

Key challenges and risk factors 1.2

The company's business is significantly impacted by governmental regulation. The company is subject to significant state, local and federal governmental regulation. The company is subject to the regulation of the Public Service Commission of Wisconsin (PSCW) as to retail electric, natural gas and steam rates in the state of Wisconsin, standards of service, issuance of securities, short-term debt obligations, construction of certain new facilities, transactions with affiliates, billing practices and various other matters. In addition, the company is subject to the regulation of the Michigan Public Service Commission (MPSC) as to the various matters associated with retail electric service in the state of Michigan, except as to the issuance of securities in the ordinary course of business, construction of certain new facilities, levels of short-term debt obligations and advance approval of transactions with affiliates in the ordinary course of business. Further, Wisconsin Electric's hydroelectric facilities are regulated by the Federal Energy Regulatory Commission (FERC), which also regulates the company's wholesale power service practices, electric reliability requirements and participation in the interstate natural gas pipeline capacity market. The significant level of regulation imposes restrictions on company operations and causes it to incur substantial compliance costs.

The company is obligated to comply in good faith with all applicable governmental rules and regulations. If it is determined that the company failed to comply with any applicable rules or regulations, whether through new interpretations or applications of the regulations or otherwise, it may be liable for customer refunds, penalties and other amounts, which could materially and adversely affect the company's results of operations and financial condition.

The company estimates that within its regulated energy segment, as of Dec. 31, 2010, approximately 87 percent of its electric revenues are regulated by the PSCW, 7 percent are regulated by the MPSC and the balance of electric revenues is regulated by FERC. All of the company's natural gas and steam revenues are regulated by the PSCW. The company's ability to obtain rate adjustments in the future is dependent upon regulatory action, and there can be no assurance that the company will be able to obtain rate adjustments in the future that will allow the company to recover its costs and expenses and to maintain its current authorized rates of return.

The company believes it has obtained the necessary permits, approvals and certificates for its existing operations and that its respective businesses are conducted in accordance with applicable laws; however, the impact of any future revision or changes in interpretations of existing regulations or the adoption of new laws and regulations applicable to it cannot be predicted. Changes in regulation, interpretations of regulations



or the imposition of additional regulations could influence the company's operating environment and may result in substantial compliance costs.

Factors beyond the company's control could adversely affect project costs and completion of major construction projects. The company is in the process of constructing new renewable generation and adding environmental control equipment to existing generating facilities. These types of large construction projects are subject to usual construction risks over which the company will have limited or no control and which might adversely affect project costs and completion time. These risks include, but are not limited to: shortages of, the ability to obtain or the cost of labor or materials; the ability of the contractors to perform under their contracts; strikes; adverse weather conditions; the ability to obtain necessary operating permits in a timely manner; legal challenges; changes in applicable law or regulations; adverse interpretation or enforcement of permit conditions, laws and regulations by courts or the permitting agencies; other governmental actions; and events in the global economy.

If the company is unable to complete the development or construction of a facility or decides to delay or cancel construction, it may not be able to recover its investment in the facility and may incur substantial cancellation payments under equipment and construction contracts. Even if a construction

project is completed, the total costs may be higher than estimated and/or higher than amounts approved by regulators, and there is no guarantee that the company will be allowed to recover these costs in rates. In addition, construction delays can result in the delay of revenues and, therefore, could affect the company's results of operations.

The company estimates that the final cost of the Oak Creek expansion is over the amount initially approved by the PSCW. If the PSCW does not allow the company to collect its share of additional costs, its results of operations could be adversely affected.

The company may face significant costs of compliance with existing and future environmental regulations.

Operations are subject to extensive environmental regulations by state and federal environmental agencies governing, among other things, air emissions such as CO₂, SO₂, NO_x, fine particulates and mercury; water discharges; and management of hazardous, toxic and solid wastes and substances. The company incurs significant expenditures in complying with these environmental requirements, including expenditures for the installation of pollution control equipment, environmental monitoring, emissions fees and permits at all of its facilities.

Existing environmental regulations may be revised or new laws or regulations may be adopted which could result in significant additional expenditures, operating restrictions on the company's facilities and increased compliance costs. In addition, the operation of emission control equipment and further regulations on the company's intake and discharge of water, including the Cross-State Air Pollution Rule (formerly known as the Clean Air Transport Rule) and the new rules for cooling water intake systems at existing facilities, could increase operating costs and could reduce the generating capacity of existing power plants. In the event the company is not able to recover all of its environmental expenditures from customers in the future, its results of operations could be adversely affected.

Environmental legislation and regulation and the related compliance costs could affect future unit retirement and replacement decisions, and could result in some of the company's coal-fueled generating units being retired or converted to an alternative type of fuel. Costs associated with these potential actions could affect the company's results of operations and financial condition.

The company's electric and natural gas utility businesses also are subject to significant liabilities related to the investigation and remediation of environmental contamination at certain of its current and former facilities, and at third-party owned sites. Due to the potential for imposition of stricter standards and greater regulation in the future and the possibility that other potentially responsible parties may not be financially able to contribute to cleanup costs, conditions may change or additional contamination may be discovered, the company's remediation costs could increase, and the timing of its capital and/or operating expenditures in the future may accelerate.

The company also may be subject to potential liability in connection with the environmental condition of the facilities that it has previously owned and operated, regardless of whether the liabilities arose before, during or after the time it owned or operated the facilities. If the company fails (or failed) to comply with environmental laws and regulations, or causes (or caused) harm to the environment or persons, even if caused by factors beyond its control, that failure or harm may result in the assessment of civil or criminal penalties and damages against the company. The incurrence of a material environmental liability or a material judgment in any action for personal injury or property damage related to environmental matters could have a significant adverse effect on the company's results of operations and financial condition.

In addition, any higher costs that are collected through rates could contribute to reduced demand for electricity, natural gas or steam, which could adversely impact the company's results of operations and financial condition.



The company could face significant costs if coal combustion products are regulated as hazardous waste.

The company currently has a program of beneficial utilization for substantially all of its coal combustion products, including fly ash, bottom ash and synthetic gypsum, which minimizes the need for disposal in specially designed landfills. Both Wisconsin and Michigan have regulations governing the use and disposal of these materials. However, the U.S. Environmental Protection Agency (EPA) issued a draft rule for public comment proposing various scenarios for regulating coal combustion products, including classifying coal combustion products as hazardous waste. If coal combustion products are classified as hazardous waste, it could have a material adverse effect on the company's ability to continue its current program.

In addition, if coal combustion products are classified as hazardous waste and the company terminates its coal combustion products utilization program, it could be required to dispose of the coal combustion products at a significant cost to the company which could adversely impact its results of operations and financial condition.

The company may face significant costs to comply with the regulation of greenhouse gas emissions. Federal and state legislative and regulatory proposals have been introduced to regulate the emission of greenhouse gases (GHG), particularly CO₂, and the president and his administration have made it clear that they are focused on reducing such emissions through legislation and/or regulation. In addition, there have been international efforts seeking legally binding reductions in emissions of GHG.

The company believes that future governmental legislation and/or regulation likely will require the company either to limit GHG emissions from operations or to purchase allowances for such emissions. However, the company cannot currently predict with any certainty what form these future regulations will take, the stringency of the regulations or when they will become effective. The company expects the U.S. Congress to continue consideration of legislation that would compel GHG emission reductions.

Legislation to regulate GHG emissions and establish renewable and efficiency standards also has been considered at the state level. The state of Michigan has enacted legislation that calls for the implementation of a renewable portfolio standard by 2015 and energy optimization (efficiency) targets up to 1 percent annually by 2015. The state of Wisconsin has adopted its own renewable portfolio standard and energy optimization targets. During its 2010 legislative session, the Wisconsin legislature considered, but ultimately did not pass, a proposal to increase Wisconsin's renewable portfolio standard and energy optimization targets. There is no guarantee the legislature will not consider similar legislation in the future.

In addition to these federal and state legislative efforts, the EPA is pursuing regulation of GHG emissions using its existing authority under the Clean Air Act (CAA). In Dec. 2009, the EPA issued its endangerment finding related to GHG emissions, which set in motion a regulatory process that is leading to regulation of GHG emissions from stationary sources, including electric generating units. In March 2010, the EPA finalized its determination of when the CAA's permitting requirements for emissions from facilities, including electric generating units, would apply to GHG emissions. The regulation of stationary sources will occur in multiple steps in the coming years, with the first step effective Jan. 2, 2011. This initial step covers sources that are already subject to EPA regulations for emissions other than GHG. The second step, which covers new construction projects and modifications at existing power plants, became effective on July 1, 2011. Additionally, in Dec. 2010, the EPA reached an agreement with several states and environmental groups to propose and finalize rules regulating GHG emissions from certain new or modified coal-fueled power plants and guidelines addressing GHG emissions from certain existing power plants by May 26, 2012. Several parties have filed for judicial review of some of the EPA's new GHG rules. Regulation of GHG emissions from power plants will impact the company's ability to do maintenance or modify its existing facilities, and



permit new facilities. In Dec. 2010, the federal court denied a motion to stay the GHG rules pending judicial review, so the rules will continue in effect unless overturned by the court.

Some states and environmental groups brought lawsuits against electric utilities and others to force reductions in GHG emissions based upon their contribution to the alleged public nuisance of climate change. On June 20, 2011, in *Connecticut v. American Electric Power Co.*, the U.S. Supreme Court reversed the decision of the lower court and ruled that the plaintiffs do not have standing to claim nuisance due to GHG released into the atmosphere by the defendants.

There is no guarantee that the company will be allowed to fully recover costs incurred to comply with any future legislation, regulation or order that requires a reduction in GHG emissions or that cost recovery will not be delayed or otherwise conditioned. Any cap-and-trade or GHG tax program that may be adopted, either at the federal or state level, or other legislation, regulation or order designed to reduce GHG emissions could have a material adverse impact on the company's electric generation and natural gas distribution operations. Such regulation could make some of the company's electric generating units uneconomic to maintain or operate, and could affect its future results of operations, cash flows and possibly financial condition if such costs are not recovered through regulated rates. The company continues to monitor the legislative, regulatory and legal developments in this area. In addition, the company shares its views with legislators and relevant congressional committees of jurisdiction. The company works with trade associations and other organizations to educate congressional offices on the climate change issue generally, the legislative proposals specifically, and the potential impact to customers and constituents. Although the company expects the regulation of GHG emissions to have a material impact on its operations and rates, the company believes it is premature to attempt to quantify the possible costs of the impacts.

The company's business is dependent on its ability to successfully access capital markets. The company relies on access to short-term and long-term capital markets to support its capital expenditures and other capital requirements, including expenditures for utility infrastructure and to comply with future regulatory requirements. The company has historically secured funds from a variety of sources, including the issuance of short-term and long-term debt securities, preferred stock and common stock. Successful implementation of its long-term business strategies is dependent upon its ability to access the capital markets, including the banking and commercial paper markets, under competitive terms and rates. If company access to any of these markets were limited, or its cost of capital significantly increased due to a rating downgrade, prevailing market conditions, negative view of the utility industry, failures

of financial institutions or other factors, its results of operations and financial condition could be materially and adversely affected.

A downgrade in the credit ratings of WEC or any of its subsidiaries could negatively affect their ability to access capital at reasonable costs and/or require the posting of collateral. There are a number of factors that impact Wisconsin Energy's and its subsidiaries' credit ratings, including, without limitation, capital structure, regulatory environment, the ability to cover liquidity requirements, and other requirements for capital. Wisconsin Energy or any of its subsidiaries could experience a downgrade in their ratings if the rating agencies determine that the level of business or financial risk of the industry or Wisconsin Energy and/or its subsidiaries has deteriorated. Changes in rating methodologies by the rating agencies could also have a negative impact on credit ratings. If Wisconsin Energy or its subsidiaries are downgraded by the rating agencies, their borrowing costs could increase, funding sources could decrease and, for any downgrade to below investment grade, collateral requirements may be triggered in several contracts.

Acts of terrorism could materially and adversely affect the company's financial condition and results of operations.

The company's electric generation and natural gas transportation facilities, including the facilities of third parties on which it relies, could be targets of terrorist activities, including cyber terrorism. A terrorist attack on company facilities (or those of third parties) could result in a full or partial disruption of the company's ability to generate, transmit, transport, purchase or distribute electricity or natural gas or cause environmental repercussions. Any operational disruption or environmental repercussions could result in a significant decrease in the company's revenues or significant reconstruction or remediation costs, which could materially and adversely affect the company's results of operations and financial condition.

The use of derivative contracts could result in financial losses. The company uses derivative instruments such as swaps, options, futures and forwards to manage commodity and, to a much lesser extent, interest rate exposures. Financial losses could be recognized as a result of volatility in the market value of these contracts or if a counterparty fails to perform. These risks are managed through risk management policies, which might not work as planned and cannot entirely eliminate the risks associated with these activities. In addition, although the hedging programs of Wisconsin Electric and Wisconsin Gas must be approved by the PSCW, derivative contracts entered into for hedging purposes might not offset the underlying exposure being hedged as expected, resulting in financial losses. In the absence of actively quoted market prices and pricing information from external sources, the value of these financial instruments can involve management's judgment or use of estimates. Changes



in the underlying assumptions or use of alternative valuation methods could affect the value of the reported fair value of these contracts.

Energy sales are impacted by seasonal factors and varying weather conditions from year-to-year.

The electric and natural gas utility businesses are generally seasonal businesses. Demand for electricity is greater in the summer and winter months associated with cooling and heating. In addition, demand for natural gas peaks in the winter heating season. Overall results in the future may fluctuate substantially on a seasonal basis. In addition, the company has historically had lower revenues and net income when weather conditions are milder. Rates in Wisconsin are set by the PSCW based on estimated temperatures which approximate 20-year averages. Mild temperatures during the summer cooling season and during the winter heating season will negatively impact the results of operations and cash flows of the company's electric utility business. In addition, mild temperatures during the winter heating season negatively impact the results of operations and cash flows of the company's natural gas utility business.

The company's revenues could be negatively impacted by competitive activity in the wholesale electricity markets.

FERC rules related to transmission are designed to facilitate competition in the wholesale electricity markets among regulated utilities, non-utility generators, wholesale power marketers and brokers by providing greater flexibility and more choices to wholesale customers, including initiatives designed to encourage the integration of renewable sources of supply. The company currently cannot predict the impact of these developments or the effect of changes in levels of wholesale supply and demand, which are driven by factors beyond its control.

An increase in natural gas costs could negatively impact the company's electric and gas utility operations.

We Energies burns natural gas in several of its peaking power plants and in Port Washington Generating Station Unit 1 and Unit 2, and as a supplemental fuel at several coal-fueled plants. In many instances, the cost of purchased power is tied to the cost of natural gas. In addition, higher natural gas costs also can have the effect of increasing demand for other sources of fuel thereby increasing the costs of those fuels as well. For Wisconsin customers, We Energies bears the risk for the recovery of fuel and purchased power costs within a symmetrical 2 percent fuel tolerance band compared to the forecast of fuel and purchased power costs established in its rate structure. The company's natural gas distribution business receives dollar for dollar recovery of the cost of natural gas, subject to tolerance bands and prudence review. However, increased natural gas costs increase the risk that customers will switch to alternative sources of fuel or reduce their usage, which could reduce future natural gas margins. In addition, an increase in natural gas costs combined with slower economic conditions could also expose the company to greater risks of accounts receivable write-offs as more customers are unable to pay their bills. Additionally, high natural gas costs increase the company's working capital requirements.

The company may not be able to obtain an adequate supply of coal, which could limit its ability to operate its coal-fueled facilities.

The company is dependent on coal for much of its electric generating capacity. Although the company currently has an adequate supply of coal at its coal-fueled facilities, there can be no assurance that it will continue to have an adequate supply of coal in the future. While the company has coal supply and transportation contracts in place, there can be no assurance that the counterparties to these agreements will be able to fulfill their obligations to supply coal. The suppliers under these agreements may experience financial or operational problems that inhibit their ability to fulfill their obligations. In addition, suppliers under these agreements may not be required to supply coal to the company under certain circumstances, such as in the event of a natural disaster. If the company significantly reduces its inventory of coal and is unable to obtain its coal requirements under its coal supply and transportation contracts, the company may be required to purchase coal at higher prices, or it may be forced to reduce generation at its coal units and replace this lost generation from higher cost generating resources or through additional power purchases in the MISO energy markets.

The company's financial performance may be adversely affected if it is unable to successfully operate its facilities.

The company's financial performance depends on the successful operation of its electric generating and

natural gas distribution facilities. Operation of these facilities involves many risks, including: operator error and breakdown or failure of equipment processes; fuel supply interruptions; labor disputes; operating limitations that may be imposed by environmental or other regulatory requirements; or catastrophic events such as fires, earthquakes, explosions, floods or other similar occurrences. Unplanned outages can result in additional maintenance expenses as well as incremental replacement power costs.

Poor investment performance of pension plan holdings and other factors impacting pension plan costs could unfavorably impact its liquidity and results of operations.

The company's cost of providing defined benefit pension plans is dependent upon a number of factors including actual plan experience and assumptions concerning the future, such as earnings on plan assets, discount rates, the level of interest rates used to measure the required minimum funding levels of the plans, future government regulation and the company's required or voluntary contributions to be made to the plans. Changes made to the plans may also impact current and future pension costs. Depending upon the growth rate of the pension investments over time and other factors impacting its costs as listed above, the company may be required to contribute significant additional amounts in the future to fund its plans. These additional funding obligations could have a material adverse impact on its cash flows, financial condition or results of operations.

The company is exposed to risks related to general economic conditions in its service territories. The company's electric and natural gas utility businesses are impacted by economic cycles and the competitiveness of the customers it serves. As the demand for products produced in its service area declines, the company ordinarily experiences reduced demand for electricity and/or natural gas. During 2010, the company's service territory experienced growth, but future growth could be impacted by the overall economy in its service territories. If the economic conditions in the company's service territories and/or demand for products produced in its service area do not continue to improve or decline again, the company could experience a reduction in demand for electricity and/or natural gas that could result in decreased earnings and cash flow. The company also would expect its collections of accounts receivable to be adversely impacted.

Customer growth in the company's service areas affects its results of operations. The company's results of operations are affected by customer growth in its service areas. Customer growth can be affected by population growth as well as economic factors in Wisconsin and the Upper Peninsula of Michigan, including job and income growth. Customer growth directly influences the demand for electricity and natural gas,

and the need for additional power generation and generating facilities. Population declines and/or business closings in company service territories or slower than anticipated customer growth has had, to a limited extent, and could continue to have, a material adverse impact on cash flow, financial condition or results of operations.

Failure to attract and retain an appropriately qualified workforce could adversely impact the company's results of operations.

Events such as an aging workforce without appropriate replacements may lead to operating challenges or increased costs. These operating challenges include lack of resources, loss of knowledge and a lengthy time period associated with skill development. Failure to hire and obtain replacement employees, including the ability to transfer significant internal historical knowledge and expertise to the new employees, may adversely affect the company's ability to manage and operate its business. If the company is unable to successfully attract and retain an appropriately qualified workforce, its results of operations could be adversely affected.

WEC is a holding company and relies on the earnings of its subsidiaries to meet its financial obligations.

As a holding company, Wisconsin Energy's ability to meet its financial obligations and pay dividends on its common stock is dependent upon the ability of its subsidiaries to pay amounts to it, whether through dividends or other payments. The ability of Wisconsin Energy's subsidiaries to pay amounts to it will depend on the earnings, cash flows, capital requirements and general financial condition of its subsidiaries and on regulatory limitations. Prior to distributing cash to WEC, its subsidiaries have financial obligations that must be satisfied, including among others, debt service and preferred stock dividends. WEC subsidiaries also have dividend payment restrictions based on the terms of their outstanding preferred stock and regulatory limitations applicable to them. In addition, each of WEC, Wisconsin Electric and Wisconsin Gas bank back-up credit facilities have specified total funded debt to capitalization ratios that must be maintained. Wisconsin Energy's subsidiaries are separate legal entities and have no obligation to provide it with funds for payment of its obligations.

Provisions of the Wisconsin Utility Holding Company Act limit WEC's ability to invest in nonutility businesses and could deter takeover attempts by a potential purchaser of its common stock that would be willing to pay a premium for its common stock.

Under the Wisconsin Utility Holding Company Act, WEC remains subject to certain restrictions that have the potential of limiting its diversification into nonutility businesses. Under the act, the sum of certain assets of all nonutility affiliates in a holding company system may not exceed 25 percent of the assets of all public utility affiliates in the system.

In addition, the act precludes the acquisition of 10 percent or more of the voting shares of a holding company of a Wisconsin public utility unless the PSCW has first determined that the acquisition is in the best interests of utility customers, investors and the public. This provision and other requirements of the Act may delay or reduce the likelihood of a sale or change of control of WEC. As a result, shareholders may be deprived of opportunities to sell some or all of their shares of WEC common stock at prices that represent a premium over market prices.

Governmental agencies could modify company permits, authorizations or licenses. Wisconsin Electric and Wisconsin Gas are required to comply with the terms of various permits, authorizations and licenses. These permits, authorizations and licenses may be revoked or modified by the agencies that granted them if facts develop that differ significantly from the facts assumed when they were issued. In addition, discharge permits and other approvals and licenses are often granted for a term that is less than the expected life of the associated facility. Licenses and permits may require periodic renewal, which may result in additional requirements being imposed by the granting agency.

Also, if the company is unable to obtain, renew or comply with these governmental permits, authorizations or licenses, or if it is unable to recover any increased costs of complying with additional license requirements or any other associated costs in rates in a timely manner, the company's results of operations and financial condition could be materially and adversely affected.

Wisconsin Electric could be subject to higher costs and penalties as a result of mandatory reliability standards. Wisconsin Electric is subject to mandatory reliability standards established by the North American Electric Reliability Corporation. Compliance with the mandatory reliability standards could subject Wisconsin Electric to higher operating costs. If Wisconsin Electric is found to be in noncompliance with the mandatory reliability standards, it could be subject to sanctions, including substantial monetary penalties.

Restructuring in the regulated energy industry could have a negative impact on the company's business. The regulated energy industry continues to experience significant structural changes. Increased competition in the retail and wholesale markets, which may result from restructuring efforts, could have a significant adverse financial impact on the company. It is uncertain when retail access might be implemented in Wisconsin; however, Michigan has adopted retail choice which allows customers to choose their own electric generation supplier. Although competition and customer switching to alternative suppliers in the company's service territories in Michigan has been limited, the additional competitive pressures resulting from retail access could lead to a loss of customers and incurring stranded costs.

FERC continues to support the existing regional transmission organizations (RTOs) that affect the structure of the wholesale market within those RTOs. In connection with its status as a FERC-approved RTO, MISO implemented bid-based energy markets that are part of the MISO energy market. The MISO energy markets rules require that all market participants submit day-ahead and/or real-time bids and offers for energy at locations across the MISO region. MISO then calculates the most efficient solution for all of the bids and offers made into the market that day and establishes a locational marginal price that reflects the market price for energy. As a participant in the MISO energy markets, the company is required to follow MISO's instructions when dispatching generating units to support MISO's responsibility for maintaining stability of the transmission system. MISO also implemented an ancillary services market for operating reserves that was simultaneously co-optimized with MISO's existing energy markets.

This market design has the potential to increase the costs of transmission, the costs associated with inefficient generation dispatching, the costs of participation in the market and the costs associated with estimated payment settlements.