

COMPANY INTERVIEW | UTILITIES

Wisconsin Energy Corporation (WEC)



GALE KLAPPA has served as chairman since May 2004, president and chief executive officer of Milwaukee-based Wisconsin Energy Corporation, one of the nation's premier energy companies. He also holds the same positions with Wisconsin Energy's principal utility, We Energies. Mr. Klappa joined Wisconsin Energy in April 2003 as president. He was elected to the company's board of directors in December 2003. Prior to joining Wisconsin Energy, he served as executive vice president, chief financial officer and treasurer of Southern Company in Atlanta, Ga. Previously in his career, Mr. Klappa was Southern Company's chief strategic officer, the North American group president of Southern Energy Inc. (now Mirant) and president and CEO of South Western Electricity — Southern Company's electric distribution utility in the United Kingdom. Before his assignment in the U.K., he was senior vice president of marketing for Georgia Power Company, a subsidiary of Southern Company. Mr. Klappa is a 1972 graduate cum laude of the University of Wisconsin-Milwaukee (UWM), with a bachelor's degree in Mass Communications.



J. PATRICK KEYES was appointed executive vice president and chief financial officer of Wisconsin Energy Corporation, and its principal utility subsidiary, We Energies in September 2012. Mr. Keyes has overall responsibility for the company's strategic and financial planning functions. He also oversees the treasury, accounting, tax, insurance and risk management functions, as well as the company's investor relations work. Prior to joining Wisconsin Energy in April 2011 as vice president and treasurer, Mr. Keyes amassed nearly 25 years of experience in the utility practice of Accenture and its predecessor organizations, Andersen Consulting and Arthur Andersen. During that time, he worked with more than 20 major utilities, providing expertise in the areas of smart metering, customer information systems, customer information management and utility customer operations. A Milwaukee native, Mr. Keyes holds a B.A. from Duke University, Durham, N.C., in economics and an MBA in accounting and finance from the University of Michigan, Ann Arbor, Michigan.

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SR: Since 2003, your organization has generated impressive absolute and relative performance and we're interested in seeing how it came about.

Mr. Klappa: The place to start is where our region found itself in the early 2000s because that is an important piece of the story. In the early 2000s, the state found itself in very significant need of additional energy infrastructure. The state did not have enough generating capacity. It did not have enough transmission capacity to support jobs and future economic growth and it got to the point where literally something had to be done. And borne out of that need our company stepped forth with a plan to upgrade the energy infrastructure of the region. Borne out of that need was what we called the Power the Future plan.

The majority of the plan was approved by the state Public Service Commission, with support from the state legislature and support from the governor. The size and scope of that plan compared to the capital base of the company at the time was very significant. If you think about the market value of Wisconsin Energy late 2002 early 2003 it was in the neighborhood of \$2.8 billion. The plan called for more than \$3B of power plant construction in and of itself not to mention the distribution system upgrades, transmission upgrades, et cetera. So just the generation component of the Power the Future plan was about as big as the capital base of the company in terms of the company's equity value at that time.

So to fast forward to where we are today, with a lot of work and a lot of talented people, we have completed the generation portion of Power the Future and by and large we have done so on time and on budget; that really is the driver of the company's performance over the last 7-8 years. There has been a dramatic expansion of the equity base and the market value of the company as we have delivered on our Power the Future projects. Does that help with your perspective?

SR: It does. What factors resulted in Power the Future coming in on time and on budget?

Mr. Klappa: There is one very significant reason for that. We were able to build a team of absolutely incredible construction management people. When I came to Wisconsin Energy in 2003 one of the first people I recruited was a gentleman by the name of Rick Kuester. I had known Rick for close to 20 years, he and I had been at Southern Company together and Rick had most recently prior to coming to here, had been the

CEO of an independent power producer in Asia. In the early to mid-1990s, Southern had taken on some diversification efforts and I had in fact been asked to go be the CEO of a utility company that Southern had purchased in England and shortly after it bought that utility in England, Southern had purchased an independent power producer in Asia. So while I was in England, Rick was in Asia based in Hong Kong.

Rick has enormous and very high quality construction experience, he built coal fired power plants in Asia and early in his career he was involved in the construction of the Vogtle nuclear unit at Georgia Power (a part of Southern

Company). Rick has just vast and extensive construction management experience, I realized that Wisconsin Energy had not had the luxury of building a lot of new capacity or had not had many major construction projects in more than a decade. We simply did not have a full complement of talent here to manage a construction program with the size and scope of Power the Future. So I recruited Rick to lead our power generation business and he and I together recruited a number of construction project managers, some of whom we worked with in the past and others that we knew of. We put together I think one of the most talented construction management teams frankly anywhere within the United States and that was the secret.

SR: Your company has been voted most reliable in your region for seven out of the last 10 years. What factors do you see have resulted in your company's enviable record of reliability and do you see any risks to this going forward?

Mr. Klappa: Very good question. To answer the first part of the question, in addition to building the power plant generation that we talked about as part of Power the Future, we also invested a significant amount of money in our distribution networks and in the reliability and quality of the distribution networks. If you add it all up from 2003 to this year, we have spent \$7.8 billion on energy infrastructure, a portion of which was the generating units for the brand new efficient power plants, but a significant portion of which was also upgrading and renewing our distribution networks. We have more work to do there, and I can talk to you about why in a minute. But we have made significant investments to maintain our reliability.

We have a cultural focus here that I am very proud of, focused on safety, customer satisfaction and reliability; people think about each of these every day when they walk in the doors. While we measure our reliability like most utilities do, we focus on reliability and safety and customer satisfaction

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from the top of this organization throughout the organization. That creates a culture of reliability and customer satisfaction here that our folks are very proud of and want to maintain.

Now I previously mentioned that we need to continue investing in renewing our networks. If you look at the engineering data as it relates to underground power lines, components of substations, transformers, you'll see that failure rates accelerate once these components of our distribution network reach 50 years old or older. There was a significant growth spurt for this company in the 1960's.

As a result, we have a program in front of us to rebuild 2,500 miles of electric distribution lines that today are 50 years old or older.

We plan to replace 28,000 power poles between now and 2016 as well as 28,000 transformers during that same time period and hundreds of substation components. Looking at our gas distribution network, we'll replace about 1,250 miles of fiberglass, plastic and steel gas mains, and 83,000 individual gas distribution lines (those are the lines that would come directly off the street to your house). And we are also planning on replacing over a quarter of a million meter sets off the gas distribution side of the business. So that program, part of the \$3.5B of capital investment for the period 2012-2016, is what we're planning to put in place to maintain the exceptional reliability that we think our customers deserve.

SR: We had a question about your two gas distribution utility operations. We noticed that there was a difference in base rate revisions for the two different gas utility customers.

Mr. Klappa: In our current rate case you are correct.

SR: Wisconsin Electric gas customers will be seeing a 0.2% decrease in gas rates. Wisconsin Gas LLC gas customers see a 2.3% decrease. What are some of the factors that are leading to the differential in base rate revisions?

Mr. Klappa: Basically, because we have two different natural gas distribution companies, there are two different rate bases, if you will. And the difference in what we are asking for in terms of rate adjustments for each of those two gas companies is strictly driven by the rate of investment and recovery of that investment. In other words, one rate base is growing faster than the other.

SR: That's very informative. Let me ask you about the purchase of WICOR (Wisconsin Gas LLC), we noticed that Wisconsin Energy has broadened its presence throughout the state of Wisconsin and is less dependent on the City of Milwaukee. Are there any localities that you are seeing above-average and noteworthy growth rates in?

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Mr. Klappa: Actually, that's a really intriguing question. And I think the answer to that is clearly yes. There are two different pockets of the areas that we serve in which we are seeing somewhat faster growth rates and the first is south of Milwaukee, between the outer suburbs of Milwaukee and the Illinois state line. We are finding a fair amount of migration from the Northern Illinois suburbs, people

moving from the Northern Illinois suburbs to the very southern areas of Wisconsin such as the Kenosha and Pleasant Prairie areas. From a timing standpoint it's funny, if you live in the Chicago Northern Illinois suburbs, you can actually get to a first class hospital in Metro Milwaukee quicker than you can get to a first class hospital in Downtown Chicago because of the traffic. So from the standpoint of quality of life and ease of movement, ease of traffic and transportation, people are finding that the southernmost part of Southeastern Wisconsin is an attractive alternative to the Northern Illinois suburbs. We're seeing some residential growth, a greater degree of growth than we have seen in the past in that area and we are also seeing some companies move there as well. Property values and housing costs are better in Southeastern Wisconsin than they are in Illinois and so I think that is also a factor.

SR: Our next question is about the returns on equity within the regulatory jurisdictions. We noticed that the (MI, WI and FERC) regulators allow WEC to have a 10.4% ROE for Wisconsin Electric (using 48.5%-53.5% equity), 10.5% for Wisconsin Gas (45-50% equity), 12.2% for ATC (50% equity) and 12.7% for your Power the Future investments (53-55% equity).

Mr. Klappa: That's correct.

SR: How does this compare with other jurisdictions? Is it higher than other states, lower or within the average median for allowable ROE?

Mr. Klappa: I would say just looking at recent rate case decisions across the US, the 10.4% that you referred to for our electric company and the 10.5% for Wisconsin Gas are pretty much at the median. You see some commissions coming in somewhat lower; you see some commissions coming in

somewhat higher, you see some coming in with bandwidths that would put the 10.4% the 10.5% at the median. So I think for our retail utilities, Wisconsin Electric, Wisconsin Gas and Wisconsin Electric Gas, we're right at the median.

SR: Okay, let me ask you a question about the regulators and the allowable ROE. What is their methodology with regards to setting the allowable ROE? For example Illinois's allowable ROE is based on government bond rates plus a spread.

Mr. Klappa: I don't think that the Wisconsin Commission has ever specifically articulated one methodology for determining the allowable return on equity for Wisconsin utilities. However, there is a prevailing and predominant philosophy that the Wisconsin commission has adhered to for decades. In fact, I didn't know if you were aware that the Wisconsin Public Service

Commission was the very first public service commission to regulate an electric utility anywhere in the United States. So the Wisconsin commission has been around for a long time and there is a real pride about how effectively they regulate the utilities in the state. And their philosophy has always been that the Wisconsin commission does not support or want the utilities in this state to have an excessive amount of debt. The preference of the Wisconsin commission has always been that the Wisconsin utilities maintain solid investment-grade ratings. I think we were the last AA rated utility in America at one time and I don't know of any utility now that is AA rated in the US. So, the predominant philosophy has been to support a return on equity that will be sufficient in terms of earnings and cash flows to carry a solid A rating at the utility level. I think that is the best shorthand description that I can give you of the philosophy of the Wisconsin commission.

SR: We saw that WEC's parent company credit rating was increased in June 2011 by S&P and that in June 2012; S&P raised the ratings outlook for WEC and its subsidiaries from stable to positive.

Mr. Klappa: Yes, they really like our new CFO.

SR: S&P said it could raise the ratings one notch within the next 12 to 18 months with sustained financial performance above our base-case forecast level of adjusted FFO to total debt of 23% and adjusted debt to total capital of about 55%. In your professional opinion, how likely do you believe that WEC will be able to achieve the credit rating upgrade? Is WEC going to be making any additional efforts in order to achieve this or is it content to maintain the A- rating?

Mr. Klappa: I'm going to ask our new CFO Pat Keyes to give you his view on that.

Mr. Keyes: It is always hard to predict what the rating agencies might do. But I think in our last couple of visits there are a couple of things that the rating agencies particularly liked. One is that with Power the Future completed, our large construction projects (and the associated risks) are behind us. As Gale mentioned, our focus is now more on our distribution network and the projects there are smaller, less risky, and easier to manage. So the rating agencies see a better risk profile from us. The second thing that they look at and really like is our free cash flow. If you look at our investor presentation, from 2012-2016 after capital investments and dividends we have about \$600M in free cash flow. As you guys know from following the industry for so long, that is very unusual for a utility. Most utilities borrow to fund capital investment; we

are generating free cash. So we don't know what the agencies will ultimately decide, but I think those two factors are helping drive their thought process.

Mr. Klappa: Pat made a very good point about our positive free cash flow and I want to underscore one thought about that. If you have done analyses and I know you have over the years on utilities, Pat is absolutely right, it is a rarity for a utility for any period of time to be free cash flow positive. We see that continuing for a number of years here and one of the things that we are going to reinforce with the rating agencies and all of our investors is that while we have greater financial flexibility today than we've had in decades, we are not going to change our risk profile in the way that we invest that free cash. And I think that the rating agencies will respond positively to that commitment. I'm old enough to remember back in the early 1990s to mid-1990s when many utilities found themselves temporarily in a free cash flow position and they thought that diversification outside their core markets was the appropriate strategy. In many cases, that movie did not end well. So you will not find us going out and buying, for example, a geyser in Hawaii. We're not going to buy a merchant power plant in the Philippines or something like that.

We are going to stick to our knitting and assuming we can't find additional projects to invest in at the risk profile that we're comfortable with, the worst you'll receive from us is a share buyback.

SR: In your interview on Fox Business, you mentioned how important it was to have a diverse portfolio of power generation fuels. What are the steps necessary to convert a plant from one fuel to another and is it technically

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possible or economically feasible for a plant to be able to run on multiple fuels at one time?

Mr. Klappa: Well I can tell you one thing, Liz Claman on Fox Business likes natural gas. At any rate I really do believe that for the long term and median term, fuel diversity is very important in terms of serving customers effectively and from a cost competitive standpoint there is no perfect fuel source. At any given time, some external event can affect the pricing or availability of a particular fuel source so we really believe in fuel diversity in our general fleet, and from the standpoint of meeting the state's renewable portfolio standards. But to directly answer your question, perhaps I can do so with an example. In August, we announced that we were going to convert the last operating plant inside the city limits of Milwaukee which we call the Valley Power Plant. Valley has been for its entire life a coal-fired power plant and it meets all of today's environmental standards.

Our view is though that by 2017 or so, as the EPA continues to add restrictions and tighten the environmental standards, that Valley would need to add scrubbers to meet the 2017-2020 environmental standards. However, there really isn't sufficient land or sufficient space (at the Valley plant) to build a scrubber. As the Valley plant is a very important piece of energy infrastructure for the City of Milwaukee, it makes sense to convert it from coal to natural gas. We will have to do two significant things: 1) We need to replace the burners that basically allow fuel to get into the boilers. We won't necessarily need to replace the boilers themselves, and 2) we need to upgrade the existing natural gas pipeline that runs near the facility (and we've already received approval from the Public Service Commission).

Right now, if we just said "We want to convert Valley from coal to natural gas", there would not be a sufficient flow of gas from the existing pipeline. So we need to upgrade the existing natural gas pipeline, enlarge it and upgrade it. It is one of those infrastructure pieces that we would have wanted to upgrade anyway because it is a 1950s vintage gas pipeline. The Wisconsin commission has given its approval to upgrade the pipeline, and that's about a \$26M investment. And then the conversion of the burners and the other technical things we need to do at the plant is another \$60M-\$65M project. So if you put the two together, it's almost a \$100M investment, but this should give you a sense of technically what needs to be done in order to permanently switch fuels.

SR: You discussed the 2009 chilled ammonia carbon capture project at Pleasant Prairie. We noticed that it

captured 90% of the Carbon Dioxide emissions from the plant and do you think that it is ready to be utilized at other WEC plants? Previously, Mr. Klappa estimated that it would take about 10-12 years (2019-2021) for it to be available on a widespread scale. Would that projection remain as of today?

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Mr. Klappa: Let me just clarify one point. This chilled ammonia technology for capturing carbon emissions from the burning of fossil fuels was the first in the nation, actually the first in the world, experiment with a new technology. And we agreed with the Electric Power Research Institute and Alstom, which was a developer of that technology to do the first test of this technology outside of the

laboratory. This technology inside the laboratory looked like it was very promising, but it needed a real world test, we conducted a real world test with them at our Pleasant Prairie power plant. Pleasant Prairie is in the area we were talking about earlier that is growing near the Illinois state line. The test was successful and it demonstrated that it captured more than 90% of the carbon.

At the time I said that based on the testing we had done at that plant, the technology was ready to be scaled up even further and be tested at another plant. The other plant where the second real world test was going to take place was an American Electric power plant in the Eastern US. So basically we tested the technology for the first time outside of a laboratory but not on the entire plant. We took a slipstream of the emissions and proved that it worked, technically. They got a lot of really good data out of that testing that we did. The next step was to scale up the technology even greater and test it on a larger scale at this American Electric power facility. That test did begin and they were also going to sequester the carbon. We don't have the capability of doing that in Wisconsin, our geology won't support that.

So the next step in the development of this technology was passed into the hands of American Electric Power. I think that they began that test but I'm not sure if they had concluded it. I think they ran into difficulty in recovering the cost from one of their public service commissions. So to answer your question about 10-12 years, I'm not sure we've made enough progress for that particular technology to see a widespread commercial use in. But clearly we have seen that this technology can work. For it to be more commercially available 10-12 years from now, two things would have to happen: One, there has to be a more extensive demonstration of the technology on a large scale, and secondly the cost would have to come down. At the time, our research showed

that this technology would be expensive to implement on a large scale. But the technology itself is very promising.

SR: We heard about the recent cost overruns for the Oak Creek plant. What is the likely amount that WEC will be able to recover when the Commission determines how much your organization can raise rates?

Mr. Klappa: To put this in perspective this is a \$2.3 billion power plant. When all of Oak Creek was conceived and approved, the commission gave the company a target price and a 5% bandwidth around the target price, because so much can happen in final design and construction that are outside of everyone's control. We were able to bring the plant in for 108% of the target price. So the real discussion in our current rate case is around the 3% that is above the bandwidth. For our company because we're an 86% owner of the plant, we're talking about \$61M on a \$2.3B project.

SR: Is there is anything else you would like to add or comment on?

Mr. Klappa: You've covered the waterfront here really well. Great questions.

SR: Thank you.

GALE KLAPPA
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