sierra Club alleges to be the EPA's unreasonable delay in performing its duties related to the grant or denial of the Title V permit. Integrys Energy Group is reviewing all these allegations but is currently unable to predict the impact on its consolidated financial statements.

Columbia Air Permit

In 2009, the EPA issued an order objecting to the Title V air permit renewal issued by the WDNR for the Columbia generation station. The order determined that a project in 2006 should have been permitted as a "major modification." The order directed the WDNR to resolve the EPA's objections within 90 days and "terminate, modify, or revoke and reissue" the Title V permit accordingly.

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 what the Sierra Club alleges to be the EPA's unreasonable delay in performing its duties related to the granting or denial of the Title V permit. The Sierra Club alleges that the EPA failed to take actions against the WDNR for its failure to take action regarding the Title V permit as ordered by the EPA.

On September 22, 2010, the WDNR issued a draft construction permit and a draft revised Title V permit. The co-owners submitted comments on these draft permits. In correspondence dated November 24, 2010, the EPA notified the WDNR that the EPA does not believe the WDNR's proposal is responsive to the order. The letter requested a response from the WDNR. On January 24, 2011, the WDNR issued a letter stating that upon review of the submitted public comments, the WDNR has determined not to issue the draft construction permit and draft revised Title V permit that were proposed to respond to the EPA’s order. WPS is currently discussing potential responses to the WDNR’s action with WP&L. While WPS believes the previously issued air permit is still valid, WPS is currently unable to predict the outcome of this matter and the impact on its 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 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 December 31, 2010, WPS estimates capital costs of approximately $19.0 million, which includes estimates for both wholly owned and jointly owned plants, to achieve the required Phase I and Phase II 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 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 in order to reduce sulfur dioxide and nitrogen oxide emissions from utility boilers located in 29 states, including Wisconsin, Michigan, Pennsylvania, and New York. Subsequently, the United States Court of Appeals (Court of Appeals) issued a decision vacating CAIR, which the EPA appealed, and in 2008, the Court of Appeals reinstated CAIR. The Court of Appeals directed the EPA to address the deficiencies noted in its ruling to vacate CAIR, and the EPA issued a draft CAIR replacement rule for comment on July 6, 2010. The State of Wisconsin's rule to implement CAIR, which incorporates the cap and trade approach, was forwarded to the EPA for final review.

As a result of the Court of Appeals' decision, CAIR was 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.

Due to the reinstatement of CAIR, units affected by the Best Available Retrofit Technology (BART) rule are considered in compliance with BART for sulfur dioxide and nitrogen oxide emissions. Although particulate emissions also contribute to visibility impairment, the WDNR's modeling has shown the impairment to be so insignificant that additional capital expenditures on controls are not warranted.

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 $437.5 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.

Manufactured Gas Plant Remediation

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 and they are coordinating the investigation and cleanup of the 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.

Integrys Energy Group's natural gas utilities are responsible for the environmental remediation of 54 sites, of which 20 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. As of December 31, 2010, Integrys Energy Group estimated and accrued for $642.5 million of future undiscounted investigation and cleanup costs for all sites. 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. As of December 31, 2010, Integrys Energy Group recorded a regulatory asset of $651.9 million (net of insurance recoveries received of $59.9 million) related to the expected recovery of both cash expenditures and estimated future expenditures. As of December 31, 2010, cash expenditures for environmental remediation not yet recovered in rates were $9.4 million.

The EPA identified NSG, the Outboard Marine Corporation, General Motors Corporation (GM), and certain other parties as potentially responsible parties (PRPs) at the Waukegan Coke Plant Site located in Waukegan, Illinois. 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 $21.0 million. NSG 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 was granted access to the bond funds, which are expected to support 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 these costs will not have a material adverse effect on the consolidated financial statements

of Integrys Energy Group. However, any changes in the approved rate mechanisms for recovery of these costs, or any adverse conclusions by the various regulatory commissions' with respect to the prudence of costs actually incurred, could materially adversely affect rate recovery of such costs.

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.

The EPA began regulating greenhouse gas emissions under the CAA in January 2011, by applying 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 issued guidance that defines BACT in terms of improvements in energy efficiency as opposed to relying on pollution control equipment. In December 2010, the EPA announced its intent to develop new source performance standards for greenhouse gas emissions for new and modified, as well as existing, electric utility steam generating units. The EPA plans to propose standards in 2011 and finalize standards in 2012. 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. Currently there is no applicable federal or state legislation pending that specifically addresses greenhouse gas emissions.

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.

Natural Gas Charge Reconciliation Proceedings and Related Matters

The ICC conducts annual proceedings regarding the reconciliation of revenues from the natural gas charge and related natural gas costs (Gas Charge) in which 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 finds that the reconciliation was inaccurate or any natural gas costs were imprudently incurred, the ICC will order PGL and NSG to refund the affected amount to customers through subsequent Gas Charge filings.

In 2006, the ICC adopted a settlement agreement for PGL's 2001 through 2004 Gas Charge reconciliation proceedings in which PEC agreed to provide the Illinois Attorney General (AG) and the City of Chicago up to $30.0 million for conservation and weatherization programs for which PGL and NSG may not seek rate recovery. The balance that remained unpaid as of December 31, 2010, was $5.2 million and was recorded in other current liabilities.

The ICC issued an order on November 21, 2010, for PGL's 2006 Gas Charge reconciliation proceeding, adopting an uncontested disallowance of $0.6 million.

PGL and NSG are not aware of any significant issues related to their open Gas Charge reconciliation proceedings for the periods 2007, 2008, 2009, and 2010.

Class Action

In 2004, a class action suit (based on alleged facts underlying PGL and NSG's 2001 through 2004 Gas Charge cases settled in 2006) was filed against PEC, PGL, and NSG by customers of PGL and NSG (PGL and NSG were subsequently dismissed as defendants) for alleged violations of the Consumer Fraud and Deceptive Business Practices Act, claiming that PEC acted in concert with others to commit a tortious act. The plaintiffs sought disgorgement and punitive damages. The parties entered into a settlement agreement that became final as of December 31, 2010, and the class releases are now effective. The full effect of the settlement has been reflected in the consolidated financial statements as of December 31, 2010.

NOTE 16--GUARANTEES

As part of normal business, Integrys Energy Group and its subsidiaries enter into various guarantees providing financial or performance assurance to third parties on behalf of certain subsidiaries. These guarantees are entered into primarily to support or enhance the creditworthiness otherwise attributed to a subsidiary on a stand-alone basis, thereby facilitating the extension of sufficient credit to accomplish the subsidiaries' intended commercial purposes.

Most of the guarantees issued by Integrys Energy Group consist of guarantees of subsidiaries' obligations or performance by the subsidiaries under certain contractual commitments. As such, these guarantees are excluded from the recognition and measurement requirements, but are subject to the disclosure requirements, of the Guarantees Topic of the FASB ASC.

The following table shows outstanding guarantees at Integrys Energy Group:

		Expiration		
(Millions)	Total Amounts Committed at December 31, 2010	Less Than 1 Year	1 to 3 Years	Over 3 Years
Guarantees supporting commodity transactions of subsidiaries (1)	$ 654.9	$410.9	$21.1	$222.9
Standby letters of credit (2)	66.2	63.4	2.8	-
Surety bonds (3)	12.7	12.2	0.5	-
Other guarantees (4)	57.3	-	35.0	22.3
Total guarantees	$ 791.1	$486.5	$59.4	$245.2

(1) Consists of parental guarantees of $423.9 million to support the business operations of Integrys Energy Services; $152.2 million and $66.8 million, respectively, related to natural gas supply at MERC and MGU; and $5.0 million at both PEC and IBS, and $2.0 million at UPPCO to support business operations. These guarantees are not reflected on the 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. This amount consists of $63.5 million issued to support Integrys Energy Services' operations; and $2.7 million related to letters of credit issued to support UPPCO, WPS, MGU, NSG, MERC, and PGL operations. These amounts are not reflected on the 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 Consolidated Balance Sheets.

(4) Consists of (a) $35.0 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; (b) $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; (c) $5.0 million related to an environmental indemnification provided by Integrys Energy Services as part of the sale of the Stoneman generation facility, under which Integrys Energy Group expects that the likelihood of required performance is remote. This amount is not reflected on the Consolidated Balance Sheets; and (d) $7.3 million related to other indemnifications and workers compensation coverage. This amount is not reflected on the Consolidated Balance Sheets.

Integrys Energy Group has provided total parental guarantees of $566.6 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 December 31, 2010, was approximately $334 million.

(Millions)	December 31, 2010
Guarantees supporting commodity transactions	$ 423.9
Standby letters of credit	63.5
Guarantee of subsidiary debt *	27.0
Surety bonds	1.7
Other	50.5
Total guarantees	$ 566.6

* 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 Consolidated Balance Sheets. In January 2011, this guarantee was replaced with a standby letter of credit, as part of refinancing the underlying debt instrument.

NOTE 17--EMPLOYEE BENEFIT PLANS

Defined Benefit Plans

Integrys Energy Group and its subsidiaries maintain one non-contributory, qualified pension plan covering substantially all employees, as well as several unfunded nonqualified retirement plans. In addition, Integrys Energy Group and its subsidiaries offer multiple other postretirement benefit plans to employees. The benefits for a portion of these plans are funded through irrevocable trusts, as allowed for income tax purposes.

Integrys Energy Group also currently offers medical, dental, and life insurance benefits to active employees and their dependents. Integrys Energy Group expenses the costs of these benefits as incurred.

Effective January 1, 2008, the defined benefit pension plans were closed to all Integrys Energy Group non-union new hires. Effective May 1, 2008, and July 1, 2008, the defined benefit pension plans were closed to new union hires at PGL and NSG, respectively. Effective April 19, 2009, and December 18, 2009, the defined benefit pension plans were closed to new union hires at UPPCO and WPS, respectively. In addition, changes in the WPS union contract resulted in a plan amendment in December 2009. Effective January 15, 2010, the defined benefit pension plans were closed to new Local 12295 union hires at MGU.

The following tables provide a reconciliation of the changes in the plans' benefit obligations and fair value of assets during 2010 and 2009.

(Millions)	Pension Benefits 2010	Pension Benefits 2009	Other Benefits 2010	Other Benefits 2009
Reconciliation of benefit obligation				
Obligation at January 1	$1,337.4	$1,230.5	$475.5	$432.7
Service cost	40.1	38.9	16.3	14.3
Interest cost	80.0	80.9	27.5	26.5
Plan amendments	-	3.0	-	-
Plan curtailment	-	0.2 *	-	-
Actuarial loss, net	98.4	78.6	41.1	23.2
Participant contributions	-	-	10.7	9.8
Benefit payments	(137.4)	(94.7)	(34.9)	(33.0)
Federal subsidy on benefits paid	-	-	2.3	2.0
Obligation at December 31	$1,418.5	$1,337.4	$538.5	$475.5
Reconciliation of fair value of plan assets				
Fair value of plan assets at January 1	$933.6	$830.3	$230.8	$191.1
Actual return on plan assets	119.1	174.5	23.8	33.1
Employer contributions	166.0	23.5	35.8	29.8
Participant contributions	-	-	10.7	9.8
Benefit payments	(137.4)	(94.7)	(34.9)	(33.0)
Fair value of plan assets at December 31	$1,081.3	$933.6	$266.2	$230.8

* In connection with the reduction in workforce discussed in Note 3, "Restructuring Expense," an insignificant curtailment loss was recognized.

Amounts recognized on Integrys Energy Group's Consolidated Balance Sheets at December 31 related to the funded status of the benefit plans consisted of:

(Millions)	Pension Benefits 2010	Pension Benefits 2009	Other Benefits 2010	Other Benefits 2009
Current liabilities	$5.8	$7.5	$0.3	$0.3
Noncurrent liabilities	331.4	396.3	272.0	244.4
Total liabilities	$337.2	$403.8	$272.3	$244.7

The accumulated benefit obligation for all defined benefit pension plans was $1.2 billion and $1.1 billion at December 31, 2010, and 2009, respectively. Information for pension plans with an accumulated benefit obligation in excess of plan assets is presented in the following table.

(Millions)	December 31 2010	December 31 2009
Projected benefit obligation	$1,418.5	$1,337.4
Accumulated benefit obligation	1,225.9	1,147.0
Fair value of plan assets	1,081.3	933.6

The following table shows the amounts that had not yet been recognized in Integrys Energy Group's net periodic benefit cost as of December 31. Amounts related to the nonregulated entities are included in accumulated other comprehensive loss, while amounts related to the utilities are recorded as regulatory assets or liabilities.

(Millions)	Pension Benefits 2010	Pension Benefits 2009	Other Benefits 2010	Other Benefits 2009
Accumulated other comprehensive loss (pre-tax)				
Net actuarial loss	$38.8	$36.2	$2.0	$-
Prior service costs (credits)	0.7	0.9	(1.4)	(1.8)
Total	$39.5	$37.1	$0.6	$(1.8)
Net regulatory assets				
Net actuarial loss	$429.3	$368.6	$98.6	$66.2
Prior service costs (credits)	16.1	21.1	(20.0)	(23.4)
Transition obligation	-	-	0.5	0.8
Merger related regulatory adjustment	-	71.5	-	38.7
Regulatory deferral *	-	4.5	-	(1.3)
Total	$445.4	$465.7	$79.1	$81.0

* The PSCW authorized recovery for net increased 2009 WPS pension and other postretirement benefit costs related to plan asset losses that occurred in 2008. Amortization and recovery of these deferred costs occurred in 2010.

Integrys Energy Group recorded the PEC pension assets acquired and liabilities assumed at fair value at the February 2007 acquisition date. However, through 2009, PGL and NSG continued to have rates set based on their historical basis of accounting, including amortizations of prior service costs (credits), actuarial losses, and transition obligations, which were recognized on the consolidated financial statements as regulatory assets at the purchase date. Therefore, the amounts reflected in net periodic benefit cost through 2009 were based on the amount used in the rate-setting process for PGL and NSG. The difference in the basis of accounting is shown as a merger related regulatory adjustment for 2009 in the table above. 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. This regulatory asset, comprised of unrecognized benefit costs that existed prior to the PEC merger, is not included in the 2010 amounts in the table above. Also, 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.

The estimated net actuarial losses and prior service costs for defined benefit pension plans that will be amortized as a component of net periodic benefit cost during 2011 are $19.0 million and $5.3 million, respectively. The estimated net actuarial losses, prior service credits, and transition obligation for other postretirement benefit plans that will be amortized as a component of net periodic benefit cost during 2011 are $4.6 million, $3.8 million, and $0.3 million, respectively.

The following table presents the components of the consolidated net periodic benefit costs for the plans:

	Pension Benefits			Other Benefits		
(Millions)	2010	2009	2008	2010	2009	2008
Net periodic benefit cost						
Service cost	$40.1	$38.9	$38.4	$16.3	$14.3	$15.7
Interest cost	80.0	80.9	76.2	27.5	26.5	26.4
Expected return on plan assets	(92.3)	(92.5)	(101.0)	(19.0)	(17.7)	(19.0)
Amortization of transition obligation	-	-	-	0.3	0.3	0.3
Amortization of prior service cost (credit)	5.3	5.0	5.1	(3.8)	(3.8)	(3.8)
Amortization of net actuarial loss (gain)	8.1	1.9	0.7	1.9	(1.5)	-
Amortization of merger related regulatory adjustment	-	20.0	9.6	-	3.3	2.1
Regulatory deferral *	4.5	(4.5)	-	(1.3)	1.3	-
Net periodic benefit cost	$45.7	$49.7	$29.0	$21.9	$22.7	$21.7

* The PSCW authorized recovery for net increased 2009 WPS pension and other postretirement benefit costs related to plan asset losses that occurred in 2008. Amortization and recovery of these deferred costs occurred in 2010.

Assumptions – Pension and Other Postretirement Benefit Plans

The weighted-average assumptions used at December 31 to determine benefit obligations for the plans were as follows:

	Pension Benefits		Other Benefits	
	2010	2009	2010	2009
Discount rate	5.80 %	6.15 %	5.66 %	5.96 %
Rate of compensation increase	4.29 %	4.26 %	N/A	N/A
Assumed medical cost trend rate (under age 65)	N/A	N/A	7.5 %	8.0 %
Ultimate trend rate	N/A	N/A	5.0 %	5.0 %
Ultimate trend rate reached in	N/A	N/A	2016	2013
Assumed medical cost trend rate (over age 65)	N/A	N/A	8.0 %	8.5 %
Ultimate trend rate	N/A	N/A	5.5 %	5.5 %
Ultimate trend rate reached in	N/A	N/A	2016	2013
Assumed dental cost trend rate	N/A	N/A	5.0 %	5.0 %

The weighted-average assumptions used to determine net periodic benefit cost for the plans were as follows for the years ended December 31:

	Pension Benefits		
	2010	2009	2008
Discount rate	6.15 %	6.45 %	6.40 %
Expected return on assets	8.50 %	8.50 %	8.50 %
Rate of compensation increase	4.26 %	4.26 %	4.27 %

Other Benefits

	2010		2009		2008	
Discount rate	5.95	%	6.48	%	6.40	%
Expected return on assets	8.50	%	8.50	%	8.50	%
Assumed medical cost trend rate (under age 65)	8.0	%	9.0	%	10.0	%
Ultimate trend rate	5.0	%	5.0	%	5.0	%
Ultimate trend rate reached in	2013		2013		2013	
Assumed medical cost trend rate (over age 65)	8.5	%	9.5	%	10.5	%
Ultimate trend rate	5.5	%	5.5	%	5.5	%
Ultimate trend rate reached in	2013		2013		2013	
Assumed dental cost trend rate	5.0	%	5.0	%	5.0	%

Integrys Energy Group establishes its expected return on assets assumption based on consideration of historical and projected asset class returns, as well as the target allocations of the benefit trust portfolios. Beginning in 2011, the expected return on assets assumption for the plans is 8.25%.

Assumed health care cost trend rates have a significant effect on the amounts reported by Integrys Energy Group for the health care plans. For the year ended December 31, 2010, a one-percentage-point change in assumed health care cost trend rates would have had the following effects:

	One-Percentage-Point	
(Millions)	Increase	Decrease
Effect on total of service and interest cost components of net periodic postretirement health care benefit cost	$6.4	$(5.2)
Effect on the health care component of the accumulated postretirement benefit obligation	68.2	(56.6)

Pension and Other Postretirement Benefit Plan Assets

Integrys Energy Group's investment policy includes various guidelines and procedures designed to ensure assets are invested in an appropriate manner to meet expected future benefits to be earned by participants. The investment guidelines consider a broad range of economic conditions. Central to the policy are target allocation ranges by major asset categories. The policy is established and administered in a manner that is compliant at all times with applicable regulations.

The objectives of the target allocations are to maintain investment portfolios that diversify risk through prudent asset allocation parameters and to achieve asset returns that meet or exceed the plans' actuarial assumptions and that are competitive with like instruments employing similar investment strategies. The portfolio diversification provides protection against significant concentrations of risk in the plan assets. The target asset allocations for pension and other postretirement benefit plans that have significant assets are: 70% equity securities and 30% fixed income securities. Equity securities primarily include investments in large-cap and small-cap companies. Fixed income securities primarily include corporate bonds of companies from diversified industries, United States government securities, and mortgage-backed securities.

The Board of Directors established the Employee Benefits Administrator Committee (composed of members of management) to manage the operations and administration of all benefit plans and trusts. The committee periodically reviews the asset allocation, and the portfolio is rebalanced when necessary.

Pension and other postretirement benefit plan investments recorded at fair value were as follows, by asset class. See Note 1(s), "Summary of Significant Accounting Policies – Fair Value," for information on the fair value hierarchy and the inputs used to measure fair value.

	December 31, 2010							
	Pension Plan Assets				Other Benefit Plan Assets			
(Millions)	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
Asset Class								
Cash and cash equivalents	$3.4	$34.0	$-	$37.4	$-	$9.8	$-	$9.8
Equity securities:								
United States equity	125.3	299.1	-	424.4	28.3	73.8	-	102.1
International equity	75.9	247.6	-	323.5	14.6	48.7	-	63.3
Fixed income securities:								
United States government	-	73.1	-	73.1	9.4	33.9	-	43.3
Foreign government	-	13.1	7.8	20.9	-	-	-	-
Corporate debt	-	143.2	2.0	145.2	-	21.9	-	21.9
Asset-backed securities	-	52.8	0.2	53.0	-	0.4	-	0.4
Other	-	5.1	-	5.1	3.0	-	-	3.0
Real estate securities	-	-	30.0	30.0	-	-	-	-
	204.6	868.0	40.0	$1,112.6	55.3	188.5	-	243.8
401(h) other benefit plan assets invested as pension assets *	(4.3)	(18.2)	(0.8)	(23.3)	4.3	18.2	0.8	23.3
Total	$200.3	$849.8	$39.2	$1,089.3	$59.6	$206.7	$0.8	$267.1

* Pension trust assets are used to pay other postretirement benefits as allowed under Internal Revenue Code Section 401(h).

	December 31, 2009							
	Pension Plan Assets				Other Benefit Plan Assets			
(Millions)	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
Asset Class								
Cash and cash equivalents	$2.1	$32.9	$-	$35.0	$-	$20.1	$-	$20.1
Equity securities:								
United States equity	261.7	171.3	-	433.0	48.0	39.6	-	87.6
International equity	31.0	144.3	-	175.3	-	26.9	-	26.9
Fixed income securities:								
United States government	-	109.6	-	109.6	-	32.4	-	32.4
Foreign government	-	12.4	0.4	12.8	-	1.5	-	1.5
Corporate debt	-	124.9	2.9	127.8	0.9	31.6	-	32.5
	-	39.3	-	39.3	-	9.0	-	9.0

Asset-backed securities								
Other	-	-	1.1	1.1	-	2.3	-	2.3
Real estate securities	-	-	24.9	24.9	-	-	-	-
	294.8	634.7	29.3	958.8	48.9	163.4	-	212.3
401(h) other benefit plan assets invested as pension assets *	(0.8)	(17.6)	(0.1)	(18.5)	0.8	17.6	0.1	18.5
Total	$294.0	$617.1	$29.2	$940.3	$49.7	$181.0	$0.1	$230.8

* Pension trust assets are used to pay other postretirement benefits as allowed under Internal Revenue Code Section 401(h).

The following table sets forth a reconciliation of changes in the fair value of pension plan assets categorized as Level 3 measurements:

(Millions)	Foreign Government Debt	Corporate Debt	Asset-Backed Securities	Other Fixed Income Securities	Real Estate Securities	Total
Beginning balance at December 31, 2008	$ 0.7	$1.8	$ 0.1	$1.5	$35.8	$39.9
Actual return on plan assets:						
Relating to assets still held at the reporting date	0.8	1.1	-	1.2	(12.2)	(9.1)
Relating to assets sold during the period	-	(0.4)	-	(0.5)	-	(0.9)
Purchases, sales, and settlements	0.1	0.7	-	(1.1)	1.3	1.0
Transfers in and/or out of Level 3	(1.2)	(0.3)	(0.1)	-	-	(1.6)
Ending balance at December 31, 2009	$ 0.4	$2.9	$ -	$1.1	$24.9	$29.3
Actual return on plan assets:						
Relating to assets still held at the reporting date	(0.2)	0.3	-	-	3.8	3.9
Relating to assets sold during the period	-	-	-	(0.1)	-	(0.1)
Purchases, sales, and settlements	7.6	(1.2)	0.2	(1.0)	1.3	6.9
Ending balance at December 31, 2010	$ 7.8	$2.0	$ 0.2	$-	$30.0	$40.0

Cash Flows Related to Pension and Other Postretirement Benefit Plans

Integrys Energy Group's funding policy is to contribute at least the minimum amounts that are required to be funded under the Employee Retirement Income Security Act, but not more than the maximum amounts that are currently deductible for income tax purposes. Integrys Energy Group expects to contribute $90.9 million to pension plans and $41.2 million to other postretirement benefit plans in 2011, dependent upon various factors affecting Integrys Energy Group, including its liquidity position and tax law changes.

The following table shows the payments, reflecting expected future service, that Integrys Energy Group expects to make for pension and other postretirement benefits. In addition, the table shows the expected federal subsidies, provided under the Medicare Prescription Drug, Improvement and Modernization Act of 2003, which will partially offset other postretirement benefits.

(Millions)	Pension Benefits	Other Benefits	Federal Subsidies
2011	$ 107.9	$ 29.7	$ (2.4)
2012	113.0	31.6	(2.6)
2013	115.7	33.6	(2.8)
2014	109.0	35.6	(3.0)
2015	114.2	38.1	(3.2)
2016-2020	619.1	229.7	(18.6)

Defined Contribution Benefit Plans

Integrys Energy Group maintains 401(k) Savings Plans for substantially all full-time employees and matches a percentage of employee contributions through an employee stock ownership plan (ESOP) or cash contribution up to certain limits. Certain union employees receive a contribution to their ESOP account regardless of their participation in the 401(k) Savings Plan. The ESOP held 3.3 million shares of Integrys Energy Group's common stock (market value of $158.6 million) at December 31, 2010. Certain employees participate in a discretionary profit-sharing contribution and/or cash match. Certain employees who are not eligible to participate in the defined benefit pension plan participate in a defined contribution pension plan, in which Integrys Energy Group contributes certain amounts to an employee's account based on the employee's wages, age, and years of service. Total costs incurred under all of these plans were $16.9 million in 2010, $16.8 million in 2009, and $17.4 million in 2008.

Integrys Energy Group maintains deferred compensation plans that enable certain key employees and non-employee directors to defer payment of a portion of their compensation or fees on a pre-tax basis. Non-employee directors can defer up to 100% of their director fees. Compensation is generally deferred in the form of cash, indexed to certain investment options or Integrys Energy Group common stock with deemed dividends paid on the common stock automatically reinvested.

The deferred compensation arrangements for which distributions are made solely in Integrys Energy Group's common stock are classified as an equity instrument. Changes in the fair value of the deferred compensation obligation are not recognized. The deferred compensation obligation associated with Integrys Energy Group common stock was $26.3 million at December 31, 2010, and $24.2 million at December 31, 2009.

The portion of the deferred compensation obligation associated with deferrals that allow for distribution in cash is classified as a liability on the Consolidated Balance Sheets and adjusted, with a charge or credit to expense, to reflect changes in the fair value of the deferred compensation obligation. The obligation classified within other long-term liabilities was $36.2 million at December 31, 2010, and $32.1 million at December 31, 2009. The costs incurred under this arrangement were $3.5 million in 2010, $4.0 million in 2009, and $1.9 million in 2008.

The deferred compensation programs are partially funded through shares of Integrys Energy Group's common stock that are held in a rabbi trust. The common stock held in the rabbi trust is classified as a

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reduction of equity in a manner similar to accounting for treasury stock. The total cost of Integrys Energy Group's common stock held in the rabbi trust was $18.5 million at December 31, 2010, and $17.2 million at December 31, 2009.

NOTE 18--PREFERRED STOCK OF SUBSIDIARY

Integrys Energy Group's subsidiary, WPS, has 1,000,000 authorized shares of preferred stock with no mandatory redemption and a $100 par value. Outstanding shares were as follows at December 31:

(Millions, except share amounts)

	2010		2009	
Series	Shares Outstanding	Carrying Value	Shares Outstanding	Carrying Value
5.00 %	130,692	$13.1	130,692	$13.1
5.04 %	29,898	3.0	29,898	3.0
5.08 %	49,905	5.0	49,905	5.0
6.76 %	150,000	15.0	150,000	15.0
6.88 %	150,000	15.0	150,000	15.0
Total	510,495	$51.1	510,495	$51.1

All shares of preferred stock of all series are of equal rank except as to dividend rates and redemption terms. Payment of dividends from any earned surplus or other available surplus is not restricted by the terms of any indenture or other undertaking by WPS. Each series of outstanding preferred stock is redeemable in whole or in part at WPS's option at any time on 30 days' notice at the respective redemption prices. WPS may not redeem less than all, nor purchase any, of its preferred stock during the existence of any dividend default.

In the event of WPS's dissolution or liquidation, the holders of preferred stock are entitled to receive (a) the par value of their preferred stock out of the corporate assets other than profits before any of such assets are paid or distributed to the holders of common stock and (b) the amount of dividends accumulated and unpaid on their preferred stock out of the surplus or net profits before any of such surplus or net profits are paid to the holders of common stock. Thereafter, the remainder of the corporate assets, surplus, and net profits shall be paid to the holders of common stock.

The preferred stock has no pre-emptive, subscription, or conversion rights, and has no sinking fund provisions.

NOTE 19--COMMON EQUITY

Integrys Energy Group's reconciliation of shares outstanding at December 31, 2010, and 2009, was as follows:

	2010			2009		
	Shares	Average Cost		Shares	Average Cost	
Common stock issued	77,781,685			76,418,843		
Less:						
Deferred compensation rabbi trust	425,273	$43.55	(1)	402,839	$42.58	(1)
Restricted stock	6,333	$58.65	(2)	35,861	$55.33	(2)
Total shares outstanding	77,350,079			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. These stock issuances increased equity $55.8 million in 2010. From January 1, 2010, to February 10, 2010, and during 2009 and 2008, Integrys Energy Group purchased shares of its common stock on the open market to meet the requirements of these plans.

Integrys Energy Group's common stock shares	
Balance at December 31, 2007	76,434,095
Restricted stock shares cancelled	(4,058)
Balance at December 31, 2008	76,430,037
Restricted stock shares cancelled	(11,194)
Balance at December 31, 2009	76,418,843
Shares issued	
Stock Investment Plan	752,360
Stock-based compensation	592,237
Rabbi trust shares	35,000
Restricted stock shares cancelled	(16,755)
Balance at December 31, 2010	77,781,685

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 2010 excluded 1.4 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 2009, because there was a net loss during the period, which would have caused the impact to be anti-dilutive. The 2009 calculation of diluted earnings per share also excluded 2.7 million out-of-the-money stock options that had an anti-dilutive effect. The calculation of diluted earnings per share for 2008 excluded 2.2 million out-of-the-money stock options that had an anti-dilutive effect. The following table reconciles the computation of basic and diluted earnings (loss) per share:

(Millions, except per share amounts)	2010	2009	2008
Numerator:			
Net income (loss) from continuing operations	$223.5	$(70.3)	$114.8
Discontinued operations, net of tax	0.2	2.8	4.7
Preferred stock dividends of subsidiary	(3.1)	(3.1)	(3.1)
Noncontrolling interest in subsidiaries	0.3	1.0	0.1
Net income (loss) attributed to common shareholders	$220.9	$(69.6)	$116.5
Denominator:			
Average shares of common stock – basic	77.5	76.8	76.7
Effect of dilutive securities			
Stock-based compensation	0.5	-	0.3
Average shares of common stock – diluted	78.0	76.8	77.0

Earnings (loss) per common share			
Basic	$2.85	$(0.91)	$1.52
Diluted	2.83	(0.91)	1.51
Dividends per common share declared	$2.72	$2.72	$2.68

Accumulated Other Comprehensive Loss

The components of accumulated other comprehensive loss, net of tax, at December 31, 2010, and 2009, were:

(Millions)	2010	2009
Cash flow hedges (1)	$(20.4)	$(24.9)
Unrecognized pension and other postretirement benefit costs (2)	(24.3)	(21.5)
Foreign currency translation	-	2.4
Total accumulated other comprehensive loss	$(44.7)	$(44.0)

(1) Includes tax benefits of $13.9 million and $18.6 million at December 31, 2010, and 2009, respectively.
(2) Includes tax benefits of $15.8 million and $13.8 million at December 31, 2010, and 2009, respectively.

NOTE 20--STOCK-BASED COMPENSATION

In May 2010, Integrys Energy Group's shareholders approved the 2010 Omnibus Incentive Compensation Plan (2010 Omnibus Plan). Under the provisions of the 2010 Omnibus Plan, the number of shares of stock that may be issued in satisfaction of plan awards may not exceed 3,000,000 shares, plus any shares remaining or forfeited under prior plans, and no more than 900,000 shares of stock, plus shares remaining or forfeited under prior plans, can be granted as full value shares in the form of performance shares or restricted stock. No additional awards will be issued under prior plans, although the plans continue to exist for purposes of the existing outstanding stock-based compensation awards. At December 31, 2010, stock options, performance stock rights, and restricted shares and restricted share units were outstanding under the various plans.

Performance stock rights, restricted shares, and restricted share units were accounted for as equity awards through June 30, 2010. However, in the third quarter of 2010, Integrys Energy Group determined that these awards should have been accounted for as liability awards due to certain changes to the deferred compensation plan approved by Integrys Energy Group's Board of Directors in the fourth quarter of 2007. In the third quarter of 2010, consistent with the guidance in the Stock Compensation Topic of the FASB ASC, Integrys Energy Group began accounting for performance stock rights, restricted shares, and restricted share units as liability awards, which are required to be recorded at fair value each reporting period. The cumulative effect of this change related to periods prior to the third quarter of 2010 was a decrease in net income from continuing operations and net income attributed to common shareholders of $2.4 million. Management determined that this amount was not material to prior periods and recorded the cumulative effect in earnings in the third quarter of 2010.

Stock Options

Under the provisions of the 2010 Omnibus Plan, no single employee who is the chief executive officer of Integrys Energy Group or any of the other three highest compensated officers of Integrys Energy Group and its subsidiaries can be granted options for more than 1,000,000 shares during any calendar year. No stock options will have a term longer than ten years. The exercise price of each stock option is equal to the fair market value of the stock on the date the stock option is granted. Generally, one-fourth of the stock options granted vest and become exercisable each year on the anniversary of the grant date.

The fair values of stock option awards granted were estimated using a binomial lattice model. The expected term of option awards is calculated based on historical exercise behavior and represents the period of time that options are expected to be outstanding. The risk-free interest rate is based on the United States Treasury yield curve. The expected dividend yield incorporates the current and historical dividend rate. Integrys Energy Group's expected stock price volatility was estimated using its 10-year historical volatility. The following table shows the weighted-average

fair values per stock option along with the assumptions incorporated into the valuation models:

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	2010		2009		2008	
Weighted-average fair value per option	$5.30		$3.83		$4.52	
Expected term	6 years		8 - 9 years		7 years	
Risk-free interest rate	2.38	%	2.50% - 2.78	%	3.40	%
Expected dividend yield	5.46	%	5.50	%	5.00	%
Expected volatility	25	%	19	%	17	%

Compensation cost recognized for stock options during 2010, 2009, and 2008, was $2.3 million, $2.0 million, and $2.6 million, respectively. Compensation cost capitalized during these same years was not significant. As of December 31, 2010, $1.3 million of compensation cost related to unvested and outstanding stock options was expected to be recognized over a weighted-average period of 2.6 years.

Cash received from option exercises was $18.8 million during 2010. Cash received from option exercises during 2009 was not significant and was $3.3 million during 2008. The tax benefit realized from these option exercises was not significant in 2010, 2009, and 2008.

A summary of stock option activity for 2010, and information related to outstanding and exercisable stock options at December 31, 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	(486,624)	38.56		$4.9
Forfeited	(110,808)	41.58		0.8
Expired	(97,247)	48.55		0.1
Outstanding at December 31, 2010	2,992,699	$ 47.59	6.27	$8.0
Exercisable at December 31, 2010	1,852,573	$ 49.75	5.09	$2.2

The aggregate intrinsic value for outstanding and exercisable options in the above table represents the total pre-tax intrinsic value that would have been received by the option holders had they all exercised their options at December 31, 2010. This is calculated as the difference between Integrys Energy Group's closing stock price on December 31, 2010, and the option exercise price, multiplied by the number of in-the-money stock options. The intrinsic value of options exercised was not significant during 2009 and 2008.

Performance Stock Rights

Performance stock rights vest over a three-year performance period and are paid out in shares of Integrys Energy Group's common stock or an employee may elect to defer the value of the award into the deferred compensation plan. No single employee who is the chief executive officer of Integrys Energy Group or any of the other three highest compensated officers of Integrys Energy Group and its subsidiaries can receive a payout in excess of 250,000 performance shares during any calendar year. The number of shares paid out is calculated by multiplying a performance percentage by the number of outstanding stock rights at the completion of the vesting period. The performance percentage is based on the total shareholder return of Integrys Energy Group's common stock relative to the total shareholder return of a peer group of companies. The payout may range from 0% to 200% of target.

Performance stock rights are accounted for as liability awards and are remeasured each reporting period throughout the requisite service period. The fair values of performance stock rights were estimated using a Monte Carlo valuation model, incorporating the assumptions in the table below. The risk-free interest rate is based on the United States Treasury yield curve. The expected dividend yield incorporates the current and historical dividend rate. The expected volatility was estimated using three years of historical data.

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	2010	2009	2008
Risk-free interest rate	0.21% - 0.56 %	1.38 %	2.18 %
Expected dividend yield	5.34 %	5.50 %	5.50 %
Expected volatility	20% - 34 %	26 %	17 %

Compensation cost recorded for performance stock rights for 2010, 2009, and 2008 was $10.0 million, $4.6 million, and $5.2 million, respectively. Compensation cost capitalized during these same years was not significant. As of December 31, 2010, $3.1 million of compensation cost related to unvested and outstanding performance stock rights was expected (based on the value of these awards at the reporting date) to be recognized over a weighted-average period of 1.8 years.

A summary of the activity related to performance stock rights for the year ended December 31, 2010, is presented below:

	Performance Stock Rights
Outstanding at December 31, 2009	301,090
Granted	150,481
Distributed	(45,847)
Adjustment for final payout	(26,009)
Forfeited	(38,077)
Outstanding at December 31, 2010	341,638

Restricted Shares and Restricted Share Units

A portion of the long-term incentive is awarded in the form of restricted shares and restricted share units. Most of these awards have a four-year vesting period, with 25% of each award vesting on each anniversary of the grant date. During the vesting period, restricted share recipients have voting rights and are entitled to dividends in the same manner as other common shareholders, whereas restricted share unit recipients receive dividend credits and do not have voting rights. Restricted shares and restricted share units are accounted for as liability awards and are remeasured each period based on Integrys Energy Group's closing stock price at the reporting date. Compensation cost recognized for these awards was $10.1 million, $4.9 million, and $4.2 million during 2010, 2009, and 2008, respectively. Compensation cost capitalized during these same years was not significant. As of December 31, 2010, $11.7 million of compensation cost related to these awards was expected (based on the value of these awards at the reporting date) to be recognized over a weighted-average period of 2.5 years.

A summary of the activity related to restricted share and restricted share unit awards for the year ended December 31, 2010, is presented below:

	Restricted Shares and Restricted Share Unit Awards
Outstanding at December 31, 2009	346,858
Granted	210,922
Vested	(106,153)
Forfeited	(46,265)

Outstanding at December 31, 2010	405,362

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NOTE 21--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. One of these purchased power agreements reimburses an independent power producing entity for coal costs relating to purchased energy. There is no obligation to purchase energy under the agreement. This contract expires in 2016. The other agreement contains a tolling arrangement in which Integrys Energy Group supplies the scheduled fuel and purchases capacity and energy from the facility. This contract also expires in 2016. As of December 31, 2010, and December 31, 2009, Integrys Energy Group had approximately 535 megawatts of capacity available under these agreements.

Integrys Energy Group has evaluated each of these variable interest entities for possible consolidation. In these cases, Integrys Energy Group 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 qualitative factors such as 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 and maintenance of the facilities. Integrys Energy Group determined it is not the primary beneficiary of these variable interest entities.

At December 31, 2010, the assets and liabilities on the 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 was a variable interest entity and that Integrys Energy Services was 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 was the primary beneficiary. In July 2010, Integrys Energy Services purchased the remaining 50% ownership interest in LGS from LGS Development, L.P. and became the sole owner.

NOTE 22--FAIR VALUE

Fair Value Measurements

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

	December 31, 2010			
(Millions)	Level 1	Level 2	Level 3	Total
Risk Management Assets				
Utility Segments				
FTRs	$-	$-	$3.1	$3.1
Natural gas contracts	0.6	3.2	-	3.8
Petroleum product contracts	0.6	-	-	0.6
Coal contract	-	-	3.7	3.7
Nonregulated Segments				
Natural gas contracts	60.7	100.7	34.6	196.0
Electric contracts	29.5	69.8	17.4	116.7
Interest rate swaps	-	0.9	-	0.9
Foreign exchange contracts	0.1	1.4	-	1.5
Total Risk Management Assets	$91.5	$176.0	$58.8	$326.3
Risk Management Liabilities				
Utility Segments				
FTRs	$-	$-	$0.2	$0.2
Natural gas contracts	3.7	22.3	-	26.0
Coal contract	-	-	1.2	1.2
Nonregulated Segments				
Natural gas contracts	66.8	110.4	4.4	181.6
Electric contracts	45.0	101.5	32.3	178.8
Foreign exchange contracts	1.4	0.1	-	1.5
Total Risk Management Liabilities	$116.9	$234.3	$38.1	$389.3
Long-term debt hedged by fairvalue hedge	$-	$50.9	$-	$50.9

	December 31, 2009			
(Millions)	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

The risk management assets and liabilities listed in the tables above 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 2, "Risk Management Activities."

The following tables show net risk management assets (liabilities) transferred between the levels of the fair value hierarchy during 2010.

Nonregulated Segments – Electric Contracts			
(Millions)	Level 1	Level 2	Level 3
Transfers into Level 1 from	N/A	$(10.1)	$(18.0)
Transfers into Level 2 from	$(0.2)	N/A	2.6

Transfers into Level 3 from	-	(4.9)	N/A

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Nonregulated Segments – Natural Gas Contracts

(Millions)	Level 1	Level 2	Level 3
Transfers into Level 1 from	N/A	$0.1	$-
Transfers into Level 2 from	$-	N/A	0.8
Transfers into Level 3 from	-	1.7	N/A

Derivatives are transferred between the levels of the fair value hierarchy 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:

2010	Nonregulated Segments		Utility Segments		
(Millions)	Natural Gas	Electric	FTRs	Coal Contract	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	38.9	(65.1)	5.3	-	(20.9)
Net unrealized (losses) gains recorded as regulatory assets or liabilities	-	-	(1.1)	2.5	1.4
Net unrealized losses included in other comprehensive loss	-	(3.1)	-	-	(3.1)
Net purchases and settlements	(41.0)	(43.7)	(4.8)	-	(89.5)
Net transfers into Level 3	1.7	(4.9)	-	-	(3.2)
Net transfers out of Level 3	(0.8)	15.4	-	-	14.6
Balance at the end of the period	$30.2	$(14.9)	$2.9	$2.5	$20.7
Net unrealized gains (losses) included in earnings related to instruments still held at the end of the period	$38.9	$(65.1)	$-	$-	$(26.2)

(Millions)	2009	2008
Balance at the beginning of period	$182.0	$44.6
Net realized and unrealized gain (loss) included in earnings	32.0	(44.7)
Net unrealized gain (loss) recorded as regulatory assets or liabilities	2.2	(8.7)
Net unrealized gain (loss) included in other comprehensive loss	16.3	(35.0)
Net purchases and settlements	(36.0)	2.5
Net transfers in/out of Level 3	(75.1)	223.3
Balance at the end of the period	$121.4	$182.0
Net unrealized gain (loss) included in earnings related to instruments still held at the end of the period	$35.4	$(55.3)

Unrealized gains and losses included in earnings related to Integrys Energy Services' risk management assets and liabilities are recorded through nonregulated revenue on the 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 Consolidated Statements of Income.

Fair Value of Financial Instruments

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

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(Millions)	2010 Carrying Amount	2010 Fair Value	2009 Carrying Amount	2009 Fair Value
Long-term debt	$2,638.5	$2,687.8	$2,511.2	$2,543.6
Preferred stock of subsidiary	51.1	46.8	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 of subsidiary are estimated based on quoted market prices when available, or by using a perpetual dividend discount model.

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

NOTE 23--MISCELLANEOUS INCOME

Integrys Energy Group's total miscellaneous income was as follows at December 31:

(Millions)	2010	2009	2008
Equity earnings on investments	$78.3	$76.1	$67.8
Gain (loss) on foreign currency translation *	4.7	(0.1)	0.9
Interest and dividend income	3.7	5.6	5.0
Key executive life insurance income	3.1	2.3	2.7
Equity portion of AFUDC	1.6	6.0	5.5
Weston 4 ATC interconnection agreement interest	-	-	2.5
(Loss) gain on sale of property	(0.1)	1.8	4.8
Other	0.2	(2.7)	(1.9)
Total miscellaneous income	$91.5	$89.0	$87.3

* The foreign currency translation gains that had accumulated in OCI were reclassified from OCI to miscellaneous income when Integrys Energy Services substantially completed the liquidation of its Canadian subsidiaries during 2010. At December 31, 2010, no amounts remained in accumulated OCI related to foreign currency translation.

NOTE 24--REGULATORY ENVIRONMENT

Wisconsin

2011 Rates

On January 13, 2011, the PSCW issued a final written order for WPS authorizing an electric rate increase of $21.0 million, excluding the impact of a $15.2 million estimated fuel refund (including carrying costs) from 2010, and requiring an $8.3 million decrease in natural gas rates, effective January 14, 2011. The new rates reflect a 10.30% return on common equity and a common equity ratio of 51.65% in WPS's regulatory capital structure. The order also adopted new electric fuel rules effective January 1, 2011. The rulemaking process to implement the new fuel rules is expected to be complete in March 2011.

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 cost over-collections, 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, and the 2010 fuel cost

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over-collections were made subject to refund as of that date. As of December 31, 2010, the balance of the 2010 fuel cost over-collections to be refunded to customers throughout 2011 was $15.2 million, which was recorded as a short-term regulatory liability.

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, which 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 does not cover large commercial and industrial customers.

2008 Rates

On January 15, 2008, the PSCW issued a final written order for WPS authorizing a retail electric rate increase of $23.0 million, and on February 11, 2008, WPS filed an application with the PSCW to adjust its 2008 electric rates for increased fuel and purchased power costs. The PSCW approved an interim annual fuel surcharge increase of $29.7 million on March 20, 2008, and an additional final fuel surcharge increase of $18.3 million, effective July 4, 2008.

On September 30, 2008, the PSCW reopened the 2008 fuel surcharge to review forecasted fuel costs, as WPS's current and anticipated annual fuel costs were below those projected in the fuel surcharge. As a result of the lower fuel and purchased power costs, WPS's rates from September 30, 2008, through December 31, 2008, were subject to refund. On February 9, 2009, WPS filed a request with the PSCW to refund approximately $5 million of 2008 fuel costs to Wisconsin electric retail customers, which resulted in a credit to customers' bills in March and April 2009.

Michigan

2011 UPPCO Rates

On December 21, 2010, the MPSC issued an order approving a settlement agreement for UPPCO authorizing a retail electric rate increase of $8.9 million, effective January 1, 2011. The new rates reflect a 10.30% return on common equity and a common equity ratio of 54.86% in UPPCO's regulatory capital structure. The order requires that UPPCO terminate its uncollectibles expense tracking mechanism (discussed below) after the close of December 2010 business, but retains the decoupling mechanism.

2010 UPPCO Rates

On December 16, 2009, the MPSC issued a final written order for UPPCO authorizing a retail electric rate increase of $6.5 million, effective January 1, 2010. The new rates reflected 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 new rates reflect 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. The MPSC also granted a decoupling mechanism for MGU, which adjusts for the impact on revenues of changes in weather-normalized use per customer for residential and small commercial customers, effective January 1, 2010.

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.

2008 WPS Rates

On December 4, 2007, the MPSC issued a final written order for WPS authorizing a retail electric rate increase of $0.6 million, effective December 5, 2007. The new rates reflected a 10.60% return on common equity and a common equity ratio of 56.39% in WPS's regulatory capital structure.

Illinois

2011 Rate Cases

On February 15, 2011, PGL and NSG filed applications with the ICC to increase retail natural gas rates $125.4 million and $8.7 million, respectively, with rates expected to be effective in January 2012. The filings for both PGL and NSG include requests for an 11.25% return on common equity and a common equity ratio of 56.00% in their regulatory capital structures. PGL and NSG each requested that the ICC make their decoupling mechanisms permanent.

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 56.00% in PGL's regulatory capital structure. The rates for NSG reflect a 10.33% return on common equity and a common equity ratio of 56.00% in NSG's 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. 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. In June 2010, the ICC issued a rehearing order approving PGL's proposed baseline of $45.28 million with an annual escalation factor. 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 AG, the Citizens Utility Board, PGL, and NSG filed appeals with the Illinois Appellate Court, First District.

On September 30, 2010, the Illinois Appellate Court, Second District, issued a decision which, among other things, rejected the ICC's approval of a Commonwealth Edison Company (ComEd) cost recovery mechanism for system modernization in the form of advanced metering technology (also called "smart grid") because it was improper single issue ratemaking. Single issue ratemaking is one of the arguments raised in the pending appeal of NSG's and PGL's decoupling mechanism approved in the 2008 rate case, and the pending appeal of Rider ICR. Integrys Energy Group is evaluating the decision of the Illinois Appellate Court, Second District, in light of other, contrary precedents, and whether differences in the decoupling mechanism and Rider ICR distinguish them from ComEd's rider. The appeal involving the decoupling mechanism is pending before the Illinois Appellate Court, Second District. The appeal involving Rider ICR is pending before the Illinois Appellate Court, First District.

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2009 Illinois Legislation

In July 2009, Illinois Senate Bill (SB) 1918 was signed into law. Under SB 1918, PGL and NSG filed a rider with the ICC in September 2009 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. The ICC approved the rider in February 2010. SB 1918 also requires a percentage of income payment plan for low-income utility customers, which PGL and NSG began offering as a transition program in 2010, 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 will begin in June 2011, which allows certain residential customers of PGL and NSG to borrow funds from a third party lender to purchase energy efficiency measures and pay back over time through a charge on their utility bill. Finally, SB 1918 requires an EEP to meet specified energy efficiency standards, which is pending before the ICC, 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 requiring a retail natural gas rate decrease of $0.2 million for NSG, both effective February 14, 2008. The rates for PGL reflected a 10.19% return on common equity and a common equity ratio of 56.00% in PGL's regulatory capital structure. The rates for NSG reflected a 9.99% return on common equity and a common equity ratio of 56.00% in NSG's 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.

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, NSG and four other parties filed appeals with the Illinois Appellate Court regarding the decoupling mechanism. In December 2010, the Illinois Appellate Court, First District, concluded it lacked jurisdiction over the appeals and transferred the matter to the Illinois Appellate Court, Second District.

Minnesota

2011 Rates

On November 30, 2010, MERC filed an application with the MPUC to increase retail natural gas rates by $15.2 million, with interim rates effective February 2011, and final rates effective during the first quarter of 2012. The filing includes a request for an 11.25% return on common equity and a common equity ratio of 50.20% in MERC's regulatory capital structure. On January 28, 2011, the MPUC approved an interim rate order authorizing MERC a retail natural gas rate increase of $7.5 million, effective February 1, 2011. The interim rates reflect a 10.21% return on common equity and a common equity ratio of 50.20% in MERC's regulatory capital structure.

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 reflected a 10.21% return on common equity and a common equity ratio of 48.77% in MERC's 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. MERC also received MPUC approval in 2010 to increase its per therm cost recovery charges related to its conservation improvement program.

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 would 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.

Integrys Energy Services initially expensed all but $4.5 million of the total $19.2 million of billings received for the 16-month transitional period, as it was considered probable that at least $4.5 million of the billings would be recovered 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 vendors for a combined $1.6 million, reducing the $4.5 million 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, approximately $1 million in the second quarter of 2010, as only about $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 25--SEGMENTS OF BUSINESS

The Segment Reporting Topic of the FASB ASC requires that companies disclose segment information based on how management makes decisions about allocating resources to segments and measuring their performance.

During the fourth quarter of 2010, Integrys Energy Group changed its method of accounting for ITCs from the flow-through method to the deferral method. As such, certain previously reported amounts have been retrospectively adjusted. See Note 1(d), "Change in Accounting Policy," for more information.

Integrys Energy Group manages its reportable segments separately due to their different operating and regulatory environments. At December 31, 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 with operations in Wisconsin, Michigan, Minnesota, and Illinois.
- Integrys Energy Services is a diversified nonregulated retail energy supply and services company that primarily sells electricity and natural gas to commercial, industrial, and residential customers in deregulated markets. In addition, Integrys Energy Services invests in energy assets with renewable attributes.

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.

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

	Regulated Operations				Nonutility and Nonregulated Operations			
2010 (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
Income Statement								
External revenues	$2,056.4	$1,312.1	$ -	$ 3,368.5	$1,822.5	$ 12.2	$ -	$ 5,203.2
Intersegment revenues	0.8	26.8	-	27.6	1.2	-	(28.8)	-
Impairment losses on property, plant, and equipment	-	-	-	-	43.2	-	-	43.2
Net loss on Integrys Energy Services' dispositions related to strategy change	-	-	-	-	14.1	-	-	14.1
Restructuring expense	(0.2)	(0.3)	-	(0.5)	8.3	0.1	-	7.9
Depreciation and amortization expense	130.9	94.7	-	225.6	17.2	23.0	-	265.8
Miscellaneous income (expense)	1.6	1.5	77.6	80.7	9.1	41.9	(40.2)	91.5
Interest expense (income)	49.7	43.9	-	93.6	6.7	87.8	(40.2)	147.9
Provision (benefit) for income taxes	65.3	63.1	31.4	159.8	3.6	(15.2)	-	148.2
Net income (loss) from continuing operations	84.6	112.3	46.2	243.1	2.8	(22.4)	-	223.5
Discontinued operations	-	-	-	-	0.2	-	-	0.2
Preferred stock dividends of subsidiary	(0.6)	(2.5)	-	(3.1)	-	-	-	(3.1)
Noncontrolling interest in subsidiaries	-	-	-	-	0.3	-	-	0.3
Net income (loss) attributed to	84.0	109.8	46.2	240.0	3.3	(22.4)	-	220.9

common shareholders								
Total assets	4,828.1	2,929.8	416.3	8,174.2	1,234.8	1,666.7	(1,258.9)	9,816.8
Cash expenditures for long-lived assets	133.6	87.2	-	220.8	15.2	22.8	-	258.8

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2009 (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			
Income Statement								
External revenues	$2,236.9	$1,258.9	$ -	$ 3,495.8	$3,992.5	$11.5	$ -	$ 7,499.8
Intersegment revenues	0.6	42.7	-	43.3	1.5	-	(44.8)	-
Impairment losses on property, plant, and equipment	-	-	-	-	0.7	-	-	0.7
Net loss on Integrys Energy Services dispositions related to strategy change	-	-	-	-	28.9	-	-	28.9
Restructuring expense	6.9	8.6	-	15.5	27.2	0.8	-	43.5
Goodwill impairment loss	291.1	-	-	291.1	-	-	-	291.1
Depreciation and amortization expense	106.1	90.3	-	196.4	19.0	15.2	-	230.6
Miscellaneous income (expense)	3.1	4.8	75.3	83.2	6.0	46.5	(46.7)	89.0
Interest expense (income)	52.2	41.6	-	93.8	13.1	104.6	(46.7)	164.8
Provision (benefit) for income taxes	7.8	51.4	29.8	89.0	19.0	(24.3)	-	83.7
Net income (loss) from continuing operations	(171.5)	91.4	45.5	(34.6)	-	(35.7)	-	(70.3)
Discontinued operations	-	-	-	-	2.8	-	-	2.8
Preferred stock dividends of subsidiary	(0.6)	(2.5)	-	(3.1)	-	-	-	(3.1)
Noncontrolling interest in subsidiaries	-	-	-	-	1.0	-	-	1.0
Net income (loss) attributed to common	(172.1)	88.9	45.5	(37.7)	3.8	(35.7)	-	(69.6)

shareholders								
Total assets	4,675.7	2,834.7	395.9	7,906.3	3,547.5	1,462.7	(1,071.9)	11,844.6
Cash expenditures for long-lived assets	136.9	250.4	-	387.3	22.4	34.5	-	444.2

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2008 (Millions)	Regulated Operations: Natural Gas Utility	Regulated Operations: Electric Utility	Regulated Operations: Electric Transmission Investment	Total Regulated Operations	Nonutility and Nonregulated Operations: Integrys Energy Services	Nonutility and Nonregulated Operations: Holding Company and Other	Reconciling Eliminations	Integrys Energy Group Consolidated
Income Statement								
External revenues	$3,025.3	$1,284.6	$ -	$ 4,309.9	$9,726.5	$ 11.4	$ -	$ 14,047.8
Intersegment revenues	0.6	44.3	-	44.9	8.7	0.6	(54.2)	-
Impairment losses on property, plant, and equipment	-	-	-	-	0.5	-	-	0.5
Goodwill impairment loss	6.5	-	-	6.5	-	-	-	6.5
Depreciation and amortization expense	108.3	84.3	-	192.6	14.5	14.3	-	221.4
Miscellaneous income (expense)	7.0	6.0	66.1	79.1	8.7	45.4	(45.9)	87.3
Interest expense (income)	56.6	36.7	-	93.3	12.1	98.6	(45.9)	158.1
Provision (benefit) for income taxes	57.1	48.1	26.4	131.6	(46.3)	(24.2)	-	61.1
Net income (loss) from continuing operations	85.5	94.7	39.7	219.9	(75.4)	(29.7)	-	114.8
Discontinued operations	-	-	-	-	3.9	0.8	-	4.7
Preferred stock dividends of subsidiary	(1.0)	(2.1)	-	(3.1)	-	-	-	(3.1)
Noncontrolling interest in subsidiaries	-	-	-	-	0.1	-	-	0.1
Net income (loss) attributed to common shareholders	84.5	92.6	39.7	216.8	(71.4)	(28.9)	-	116.5
Total assets	5,173.8	2,752.4	346.9	8,273.1	5,046.4	2,144.3	(1,195.1)	14,268.7
Cash expenditures for long-lived assets	237.3	207.4	-	444.7	68.1	20.0	-	532.8

Geographic Information (Millions)	2010 Revenues	2010 Long-Lived Assets	2009 Revenues	2009 Long-Lived Assets	2008 Revenues	2008 Long-Lived Assets
United States	$5,199.7	$7,677.0	$6,628.5	$7,537.0	$11,639.3	$7,572.6
Canada *	3.5	-	871.3	-	2,408.5	20.0
Total	$5,203.2	$7,677.0	$7,499.8	$7,537.0	$14,047.8	$7,592.6

* Revenues and assets of Canadian subsidiaries. Includes the impact in 2009 of the sale of Canadian operations at Integrys Energy Services.

NOTE 26--QUARTERLY FINANCIAL INFORMATION (Unaudited)

During the fourth quarter of 2010, Integrys Energy Group changed its method of accounting for ITCs from the flow-through method to the deferral method. As such, certain previously reported amounts have been retrospectively adjusted. See Note 1(d), "Change in Accounting Policy," for more information.

As Computed Under Deferral Method

(Millions, except share amounts)	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total
2010					
Total revenues	$1,903.4	$1,014.8	$997.9	$1,287.1	$5,203.2
Operating income	119.4	136.2	39.2	133.3	428.1
Net income (loss) from continuing operations	50.4	79.6	21.1	72.4	223.5
Net income (loss)	50.5	79.6	21.1	72.5	223.7
Net income attributed to common shareholders	49.7	79.1	20.4	71.7	220.9
Earnings per common share (basic) *					
Net income (loss) from continuing operations	0.65	1.02	0.26	0.92	2.85
Earnings (loss) per common share (basic)	0.65	1.02	0.26	0.92	2.85
Earnings per common share (diluted) *					
Net income (loss) from continuing operations	0.64	1.02	0.26	0.91	2.83
Earnings (loss) per common share (basic)	0.64	1.02	0.26	0.91	2.83
2009					
Total revenues	$3,200.8	$1,427.6	$1,297.8	$1,573.6	$7,499.8
Operating income (loss)	(145.0)	74.5	93.4	66.3	89.2
Net income (loss) from continuing operations	(179.3)	36.2	49.3	23.5	(70.3)
Net income (loss)	(179.3)	36.5	51.6	23.7	(67.5)
Net income (loss) attributed to common shareholders	(180.0)	35.9	51.3	23.2	(69.6)
Earnings per common share (basic) *					
Net income (loss) from continuing operations	(2.35)	0.47	0.64	0.30	(0.95)
Earnings (loss) per common share (basic)	(2.35)	0.47	0.67	0.30	(0.91)
Earnings per common share (diluted) *					
Net income (loss) from continuing operations	(2.35)	0.47	0.64	0.30	(0.95)
Earnings (loss) per common share (basic)	(2.35)	0.47	0.67	0.30	(0.91)

* Earnings per share for the individual quarters do not total the year ended earnings per share amount because of changes to the average number of shares outstanding and changes in incremental issuable shares throughout the year.

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As Computed Under Flow-Through Method

(Millions, except share amounts)	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total
2010					
Total revenues	$1,903.4	$1,014.8	$997.9	$1,287.1	$5,203.2
Operating income	119.3	136.1	39.1	133.2	427.7
Net income (loss) from continuing operations	50.2	79.4	20.9	72.1	222.6
Net income (loss)	50.3	79.4	20.9	72.2	222.8
Net income attributed to common shareholders	49.5	78.9	20.2	71.4	220.0
Earnings per common share (basic) *					
Net income (loss) from continuing operations	0.64	1.02	0.26	0.92	2.84
Earnings (loss) per common share (basic)	0.64	1.02	0.26	0.92	2.84
Earnings per common share (diluted) *					
Net income (loss) from continuing operations	0.64	1.01	0.26	0.91	2.82
Earnings (loss) per common share (basic)	0.64	1.01	0.26	0.91	2.82
2009					
Total revenues	$3,200.8	$1,427.6	$1,297.8	$1,573.6	$7,499.8
Operating income (loss)	(145.1)	72.9	93.3	66.3	87.4
Net income (loss) from continuing operations	(179.5)	35.0	49.1	23.8	(71.6)
Net income (loss)	(179.5)	35.3	51.4	24.0	(68.8)
Net income (loss) attributed to common shareholders	(180.2)	34.7	51.1	23.5	(70.9)
Earnings per common share (basic) *					
Net income (loss) from continuing operations	(2.35)	0.45	0.64	0.31	(0.96)
Earnings (loss) per common share (basic)	(2.35)	0.45	0.67	0.31	(0.92)
Earnings per common share (diluted) *					
Net income (loss) from continuing operations	(2.35)	0.45	0.63	0.31	(0.96)
Earnings (loss) per common share (basic)	(2.35)	0.45	0.66	0.31	(0.92)

* Earnings (loss) per share for the individual quarters do not total the year ended earnings (loss) per share amount because of changes to the average number of shares outstanding and changes in incremental issuable shares throughout the year.

Because of various factors, the quarterly results of operations are not necessarily comparable.

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H. REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON FINANCIAL STATEMENTS

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

We have audited the accompanying consolidated balance sheets of Integrys Energy Group, Inc. and subsidiaries (the "Company") as of December 31, 2010 and 2009, and the related consolidated statements of income, equity, and cash flows for each of the three years in the period ended December 31, 2010. Our audits also included the financial statement schedules listed in the Index at Item 15. These financial statements and financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements and financial statement schedules based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Integrys Energy Group, Inc. and subsidiaries as of December 31, 2010 and 2009, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2010, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedules, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2010, based on the criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 23, 2011 expressed an unqualified opinion on the Company's internal control over financial reporting.

/s/ Deloitte & Touche LLP

Milwaukee, Wisconsin
February 23, 2011

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Integrys Energy Group's management, with the participation of Integrys Energy Group's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of Integrys Energy Group's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of the end of the period covered by this report and has concluded that, as of the end of such period, Integrys Energy Group's disclosure controls and procedures were effective to ensure that information required to be disclosed by Integrys Energy Group in the reports that it files or submits under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms and is accumulated and communicated to Integrys Energy Group's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Controls

There were no changes in Integrys Energy Group's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended December 31, 2010, that have materially affected, or are reasonably likely to materially affect, its internal control over financial reporting.

Management Report on Internal Control over Financial Reporting

For Integrys Energy Group's Management Report on Internal Control over Financial Reporting, see Section A of Item 8.

Reports of Independent Registered Public Accounting Firm

For Integrys Energy Group's Reports of Independent Registered Public Accounting Firm, see Sections B and H of Item 8.

ITEM 9B. OTHER INFORMATION

None.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Information required by this Item regarding the directors of Integrys Energy Group, Section 16 compliance, and the members of the Audit Committee and the Audit Committee financial expert can be found in Integrys Energy Group's Proxy Statement for its Annual Meeting of Shareholders to be held May 11, 2011 (Proxy Statement), under the captions "Election of Directors," "Ownership of Voting Securities – Section 16(a) Beneficial Ownership Reporting Compliance," and "Board Committees," respectively. Such information is incorporated by reference as if fully set forth herein.

Information regarding the executive officers of Integrys Energy Group can be found in this Annual Report on Form 10-K in Item 1, "Business – Executive Officers of Integrys Energy Group."

Integrys Energy Group has adopted a Code of Conduct, which serves as its Code of Business Conduct and Ethics. The Code of Conduct applies to all of Integrys Energy Group's directors, officers, and employees, including the Chief Executive Officer, Chief Financial Officer, Corporate Controller, and any other persons performing similar functions. Integrys Energy Group has also adopted Corporate Governance Guidelines.

Integrys Energy Group's Code of Conduct, Corporate Governance Guidelines, and charters of the board committees may be accessed on its website at www.integrysgroup.com by selecting "Investor" then selecting "Corporate Governance." Amendments to, or waivers from, the Code of Conduct will be disclosed on the website within the prescribed time period.

ITEM 11. EXECUTIVE COMPENSATION

Information required by this Item regarding compensation paid by Integrys Energy Group to its directors and its "named executive officers" in 2010 can be found in Integrys Energy Group's Proxy Statement under the captions "Director Compensation," "Executive Compensation," and "Compensation Risk Assessment." Such information is incorporated by reference as if fully set forth herein.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Information required by this Item regarding the principal security holders of Integrys Energy Group and the security holdings of its directors and executive officers can be found in Integrys Energy Group's Proxy Statement under the caption "Ownership of Voting Securities – Beneficial Ownership." Such information is incorporated by reference as if fully set forth herein.

Information required by this Item regarding equity compensation plans of Integrys Energy Group can be found in Integrys Energy Group's Proxy Statement under the caption "Ownership of Voting Securities – Equity Compensation Plan Information." Such information is incorporated by reference as if fully set forth herein.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

Information required by this Item regarding Integrys Energy Group's related person transactions and director independence can be found in Integrys Energy Group's Proxy Statement under the captions "Election of Directors – Related Person Transaction Policy" and "Election of Directors – Director Independence," respectively. Such information is incorporated by reference as if fully set forth herein.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

For a summary of the fees billed to Integrys Energy Group (including its subsidiaries) by Deloitte & Touche LLP for professional services performed for 2010 and 2009 and the Audit Committee’s preapproval policies and procedures, please see Integrys Energy Group's Proxy Statement under the caption "Board Committees – Audit Committee." Such information is incorporated by reference as if fully set forth herein.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

Documents filed as part of this report:

(1) Consolidated Financial Statements included in Part II at Item 8 above:

Description	Pages in 10-K
Consolidated Statements of Income for the three years ended December 31, 2010, 2009, and 2008	69
Consolidated Balance Sheets as of December 31, 2010 and 2009	70
Consolidated Statements of Common Shareholders' Equity for the three years ended December 31, 2010, 2009, and 2008	71
Consolidated Statements of Cash Flows for the three years ended December 31, 2010, 2009, and 2008	72
Notes to Consolidated Financial Statements	73
Report of Independent Registered Public Accounting Firm	143

(2) Financial Statement Schedules.

The following financial statement schedules are included in Part IV of this report. Schedules not included herein have been omitted because they are not applicable or the required information is shown in the financial statements or notes thereto.

Description		Pages in 10-K
Schedule I – Condensed Parent Company Only Financial Statements		
A.	Statements of Income and Retained Earnings	149
B.	Balance Sheets	150
C.	Statements of Cash Flows	151
D.	Notes to Parent Company Financial Statements	152
Schedule II – Integrys Energy Group, Inc. Valuation and Qualifying Accounts		155

(3) Listing of all exhibits, including those incorporated by reference.

See the attached Exhibit Index.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on this 23rd day of February, 2011.

INTEGRYS ENERGY GROUP, INC.

(Registrant)

By: /s/ Charles A. Schrock
Charles A. Schrock
Chairman, President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Signature	Title	Date
Keith E. Bailey *	Director	
Richard A. Bemis *	Director	
William J. Brodsky *	Director	
Albert J. Budney, Jr. *	Director	
Pastora San Juan Cafferty *	Director	
Ellen Carnahan *	Director	
Robert C. Gallagher *	Director	
Kathryn M. Hasselblad-Pascale *	Director	
John W. Higgins *	Director	
James L. Kemerling *	Director	
Michael E. Lavin *	Director	
William F. Protz, Jr. *	Director	
Charles A. Schrock *	Director and Chairman	
/s/ Charles A. Schrock Charles A. Schrock	Chairman, President and Chief Executive Officer (principal executive officer)	February 23, 2011
/s/ Joseph P. O'Leary Joseph P. O'Leary	Senior Vice President and Chief Financial Officer (principal financial officer)	February 23, 2011
/s/ Diane L. Ford Diane L. Ford	Vice President and Corporate Controller (principal accounting officer)	February 23, 2011

* By: /s/ Diane L. Ford		
Diane L. Ford	Attorney-in-Fact	February 23, 2011

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SCHEDULE I - CONDENSED
PARENT COMPANY FINANCIAL STATEMENTS
INTEGRYS ENERGY GROUP, INC. (PARENT COMPANY ONLY)

A. STATEMENTS OF INCOME AND RETAINED EARNINGS

Year Ended December 31 (Millions, except per share data)	2010	2009	2008
Equity earnings (loss) in excess of dividends from subsidiaries	$119.8	$(157.2)	$34.3
Dividends from subsidiaries	153.7	147.0	134.9
Income (loss) from subsidiaries	273.5	(10.2)	169.2
Investment income and other	29.9	25.5	19.4
Total income	303.4	15.3	188.6
Operating expense	6.3	6.3	3.4
Operating income	297.1	9.0	185.2
Interest expense	65.8	79.4	75.0
Income (loss) before taxes	231.3	(70.4)	110.2
Provision (benefit) for income taxes	10.6	2.0	(1.6)
Net income (loss) from continuing operations	220.7	(72.4)	111.8
Discontinued operations, net of tax	0.2	2.8	4.7
Net income (loss)	$220.9	$(69.6)	$116.5
Retained earnings, beginning of year	$337.0	$614.7	$701.9
Common stock dividends	(208.7)	(206.9)	(203.9)
Other	1.6	(1.2)	0.2
Retained earnings, end of year	$350.8	$337.0	$614.7
Average shares of common stock			
Basic	77.5	76.8	76.7
Diluted	78.0	76.8	77.0
Earnings (loss) per common share (basic)			
Net income (loss) from continuing operations	$2.85	$(0.95)	$1.46
Discontinued operations, net of tax	-	0.04	0.06
Earnings (loss) per common share (basic)	$2.85	$(0.91)	$1.52
Earnings (loss) per common share (diluted)			
Net income (loss) from continuing operations	$2.83	$(0.95)	$1.45
Discontinued operations, net of tax	-	0.04	0.06
Earnings (loss) per common share (diluted)	$2.83	$(0.91)	$1.51

Dividends per common share declared	$2.72	$2.72	$2.68

The accompanying notes to Integrys Energy Group's parent company financial statements are an integral part of these statements.

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SCHEDULE I - CONDENSED
PARENT COMPANY FINANCIAL STATEMENTS
INTEGRYS ENERGY GROUP, INC. (PARENT COMPANY ONLY)

B. BALANCE SHEETS

At December 31 (Millions)	2010	2009
Assets		
Cash and cash equivalents	$100.6	$19.0
Accounts receivable from related parties	34.1	38.7
Interest receivable from related parties	4.7	4.6
Receivable from related parties	12.9	-
Notes receivable from related parties	55.6	53.0
Other current assets	82.1	29.5
Current assets	290.0	144.8
Total investments in subsidiaries, at equity	4,057.8	3,954.0
Notes receivable from related parties	234.6	220.3
Property and equipment, net of accumulated depreciation of $0.9 and $0.7, respectively	5.0	5.2
Receivables from related parties	23.2	9.0
State deferred income taxes	26.3	27.9
Other	31.5	27.0
Total assets	$4,668.4	$4,388.2
Liabilities and Equity		
Short-term debt to related parties	$487.0	$315.7
Short-term debt	-	205.1
Current portion of long-term debt to related parties	325.0	-
Current portion of long-term debt	-	65.6
Accounts payable to related parties	1.8	3.9
Interest payable to related parties	4.7	4.7
Accounts payable	1.1	0.6
Liabilities from risk management activities	-	1.9
Deferred income taxes	11.9	7.3
Other current liabilities	23.0	4.4
Current liabilities	854.5	609.2
Long-term debt to related parties	21.0	346.0
Long-term debt	804.7	554.7
Federal deferred income taxes	60.9	23.2
Payables to related parties	3.1	2.4
Other	18.4	2.7
Long-term liabilities	908.1	929.0

Commitments and contingencies		
Total common shareholders' equity	2,905.8	2,850.0
Total liabilities and Equity	$4,668.4	$4,388.2

The accompanying notes to Integrys Energy Group's parent company financial statements are an integral part of these statements.

SCHEDULE I - CONDENSED
PARENT COMPANY FINANCIAL STATEMENTS
INTEGRYS ENERGY GROUP, INC. (PARENT COMPANY ONLY)

C. STATEMENTS OF CASH FLOWS

Year Ended December 31 (Millions)	2010	2009	2008
Operating Activities			
Net income (loss)	$ 220.9	$ (69.6)	$ 116.5
Adjustments to reconcile net income (loss) to net cash provided by operating activities			
Discontinued operations, net of tax	(0.2)	(2.8)	(4.7)
Equity loss (income) from subsidiaries, net of dividends	(119.8)	157.2	(34.3)
Deferred income taxes	44.2	24.4	19.7
Gain on sale of investment	-	(0.4)	-
Other	21.0	23.7	7.9
Changes in working capital			
Acounts receivables	1.4	0.5	1.2
Accounts receivables from related parties	4.4	(4.2)	20.3
Receivable from related parties	(12.9)	-	-
Other current assets	(54.5)	(2.4)	(25.2)
Accounts payable	0.4	0.5	(1.6)
Accounts payable to related parties	(2.0)	(44.6)	41.7
Other current liabilities	5.5	(7.4)	(30.4)
Net cash provided by operating activities	108.4	74.9	111.1
Investing Activities			
Short-term notes receivable from related parties	(2.6)	97.9	(84.6)
Long-term notes receivable from related parties	(15.0)	(10.0)	-
Receivables from related parties	(14.2)	1.5	1.6
Equity contributions to subsidiaries	(57.8)	(56.1)	(163.0)
Return of capital from subsidiaries	78.0	155.5	83.4
Proceeds from sale of investment	0.4	0.5	-
Other	0.7	0.5	7.4
Net cash (used for) provided by investing activities	(10.5)	189.8	(155.2)
Financing Activities			
Commercial paper, net	(205.1)	(47.7)	182.5
Notes payable to related parties	171.3	39.6	55.2
Issuance of notes payable	-	-	155.7
Issuance of short-term debt	-	-	50.0
Redemption of notes payable	-	(157.9)	-
Redemption of short-term debt	-	(50.0)	-
Issuance of long-term debt	250.0	155.0	-
Redemption of long-term debt	(65.6)	(150.0)	-

Issuance of common stock		33.2			-			-
Dividends paid on common stock		(186.1	)		(206.9	)		(203.9	)
Other		(14.0	)		(18.7	)		(4.5	)
Net cash (used for) provided by financing activities		(16.3	)		(436.6	)		235.0
Change in cash and cash equivalents		81.6			(171.9	)		190.9
Cash and cash equivalents at beginning of year		19.0			190.9			-
Cash and cash equivalents at end of year	$	100.6		$	19.0		$	190.9

The accompanying notes to Integrys Energy Group's parent company financial statements are an integral part of these statements.

SCHEDULE I - CONDENSED
PARENT COMPANY FINANCIAL STATEMENTS
INTEGRYS ENERGY GROUP, INC. (PARENT COMPANY ONLY)

D. NOTES TO PARENT COMPANY FINANCIAL STATEMENTS

SUPPLEMENTAL NOTES

NOTE 1--SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Basis of Presentation--For Parent Company only presentation, investments in subsidiaries are accounted for using the equity method. The condensed Parent Company financial statements and notes should be read in conjunction with the consolidated financial statements and notes of Integrys Energy Group appearing in this Form 10-K. The consolidated financial statements of Integrys Energy Group reflect certain businesses as discontinued operations. In the Integrys Energy Group consolidated financial statements, $26.5 million assets were reported as held for sale and $0.3 million liabilities were reported as held for sale in 2009. For Parent Company only presentation, the investments in discontinued operations are recorded in Investments in Subsidiary Companies. The condensed Parent Company statements of income and statements of cash flows report the earnings and cash flows of these businesses as discontinued operations.

(b) Cash and Cash Equivalents--Short-term investments with an original maturity of three months or less are reported as cash equivalents.

The following is supplemental disclosure to the Integrys Energy Group Parent Company Statements of Cash Flows:

(Millions)	2010	2009	2008
Cash paid for interest	$37.0	$57.3	$46.1
Cash paid for interest – related parties	20.2	23.6	24.9
Cash paid (received) for income taxes	13.6	(15.4)	27.2

Significant non-cash transactions were as follows:

(Millions)	2010	2009	2008
Equity issued for reinvested dividends	$22.6	$-	$-
Equity issued for stock-based compensation plans	3.0	-	-

NOTE 2--FAIR VALUE OF FINANCIAL INSTRUMENTS – RELATED PARTIES

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

(Millions)	2010		2009	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Long-term notes receivable from related parties	$234.6	$261.2	$220.3	$235.5
Current portion of long-term debt to related parties	325.0	325.7	-	-
Long-term debt to related parties	21.0	21.0	346.0	361.3

NOTE 3--SHORT-TERM NOTES RECEIVABLE – RELATED PARTIES

(Millions)	2010	2009
UPPCO	$ 9.0	$ 10.4
MERC	14.9	3.6
MGU	8.7	8.7
IBS	23.0	30.3
Total	$ 55.6	$ 53.0

NOTE 4--LONG-TERM NOTES RECEIVABLE – RELATED PARTIES

(Millions)		2010	2009
WPS			
Series	Year Due		
8.76 %	2015	$ 3.4	$ 3.8
7.35 %	2016	5.2	5.5
UPPCO			
Series	Year Due		
5.25 %	2013	15.0	15.0
6.06 %	2017	15.0	15.0
5.04 %	2020	15.0	-
MERC			
Series	Year Due		
6.03 %	2013	29.0	29.0
6.16 %	2016	29.0	29.0
6.40 %	2021	29.0	29.0
MGU			
Series	Year Due		
5.72 %	2013	28.0	28.0
5.76 %	2016	28.0	28.0
5.98 %	2021	28.0	28.0
IBS			
Series	Year Due		
6.86 %	2014	10.0	10.0
Total		$ 234.6	$ 220.3

NOTE 5--SHORT-TERM NOTES PAYABLE – RELATED PARTIES

(Millions)	2010	2009
Integrys Energy Services	$ 349.8	$ 218.7
PEC	137.2	97.0

Total	$ 487.0	$ 315.7

NOTE 6--LONG-TERM DEBT – RELATED PARTIES

(Millions)	2010	2009
Long-term notes to PEC due 2011 (1)	$ 325.0	$ 325.0
Long-term notes to Integrys Energy Services due 2021 (2)	21.0	21.0
Total	$ 346.0	$ 346.0
Less current portion	(325.0)	-
Total long-term debt – related parties	$ 21.0	$ 346.0

(1) On September 28, 2007, Integrys Energy Group issued a $325.0 million long-term promissory note to PEC. The note bears interest at a rate of 5.25% and matured in January 2011. Proceeds of the note were used to reduce the balance of commercial paper outstanding.

(2) Integrys Energy Group has a long-term note payable to Integrys Energy Services at December 31, 2010 and 2009 of $21.0 million. The note bears interest at a rate that approximates current market rates and is due in 2021.

At December 31, 2010, Integrys Energy Group (Parent Company) was in compliance with all covenants relating to outstanding debt to the related parties. A schedule of all principal debt payment amounts for Integrys Energy Group (Parent Company) is as follows:

Year ending December 31 (Millions)	
2011	$ 325.0
2012	-
2013	-
2014	-
2015	-
Later years	21.0
Total payments	$ 346.0

NOTE 7--INCOME TAXES

The principal components of Integrys Energy Group's deferred income tax assets and liabilities recognized in the balance sheet as of December 31 are as follows:

(Millions)	2010	2009
Deferred income tax assets:		
State capital and operating loss carryforwards	$ 9.9	$ 10.0
Employee benefits	4.5	6.1
Price risk management	3.3	-
Deferred deductions	0.3	0.5
Total deferred income tax assets	$ 18.0	$ 16.6
Deferred income tax liabilities:		
Plant related	$ 53.6	$ 12.9
Price risk management	-	0.2

Other		10.9		6.1
Total deferred income tax liabilities	$	64.5	$	19.2

Carryforward periods for state capital and operating loss carryforwards vary, but in the majority of states in which we do business, the period is 15 years or more. The balance of the carryforwards of state net operating losses is $192.4 million for all states. No valuation allowances have been established due to the reasonable certainty of the ability to realize the benefit of these losses in the future.

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SCHEDULE II
INTEGRYS ENERGY GROUP
VALUATION AND QUALIFYING ACCOUNTS

Allowance for Doubtful Accounts
Years Ended December 31, 2010, 2009, and 2008
(in Millions)

Fiscal Year	Balance at Beginning of Year	Additions Charged to Expense	Additions (Subtractions) Charged to Other Accounts (1)	Reductions (2)	Balance at End of Year
2008	$ 56.0	$ 76.8	$ 5.6	$ 75.9	$ 62.5
2009	$ 62.5	$ 54.6	$ 15.1	$ 74.7	$ 57.5
2010	$ 57.5	$ 48.0	$ (14.1)	$ 49.5	$ 41.9

(1) Represents additions (subtractions) charged to regulatory assets and amounts charged to tax liabilities related to revenue
taxes and state use taxes uncollectible from customers.
(2) Represents amounts written off to the reserve, including any adjustments.

EXHIBIT INDEX

Set forth below is a listing of all exhibits to this Annual Report on Form 10-K, including those incorporated by reference.

Certain other instruments, which would otherwise be required to be listed below, have not been so listed as such instruments do not authorize long-term debt securities in an amount that exceeds 10% of the total assets of Integrys Energy Group and its subsidiaries on a consolidated basis. Integrys Energy Group agrees to furnish a copy of any such instrument to the SEC upon request.

Explanatory Note: Many of the exhibits listed below were entered into when Integrys Energy Group, Inc. was known as WPS Resources Corporation but have been referred to below by reference to its current name.

Exhibit Number	Description of Documents
2.1*	Asset Contribution Agreement between ATC and Wisconsin Electric Power Company, Wisconsin Power and Light Company, WPS, Madison Gas & Electric Co., Edison Sault Electric Company, South Beloit Water, Gas and Electric Company, dated as of December 15, 2000. (Incorporated by reference to Exhibit 2A-3 to Integrys Energy Group's Form 10-K for the year ended December 31, 2000.)
2.2* #	Purchase and Sale Agreement between Integrys Energy Services, Inc., as Seller, and Macquarie Cook Power, Inc., as Purchaser, dated as of December 23, 2009. (Incorporated by reference to Exhibit 2.2 to Integrys Energy Group’s Form 10-K/A filed April 23, 2010.)
2.3#	First Amendment to Purchase and Sale Agreement dated January 26, 2010, between Integrys Energy Services, Inc., as Seller, and Macquarie Cook Power, Inc., as Purchaser. (Incorporated by reference to Exhibit 2.3 to Integrys Energy Group’s Form 10-K/A filed April 23, 2010.)
3.1	Restated Articles of Incorporation of Integrys Energy Group, as amended. (Incorporated by reference to Exhibit 3.2 to Integrys Energy Group's Form 8-K filed February 27, 2007.)
3.2	By-Laws of Integrys Energy Group, as amended through April 1, 2010. (Incorporated by reference to Exhibit 3.2 to Integrys Energy Group's Form 8-K filed April 1, 2010.)
4.1	Senior Indenture, dated as of October 1, 1999, between Integrys Energy Group and U.S. Bank National Association (successor to Firstar Bank Milwaukee, N.A., National Association) (Incorporated by reference to Exhibit 4(b) to Amendment

No. 1 to Form S-3 filed October 21, 1999 [Reg. No. 333-88525]); First Supplemental Indenture, dated as of November 1, 1999 between Integrys Energy Group and Firstar Bank, National Association (Incorporated by reference to Exhibit 4A of Form 8-K filed November 12, 1999); Second Supplemental Indenture, dated as of November 1, 2002 between Integrys Energy Group and U.S. Bank National Association (Incorporated by reference to Exhibit 4A of Form 8-K filed November 25, 2002); Third Supplemental Indenture, dated as of June 1, 2009, by and between Integrys Energy Group and U.S. Bank National Association (Incorporated by reference to Exhibit 4.1 to Integrys Energy Group's Form 8-K filed June 17, 2009); Fourth Supplemental Indenture, dated as of June 1, 2009, by and between Integrys Energy Group (Incorporated by reference to Exhibit 4.2 to Integrys Energy Group's Form 8-K filed June 17, 2009); and Fifth Supplemental Indenture, dated as of November 1, 2010, by and between

Integrys Energy Group and U.S. Bank National Association (Incorporated by reference to Exhibit 4 to Integrys Energy Group's Form 8-K filed November 15, 2010). All references to filings are those of Integrys Energy Group (File No. 1-11337).

4.2 Subordinated Indenture, dated as of November 13, 2006, between Integrys Energy Group and U.S. Bank National Association, as trustee (Incorporated by reference to Exhibit 4(c) to Amendment No. 1 to Form S-3 filed December 4, 2006 [Reg. No. 333-133194]; and First Supplemental Indenture by and between Integrys Energy Group, Inc. and U.S. Bank National Association, as trustee, dated December 1, 2006. (Incorporated by reference to Exhibit 4 to Integrys Energy Group's Form 8-K filed December 1, 2006.)

4.3 Replacement Capital Covenant of Integrys Energy Group, Inc., dated December 1, 2010. (Incorporated by reference to Exhibit 99.1 to Integrys Energy Group Form 8-K filed November 15, 2010.)

4.4 Credit Agreement dated as of June 13, 2006, by and among PEC, the financial institutions party hereto, and Bank of America, N.A., JPMorgan Chase Bank, N.A., ABN AMRO Incorporated, US Bank National Association, and The Bank of Tokyo-Mitsubishi, Ltd. Chicago Branch, as agents. (Incorporated by reference to Exhibit 10(a) to PEC - Form 10-Q filed August 9, 2006 [File No. 1-05540].)

4.5 Guaranty, dated May 18, 2007, by and among Integrys Energy Group, Inc. and Bank of America, N.A. in its capacity as Administrative Agent. (Incorporated by reference to Exhibit 10.1 to Integrys Energy Group's Form 8-K filed May 22, 2007.)

4.6 First Amendment and Consent to Credit Agreement dated May 18, 2007 between PEC and Bank of America N.A., as Administrative Agent. (Incorporated by reference to Exhibit 10.2 to Integrys Energy Group's Form 8-K filed May 22, 2007.)

4.7 First Mortgage and Deed of Trust, dated as of January 1, 1941, from WPS to U.S. Bank National Association (successor to First Wisconsin Trust Company), Trustee (Incorporated by reference to Exhibit 7.01 - File No. 2-7229); Supplemental Indenture, dated as of November 1, 1947 (Incorporated by reference to Exhibit 7.02 - File No. 2-7602); Supplemental Indenture, dated as of November 1, 1950 (Incorporated by reference to Exhibit 4.04 - File No. 2-10174); Supplemental Indenture, dated as of May 1, 1953 (Incorporated by reference to Exhibit 4.03 - File No. 2-10716); Supplemental Indenture, dated as of October 1, 1954 (Incorporated by reference to Exhibit 4.03 - File No. 2-13572); Supplemental Indenture, dated as of December 1, 1957 (Incorporated by reference to Exhibit 4.03 - File No. 2-14527); Supplemental Indenture, dated as of October 1, 1963 (Incorporated by reference to Exhibit 2.02B - File No. 2-65710); Supplemental Indenture, dated as of June 1, 1964 (Incorporated by reference to Exhibit 2.02B - File No. 2-65710); Supplemental Indenture, dated as of November 1, 1967 (Incorporated by reference to Exhibit 2.02B - File No. 2-65710); Supplemental Indenture, dated as of April 1, 1969 (Incorporated by reference to Exhibit 2.02B -

File No. 2-65710); Fifteenth Supplemental Indenture, dated as of May 1, 1971 (Incorporated by reference to Exhibit 2.02B - File No. 2-65710); Sixteenth Supplemental Indenture, dated as of August 1, 1973 (Incorporated by reference to Exhibit 2.02B - File No. 2-65710); Seventeenth Supplemental Indenture, dated as of September 1, 1973 (Incorporated by reference to Exhibit 2.02B - File No. 2-65710); Eighteenth Supplemental Indenture, dated as of October 1, 1975 (Incorporated by reference to Exhibit 2.02B - File No. 2-65710); Nineteenth Supplemental Indenture, dated as of February 1, 1977 (Incorporated by reference to Exhibit 2.02B - File No. 2-65710); Twentieth Supplemental Indenture, dated as of July 15, 1980 (Incorporated by reference to Exhibit 4B to Form 10-K for the year ended December 31, 1980); Twenty-First Supplemental Indenture, dated as of December 1, 1980 (Incorporated by reference to Exhibit 4B to Form 10-K for the year ended December 31, 1980); Twenty-Second Supplemental Indenture dated as of April 1, 1981 (Incorporated by reference to Exhibit 4B to Form 10-K for the year ended December 31, 1981); Twenty-Third

Supplemental Indenture, dated as of February 1, 1984 (Incorporated by reference to Exhibit 4B to Form 10-K for the year ended December 31, 1983); Twenty-Fourth Supplemental Indenture, dated as of March 15, 1984 (Incorporated by reference to Exhibit 1 to Form 10-Q for the quarter ended June 30, 1984); Twenty-Fifth Supplemental Indenture, dated as of October 1, 1985 (Incorporated by reference to Exhibit 1 to Form 10-Q for the quarter ended September 30, 1985); Twenty-Sixth Supplemental Indenture, dated as of December 1, 1987 (Incorporated by reference to Exhibit 4A-1 to Form 10-K for the year ended December 31, 1987); Twenty-Seventh Supplemental Indenture, dated as of September 1, 1991 (Incorporated by reference to Exhibit 4 to Form 8-K filed September 18, 1991); Twenty-Eighth Supplemental Indenture, dated as of July 1, 1992 (Incorporated by reference to Exhibit 4B - File No. 33-51428); Twenty-Ninth Supplemental Indenture, dated as of October 1, 1992 (Incorporated by reference to Exhibit 4 to Form 8-K filed October 22, 1992); Thirtieth Supplemental Indenture, dated as of February 1, 1993 (Incorporated by reference to Exhibit 4 to Form 8-K filed January 27, 1993); Thirty-First Supplemental Indenture, dated as of July 1, 1993 (Incorporated by reference to Exhibit 4 to Form 8-K filed July 7, 1993); Thirty-Second Supplemental Indenture, dated as of November 1, 1993 (Incorporated by reference to Exhibit 4 to Form 10-Q for the quarter ended September 30, 1993); Thirty-Third Supplemental Indenture, dated as of December 1, 1998 (Incorporated by reference to Exhibit 4D to Form 8-K filed December 18, 1998); Thirty-Fourth Supplemental Indenture, dated as of August 1, 2001 (Incorporated by reference to Exhibit 4D to Form 8-K filed August 24, 2001); Thirty-Fifth Supplemental Indenture, dated as of December 1, 2002 (Incorporated by reference to Exhibit 4D to Form 8-K filed December 16, 2002); Thirty-Sixth Supplemental Indenture, dated as of December 8, 2003 (Incorporated by reference to Exhibit 4.2 to Form 8-K filed December 9, 2003); Thirty-Seventh Supplemental Indenture, dated as of December 1, 2006 (Incorporated by reference to Exhibit 4.2 to Form 8-K filed November 30, 2006); Thirty-Eighth Supplemental Indenture, dated as of August 1, 2006 (Incorporated by reference to Exhibit 4.1 to Form 10-K for the year ended December 31, 2006); Thirty-Ninth Supplemental Indenture, dated as of November 1, 2007 (Incorporated by reference to Exhibit 4.2 to Form 8-K filed November 16, 2007); Fortieth Supplemental Indenture, dated as of December 1, 2008 (Incorporated by reference to Exhibit 4.2 to Form 8-K filed December 4, 2008); Forty-First Supplemental Indenture, dated as of December 18, 2008 (Incorporated by reference to Exhibit 4.1 to Form 10-Q filed May 6, 2010); and 42nd Supplemental Indenture, dated as of April 25, 2010 (Incorporated by reference to Exhibit 4.2 to Form 10-Q filed May 6, 2010). All references to periodic reports are to those of WPS (File No. 1-3016).

4.8 Indenture, dated as of December 1, 1998, between WPS and U.S. Bank National Association (successor to Firstar Bank Milwaukee, N.A., National Association) (Incorporated by reference to Exhibit 4A to Form 8-K filed December 18, 1998); First Supplemental Indenture, dated as of December 1, 1998, between WPS and Firstar Bank Milwaukee, N.A., National Association (Incorporated by reference to Exhibit 4C to Form 8-K filed December 18, 1998); Second Supplemental Indenture, dated as of August 1, 2001, between WPS and Firstar Bank, National Association (Incorporated by reference to Exhibit 4C of Form 8-K filed August 24, 2001); Third Supplemental Indenture, dated as of December 1, 2002,

between WPS and U.S. Bank National Association (Incorporated by reference to Exhibit 4C of Form 8-K filed December 16, 2002); Fourth Supplemental Indenture, dated as of December 8, 2003, by and between WPS and U.S. Bank National Association (successor to Firstar Bank, National Association and Firstar Bank Milwaukee, N.A., National Association) (Incorporated by reference to Exhibit 4.1 to Form 8-K filed December 9, 2003); Fifth Supplemental Indenture, dated as of December 1, 2006, by and between WPS and U.S. Bank National Association (successor to Firstar Bank, National Association and Firstar Bank Milwaukee, N.A., National Association) (Incorporated by reference to Exhibit 4.1 to Form 8-K filed November 30, 2006); Sixth Supplemental Indenture, dated as of December 1, 2006, by and between WPS and U.S. Bank National Association (successor to Firstar Bank, National Association and Firstar Bank Milwaukee, N.A., National Association) (Incorporated by reference to Exhibit 4.2 to Form 10-K for the year ended December 31, 2006); Seventh Supplemental Indenture, dated as of November 1, 2007, by and between WPS and U.S. Bank National Association

(successor to Firstar Bank, National Association and Firstar Bank Milwaukee, N.A., National Association) (Incorporated by reference to Exhibit 4.1 to Form 8-K filed November 16, 2007); and Eighth Supplemental Indenture, dated as of December 1, 2008, by and between WPS and U.S. Bank National Association (successor to Firstar Bank, National Association and Firstar Bank Milwaukee, N.A., National Association). (Incorporated by reference to Exhibit 4.1 to Form 8-K filed December 4, 2008.) References to periodic reports are to those of WPS (File No. 1-3016).

4.9 Indenture, dated as of January 18, 2001, between PEC and Bank One Trust Company National Association. (Incorporated by reference to Exhibit 4(a) to PEC Form 10-Q filed May 15, 2001[File No. 1-05540].)

4.10 First Supplemental Indenture, dated as of March 5, 2007, by and among PEC, Integrys Energy Group, Inc. and The Bank of New York Trust Company, N.A., as Trustee including a Guaranty of Integrys Energy Group, Inc. (Incorporated by reference to Exhibit 4.1 to Integrys Energy Group's Form 8-K filed March 9, 2007.)

4.11 PGL First and Refunding Mortgage, dated January 2, 1926, from Chicago By-Product Coke Company to Illinois Merchants Trust Company, Trustee, assumed by PGL by Indenture dated March 1, 1928 (PGL - May 17, 1935, Exhibit B-6a, Exhibit B-6b A-2 File No. 2-2151, 1936); Supplemental Indenture dated as of May 20, 1936, (PGL - Form 8-K for the year 1936, Exhibit B-6f); Supplemental Indenture dated as of March 10, 1950 (PGL - Form 8-K for the month of March 1950, Exhibit B-6i); Supplemental Indenture dated as of June 1, 1951 (PGL - File No. 2-8989, Post-Effective, Exhibit 7-4(b)); Supplemental Indenture dated as of August 15, 1967 (PGL - File No. 2-26983, Post-Effective, Exhibit 2-4); Supplemental Indenture dated as of September 15, 1970 (PGL - File No. 2-38168, Post-Effective Exhibit 2-2); Supplemental Indenture dated June 1, 1995 (PGL - Form 10-K for fiscal year ended September 30, 1995); Supplemental Indenture, First and Refunding Mortgage Multi-Modal Bonds, Series HH of PGL, effective March 1, 2000 (PGL - Form 10-K for fiscal year ended September 30, 2000, Exhibit 4(b)); Supplemental Indenture dated as of February 1, 2003, First and Refunding Mortgage 5% Bonds, Series KK (PEC and PGL - Form 10-Q for the quarter ended March 31, 2003, Exhibit 4(a)); Supplemental Indenture dated as of February 1, 2003, First and Refunding Mortgage Multi-Modal Bonds, Series LL (PEC and PGL - Form 10-Q for the quarter ended March 31, 2003, Exhibit 4(b)); Supplemental Indenture dated as of February 15, 2003, First and Refunding Mortgage 4.00% Bonds, Series MM-1 and Series MM-2 (PEC and PGL - Form 10-Q for the quarter ended March 31, 2003, Exhibit 4(c)); Supplemental Indenture dated as of April 15, 2003, First and Refunding Mortgage 4.625% Bonds, Series NN-1 and Series NN-2 (PEC and PGL - Form 10-Q for the quarter ended March 31, 2003, Exhibit 4(e)); Supplemental Indenture dated as of October 1, 2003, First and Refunding Mortgage Bonds, Series OO (PEC and PGL - Form 10-Q for the quarter ended December 31, 2003, Exhibit 4(a)); PGL Supplemental Indenture dated as of October 1, 2003, First and Refunding Mortgage Bonds, Series PP (PEC and PGL - Form 10-Q for the quarter ended December 31, 2003, Exhibit 4(b)); PGL Supplemental Indenture dated as of November 1, 2003, First and Refunding

Mortgage Multi-Modal Bonds, Series QQ (PEC and PGL - Form 10-Q for the quarter ended December 31, 2003, Exhibit 4(c)); PGL Supplemental Indenture dated as of January 1, 2005, First and Refunding Mortgage Bonds, Series RR (PEC and PGL - Form 10-Q for the quarter ended December 31, 2004, Exhibit 4(b)); Loan Agreement between PGL and Illinois Development Finance Authority dated October 1, 2003, Gas Supply Refunding Revenue Bonds, Series 2003C (PEC and PGL - Form 10-Q for the quarter ended December 31, 2003, Exhibit 4(d)); Loan Agreement between PGL and Illinois Development Finance Authority dated October 1, 2003, Gas Supply Refunding Revenue Bonds, Series 2003D (PEC and PGL - Form 10-Q for the quarter ended December 31, 2003, Exhibit 4(e)); Loan Agreement between PGL and Illinois Development Finance Authority dated November 1, 2003, Gas Supply Refunding Revenue Bonds, Series 2003E (PEC and PGL - Form 10-Q for the quarter ended December 31, 2003, Exhibit 4(f)); Loan Agreement between PGL and Illinois Finance

Authority dated as of January 1, 2005 (incorporated by reference to Exhibit 4(a) to PEC Form 10-Q filed February 9, 2005); Supplemental Indenture dated as of November 1, 2008, First and Refunding Mortgage 7.00% Bonds, Series SS (incorporated by reference to Exhibit 4.11 to Integrys Energy Group's Form 10-K filed February 26, 2009); Supplemental Indenture dated as of November 1, 2008, First and Refunding Mortgage 8.00% Bonds, Series TT (incorporated by reference to Exhibit 4.11 to Integrys Energy Group's Form 10-K filed February 26, 2009); Supplemental Indenture dated as of September 1, 2009, First and Refunding Mortgage 4.63% Bonds, Series UU (incorporated by reference to Exhibit 4.11 to Integrys Energy Group's Form 10-K/A filed April 23, 2010); Supplemental Indenture dated as of August 1, 2010, First Mortgage 2.125% Bonds, Series VV; and Supplemental Indenture dated as of October 1, 2010, First Mortgage 2.625% Bonds, Series WW.

4.12 NSG Indenture, dated as of April 1, 1955, from NSG to Continental Bank, National Association, as Trustee; Third Supplemental Indenture, dated as of December 20, 1963 (NSG - File No. 2-35965, Exhibit 4-1); Fourth Supplemental Indenture, dated as of May 1 1964 (NSG - File No. 2-35965, Exhibit 4-1); Fifth Supplemental Indenture dated as of February 1, 1970 (NSG - File No. 2-35965, Exhibit 4-2); Ninth Supplemental Indenture dated as of December 1, 1987 (NSG - Form 10-K for the fiscal year ended September 30, 1987, Exhibit 4); Thirteenth Supplemental Indenture dated December 1, 1998 (NSG Gas - Form 10-Q for the quarter ended March 31, 1999, Exhibit 4); Fourteenth Supplemental Indenture dated as of April 15, 2003, First Mortgage 4.625% Bonds, Series N-1 and Series N-2 (Incorporated by reference to Exhibit 4(g) to PEC Form 10-Q filed May 13, 2003) and Fifteenth Supplemental Indenture dated as of November 1, 2008, First Mortgage 7.00% Bonds, Series O. (Incorporated by reference to Exhibit 4.12 to Integrys Energy Group's Form 10-K filed February 26, 2009.)

10.1+ Form of Key Executive Employment and Severance Agreement entered into between Integrys Energy Group and each of the following: Phillip M. Mikulsky and Larry L. Weyers. (Incorporated by reference to Exhibit 10.1 to Integrys Energy Group's Form 10-K filed February 26, 2009.)

10.2+ Form of Key Executive Employment and Severance Agreement entered into between Integrys Energy Group and each of the following: Charles A. Schrock, Joseph P. O'Leary, Mark A. Radtke, Lawrence T. Borgard, Diane L. Ford, Daniel J. Verbanac, and Barth J. Wolf. (Incorporated by reference to Exhibit 10.1 to Integrys Energy Group's Form 8-K filed May 12, 2010.)

10.3+ Integrys Energy Group Executive Change in Control Severance Plan applicable to the following: William D. Laakso and James F. Schott.

10.4+ Form of Integrys Energy Group 2005 Omnibus Incentive Compensation Plan Performance NonQualified Stock Option Agreement approved December 7, 2005. (Incorporated by reference to Exhibit 10.1 to Integrys Energy Group's Form 8-K filed December 13, 2005.)

10.5+

Form of Integrys Energy Group 2005 Omnibus Incentive Compensation Plan Performance NonQualified Stock Option Agreement approved December 7, 2006. (Incorporated by reference to Exhibit 10.2 to Integrys Energy Group's Form 8-K filed December 13, 2006.)

10.6+ Form of Integrys Energy Group 2007 Omnibus Incentive Compensation Plan Restricted Stock Award Agreement approved May 17, 2007. (Incorporated by reference to Exhibit 10.8 to Integrys Energy Group's Form 10-K filed February 28, 2008.)

10.7+ Form of Integrys Energy Group 2007 Omnibus Incentive Compensation Plan NonQualified Stock Option Agreement approved May 17, 2007. (Incorporated by reference to Exhibit 10.10 to Integrys Energy Group's Form 10-K filed February 28, 2008.)

10.8+ Form of Integrys Energy Group 2007 Omnibus Incentive Compensation Plan Performance Stock Right Agreement approved February 14, 2008. (Incorporated by reference to Exhibit 10.6 to Integrys Energy Group's Form 10-K filed February 28, 2008.)

10.9+ Form of Integrys Energy Group 2007 Omnibus Incentive Compensation Plan Restricted Stock Unit Award Agreement approved February 14, 2008. (Incorporated by reference to Exhibit 10.9 to Integrys Energy Group's Form 10-K filed February 28, 2008.)

10.10+ Form of Integrys Energy Group 2007 Omnibus Incentive Compensation Plan NonQualified Stock Option Agreement approved February 14, 2008. (Incorporated by reference to Exhibit 10.11 to Integrys Energy Group's Form 10-K filed February 28, 2008.)

10.11+ Form of Integrys Energy Group, Inc. 2010 Omnibus Incentive Compensation Plan Performance Stock Right Agreement approved September 16, 2010. (Incorporated by reference to Exhibit 10.3 to Integrys Energy Group’s Form 8-K filed September 22, 2010.)

10.12+ Form of Integrys Energy Group, Inc. 2010 Omnibus Incentive Compensation Plan Restricted Stock Unit Award Agreement approved September 16, 2010. (Incorporated by reference to Exhibit 10.4 to Integrys Energy Group’s Form 8-K filed September 22, 2010.)

10.13+ Form of Integrys Energy Group, Inc. 2010 Omnibus Incentive Compensation Plan Nonqualified Stock Option Agreement approved September 16, 2010. (Incorporated by reference to Exhibit 10.5 to Integrys Energy Group’s Form 8-K filed September 22, 2010.)

10.14+ Integrys Energy Group Deferred Compensation Plan as Amended and Restated Effective April 1, 2008. (Incorporated by reference to Exhibit 10.14 to Integrys Energy Group's Form 10-K filed February 28, 2008.)

10.15+ Integrys Energy Group, Inc. Deferred Compensation Plan, as Amended and Restated Effective January 1, 2011. (Incorporated by reference to Exhibit 10.1 to Integrys Energy Group’s Form 8-K filed September 22, 2010.)

10.16+ Integrys Energy Group Pension Restoration and Supplemental Retirement Plan, as Amended and Restated Effective April 1, 2008. (Incorporated by reference to Exhibit 10.1 to Integrys Energy Group's Form 8-K filed April 15, 2008.)

10.17+ Integrys Energy Group, Inc. Pension Restoration and Supplemental Retirement Plan, as Amended and Restated Effective January 1, 2011. (Incorporated by reference to Exhibit 10.2 to Integrys Energy Group’s Form 8-K filed September 22, 2010.)

10.18+

Integrys Energy Group 2001 Omnibus Incentive Compensation Plan. (Incorporated by reference to Exhibit 10.16 to Integrys Energy Group's Form 10-K for the year ended December 31, 2005, filed February 28, 2006.)

10.19+ Integrys Energy Group 2005 Omnibus Incentive Compensation Plan. (Incorporated by reference to Exhibit 10.2 to Integrys Energy Group's Form 10-Q filed August 4, 2005.)

10.20+ Integrys Energy Group 2007 Omnibus Incentive Compensation Plan. (Incorporated by reference to Exhibit 10.17 to Integrys Energy Group's Form 10-K filed February 28, 2008.)

10.21+ Integrys Energy Group 2010 Omnibus Incentive Compensation Plan. (Incorporated by reference to Exhibit 4 to Integrys Energy Group's Registration Statement on Form S-8 (Reg. No. 333-168540) filed August 5, 2010.)

10.22+ PEC Directors Stock and Option Plan as amended December 4, 2002. (Incorporated by reference to Exhibit 10(g) to PEC Form 10-Q, filed February 11, 2003 [File No. 1-05540].)

10.23+ PEC Directors Deferred Compensation Plan as amended and restated April 7, 2004. (Incorporated by reference to Exhibit 10(a) to PEC Form 10-Q filed August 4, 2005.)

10.24+ PEC Executive Deferred Compensation Plan amended as of December 4, 2002. (Incorporated by reference to Exhibit 10 (c) to PEC Form 10-Q filed February 11, 2003.)

10.25+ PEC 1990 Long-Term Incentive Compensation Plan as amended December 4, 2002. (Incorporated by reference to Exhibit 10(d) to Quarterly Report on Form 10-Q of PEC for the quarterly period ended December 31, 2002, filed February 11, 2003 [File No. 1-05540].)

10.26+ Amended and Restated Trust under PEC Directors Deferred Compensation Plan, Directors Stock and Option Plan, Executive Deferred Compensation Plan and Supplemental Retirement Benefit Plan, dated as of August 13, 2003. (Incorporated by reference to Exhibit 10 (a) to PEC Form 10-K filed December 11, 2003.)

10.27+ Amendment Number One to the Amended and Restated Trust under PEC Directors Deferred Compensation Plan, Directors Stock and Option Plan, Executive Deferred Compensation Plan and Supplemental Retirement Benefit Plan, dated as of July 24, 2006. (Incorporated by reference to Exhibit 10(e) to PEC Form 10-K filed December 14, 2006.)

10.28 Credit Agreement with JPMorgan Chase Bank, N.A., U.S. Bank National Association, Wells Fargo Bank, National Association, KeyBank National Association, and The Bank of Tokyo-Mitsubishi UFJ, Ltd., as Syndication Agents; Bank of America, N.A., as Administrative Agent, Swing Line Lender and L/C Issuer; and Banc of America Securities LLC and J.P. Morgan Securities Inc., as Lead Arrangers, Book Managers, and Global Coordinators, dated as of April 23, 2010. (Incorporated by reference to Exhibit 10 to Integrys Energy Group’s Form 8-K filed April 29, 2010.)

10.29 Five Year Credit Agreement among Integrys Energy Group, Inc., as Borrower, the Lenders Identified Therein, Citibank, N.A., as Syndication Agent, U.S. Bank National Association, Bank of America, N.A., JPMorgan Chase Bank, N.A., as Co-Documentation Agents, Wachovia Bank, National Association, as Agent, and Wachovia Bank, National Association and Citigroup Global Markets Inc, as Co-Lead Arrangers and Book Managers dated as of June 9, 2006. (Incorporated by reference to Exhibit 99.1 to Integrys Energy Group's Form 8-K filed June 15, 2006.)

10.30* # Joint Plant Agreement by and between WPS and Dairyland Power Cooperative, dated as of November 23, 2004. (Incorporated by reference to Exhibit 10.19 to Integrys Energy Group's and WPS's Form 10-K for the year ended December 31, 2004.)

10.31+	Incentive Agreement, dated as of April 2, 2009, between Integrys Energy Group and Mark A. Radtke. (Incorporated by reference to Exhibit 10.29 to Integrys Energy Group's Form 10-K filed February 26, 2010.)
12	Integrys Energy Group Ratio of Earnings to Fixed Charges.
21	Subsidiaries of Integrys Energy Group.
23.1	Consent of Independent Registered Public Accounting Firm for Integrys Energy Group.
23.2	Consent of Independent Registered Public Accounting Firm for American Transmission Company LLC.
24	Powers of Attorney.

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

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

32 Written Statement of the Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 for Integrys Energy Group.

99.1 Proxy Statement for Integrys Energy Group's 2011 Annual Meeting of Shareholders. [To be filed with the SEC under Regulation 14A within 120 days after December 31, 2010; except to the extent specifically incorporated by reference, the Proxy Statement for the 2011 Annual Meeting of Shareholders shall not be deemed to be filed with the SEC as part of this Annual Report on Form 10-K.]

99.2 Financial Statements of American Transmission Company LLC.

101 ^ Financial statements from the Annual Report on Form 10-K of Integrys Energy Group, Inc. for the year ended December 31, 2010, filed on February 23, 2011, formatted in XBRL: (i) the Consolidated Statements of Income; (ii) the Consolidated Balance Sheets; (iii) the Consolidated Statements of Equity; (iv) the Consolidated Statements of Cash Flows; and (v) the Notes to Consolidated Financial Statements tagged as blocks of text.

*Schedules and exhibits to this document are not filed therewith. The registrant agrees to furnish supplementally a copy of any such schedule or exhibit to the SEC upon request.

+A management contract or compensatory plan or arrangement.

#Portions of this exhibit have been redacted and are subject to a confidential treatment request filed with the Secretary of SEC pursuant to Rule 24b-2 under the Securities and Exchange Act of 1934, as amended. The redacted material was filed separately with the SEC.

^In accordance with Rule 406T of Regulation S-T, the information in these exhibits shall not be deemed to be "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to liability under that section, and shall not be incorporated by reference into any registration statement or other document filed under the Securities Act of 1933, as amended, except as expressly set forth by specific reference in such filing.