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

**FORM 10-Q**

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

For the quarterly period ended September 30, 2008

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission  
File Number

2-35965

Registrant; State of Incorporation;  
Address; and Telephone Number

NORTH SHORE GAS COMPANY  
(An Illinois Corporation)  
130 East Randolph Drive  
Chicago, Illinois 60601-6207  
(312) 240-4000

IRS Employer  
Identification No.

36-1558720

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 ☒ No ☐

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

Large accelerated filer ☐

Accelerated filer ☐

Non-accelerated filer ☒

Smaller reporting company ☐

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

Yes ☐ No ☒

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date: 3,625,887 shares of common stock, without par value, outstanding at November 5, 2008, all of which were held, beneficially and of record, by Peoples Energy Corporation, a wholly owned subsidiary of Integrys Energy Group, Inc.

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**NORTH SHORE GAS COMPANY**  
**FORM 10-Q FOR THE QUARTER ENDED SEPTEMBER 30, 2008**

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### Commonly Used Acronyms

EPA	United States Environmental Protection Agency
FASB	Financial Accounting Standards Board
FERC	Federal Energy Regulatory Commission
ICC	Illinois Commerce Commission
IRS	United States Internal Revenue Service
LIFO	Last in, first out
NSG	North Shore Gas Company
NYMEX	New York Mercantile Exchange
PEC	Peoples Energy Corporation
PGL	The Peoples Gas Light and Coke Company
SEC	United States Securities and Exchange Commission
SFAS	Statement of Financial Accounting Standards
VBA	Volume Balancing Adjustment

## Forward-Looking Statements

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

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

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

Forward-looking statements involve a number of risks and uncertainties. There are many factors that could cause actual results to differ materially from those expressed or implied in this report. Some risk factors that could cause results to differ from any forward-looking statement include those described in Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2007, as may be amended or supplemented in Part II, Item 1A of this report. Other factors include:

- Integrys Energy Group, the parent of NSG, may be unable to achieve the forecasted synergies at its utility subsidiaries that are anticipated from the PEC merger, or it may take longer or cost more than expected to achieve these synergies;
- Resolution of future rate cases and negotiations (including the recovery of deferred costs) and other regulatory decisions;
- The impact of recent and future federal and state regulatory changes, including legislative and regulatory initiatives regarding deregulation and restructuring of the natural gas utility industry and possible future initiatives to address concerns about global climate change, changes in environmental, tax, and other laws and regulations to which NSG is subject, as well as changes in the application of existing laws and regulations;
- Current and future litigation, regulatory investigations, proceedings or inquiries, including but not limited to, manufactured gas plant site cleanup and proceedings concerning the prudence review of NSG's natural gas purchases and costs actually incurred;
- Resolution of audits or other tax disputes with the IRS, Illinois state revenue agencies, or other taxing authorities;
- Available sources and costs of natural gas;
- Investment performance of employee benefit plan assets;
- Advances in technology;
- Effects of and changes in political and legal developments, as well as economic conditions and the related impact on customer demand;
- Potential business strategies, including acquisitions and construction or disposition of assets or businesses, which cannot be assured to be completed timely or within budgets;
- The direct or indirect effects of terrorist incidents, natural disasters, or responses to such events;
- The impacts of changing financial market conditions, credit ratings, and interest rates on our liquidity and financing efforts;
- The risks associated with changing commodity prices (particularly natural gas), including counterparty credit risk and the impact on general market liquidity;
- The effect of accounting pronouncements issued periodically by standard-setting bodies; and
- Other factors discussed elsewhere herein and in other reports filed by NSG and/or Integrys Energy Group from time to time with the SEC.

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

## PART 1. FINANCIAL INFORMATION

### Item 1. Financial Statements

#### NORTH SHORE GAS COMPANY

CONDENSED STATEMENTS OF INCOME (LOSS) (Unaudited)	Three Months Ended		Nine Months Ended	
	September 30		September 30	
(Millions)	2008	2007	2008	2007
<b>Natural gas operating revenues</b>	<b>\$33.2</b>	<b>\$22.9</b>	<b>\$215.6</b>	<b>\$192.6</b>
Natural gas purchased for resale	20.8	13.4	163.5	145.8
Operating and maintenance expense	9.3	8.7	35.0	28.8
Natural gas charge settlement	-	-	-	2.0
Depreciation and amortization expense	2.0	1.4	5.3	4.4
Taxes other than income taxes	0.5	0.8	1.5	2.0
<b>Operating income (loss)</b>	<b>0.6</b>	<b>(1.4)</b>	<b>10.3</b>	<b>9.6</b>
Miscellaneous income	0.1	0.3	0.7	1.1
Interest expense	(1.1)	(1.1)	(3.1)	(3.1)
<b>Other expense</b>	<b>(1.0)</b>	<b>(0.8)</b>	<b>(2.4)</b>	<b>(2.0)</b>
Income (loss) before taxes	(0.4)	(2.2)	7.9	7.6
Provision (benefit) for income taxes	-	(0.9)	2.9	2.7
<b>Net income (loss)</b>	<b>(\$0.4)</b>	<b>(\$1.3)</b>	<b>\$5.0</b>	<b>\$4.9</b>

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

# NORTH SHORE GAS COMPANY

<b>CONDENSED BALANCE SHEETS (Unaudited)</b>	<b>September 30</b>	<b>December 31</b>
(Millions)	<b>2008</b>	<b>2007</b>
<b>Assets</b>		
Cash and cash equivalents	\$ -	\$ -
Accounts receivable, net of reserves of \$2.4 and \$2.0, respectively	15.1	26.3
Receivables from related parties	0.1	2.3
Accrued unbilled revenues	6.1	23.9
Natural gas in storage, primarily at LIFO	26.6	8.9
Assets from risk management activities	1.1	2.0
Regulatory assets	30.6	9.8
Other current assets	1.7	2.0
<b>Current assets</b>	<b>81.3</b>	<b>75.2</b>
Property, plant, and equipment, net of accumulated depreciation of \$158.9 and \$154.2, respectively	244.1	244.8
Regulatory assets	114.0	101.7
Other	1.3	3.2
<b>Total assets</b>	<b>\$440.7</b>	<b>\$424.9</b>
<b>Liabilities and Shareholder's Equity</b>		
Accounts payable	\$23.8	\$25.8
Payables to related parties	4.9	7.3
Notes payable to related parties	4.8	11.9
Liabilities from risk management activities	22.6	5.7
Accrued taxes	3.3	2.5
Customer credit balances	5.6	8.1
Regulatory liabilities	3.9	8.9
Other current liabilities	7.6	5.6
<b>Current liabilities</b>	<b>76.5</b>	<b>75.8</b>
Long-term debt	69.0	69.0
Deferred income taxes	39.7	39.0
Environmental remediation liabilities	92.8	84.6
Pension and postretirement benefit obligations	27.5	25.1
Asset retirement obligations	23.9	23.0
Other	9.1	7.0
<b>Long-term liabilities</b>	<b>262.0</b>	<b>247.7</b>
<b>Commitments and contingencies</b>		
Common stock equity	102.2	101.4
<b>Total liabilities and shareholder's equity</b>	<b>\$440.7</b>	<b>\$424.9</b>

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

# NORTH SHORE GAS COMPANY

<b>CONDENSED STATEMENTS OF CAPITALIZATION (Unaudited)</b>			<b>September 30</b>	<b>December 31</b>
(Millions, except share amounts)			<b>2008</b>	<b>2007</b>
<b>Common stock equity</b>				
Common stock, without par value, 5,000,000 shares authorized,				
3,625,887 shares outstanding			<b>\$24.8</b>	\$24.8
Accumulated other comprehensive loss			<b>(0.1)</b>	(0.1)
Retained earnings			<b>77.5</b>	76.7
<b>Total common stock equity</b>			<b>102.2</b>	101.4
<b>Long-term debt</b>				
First mortgage bonds				
	<u>Series</u>	<u>Year Due</u>		
	5.000%	2028	<b>29.0</b>	29.0
	4.625%	2013	<b>40.0</b>	40.0
Total long-term debt			<b>69.0</b>	69.0
<b>Total capitalization</b>			<b>\$171.2</b>	\$170.4

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

# NORTH SHORE GAS COMPANY

<b>CONDENSED STATEMENTS OF CASH FLOWS (Unaudited)</b>		<b>Nine Months Ended</b>	
		<b>September 30</b>	
<b>(Millions)</b>		<b>2008</b>	<b>2007</b>
<b>Operating Activities</b>			
Net income		<b>\$5.0</b>	\$4.9
Adjustments to reconcile net income to net cash provided by operating activities			
Depreciation and amortization expense		<b>5.3</b>	4.4
Deferred income taxes		<b>3.3</b>	(1.1)
Pension and postretirement expense		<b>3.1</b>	3.2
Pension and postretirement funding		<b>(1.1)</b>	-
Natural gas charge settlement		-	2.0
Gas charge reconciliation expense		-	0.7
Other, net		<b>(0.1)</b>	(6.9)
<b>Changes in -</b>			
Customer and other receivables		<b>13.0</b>	8.5
Accrued unbilled revenues		<b>17.8</b>	15.6
Natural gas in storage		<b>(17.7)</b>	(9.8)
Other current assets		<b>(0.6)</b>	3.7
Accounts payable		<b>(4.5)</b>	(2.3)
Accrued taxes		<b>0.8</b>	(4.5)
Other current liabilities		<b>(7.2)</b>	(2.2)
<b>Net cash provided by operating activities</b>		<b>17.1</b>	16.2
<b>Investing Activities</b>			
Capital expenditures		<b>(6.4)</b>	(6.5)
Note receivable from related party		-	0.1
<b>Net cash used for investing activities</b>		<b>(6.4)</b>	(6.4)
<b>Financing Activities</b>			
Payments of related-party short-term debt		<b>(7.1)</b>	-
Dividends to parent		<b>(3.6)</b>	(4.6)
<b>Net cash used for financing activities</b>		<b>(10.7)</b>	(4.6)
<b>Net change in cash and cash equivalents</b>		<b>-</b>	5.2
Cash and cash equivalents at beginning of period		-	0.1
<b>Cash and cash equivalents at end of period</b>		<b>\$ -</b>	\$5.3

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



**NORTH SHORE GAS COMPANY**  
**CONDENSED NOTES TO FINANCIAL STATEMENTS**  
**September 30, 2008**

**NOTE 1--FINANCIAL INFORMATION**

We have prepared the condensed financial statements of NSG under the rules and regulations of the SEC.

These financial statements on Form 10-Q have not been audited. Management believes that these financial statements include all adjustments (which, unless otherwise noted, include only normal recurring adjustments) necessary for a fair presentation of the financial results for each period shown. We have condensed or omitted certain financial information and note disclosures normally included in our annual audited financial statements. These condensed financial statements should be read along with the audited financial statements included in the NSG Annual Report on Form 10-K for the year ended December 31, 2007. Due to a number of factors, including the seasonality of NSG's business and market price volatility, the quarterly results of operations and statements of financial position and cash flows should not be considered indicative of the results to be expected for the year as a whole.

We reclassified certain prior year financial statement amounts, none of which are significant, to conform to the current year presentation.

**NOTE 2--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 NSG Condensed Statements of Cash Flows:

	<b>Nine Months Ended September 30</b>	
<b>(Millions)</b>	<b>2008</b>	<b>2007</b>
Cash paid for interest	<b>\$2.9</b>	\$1.9
Cash paid (received) for income taxes	<b>(3.4)</b>	9.6

**NOTE 3--RISK MANAGEMENT ACTIVITIES**

The following table shows NSG's assets and liabilities from risk management activities as of September 30, 2008, and December 31, 2007:

	<b>Assets</b>		<b>Liabilities</b>	
	<b>September 30,</b>	<b>December 31,</b>	<b>September 30,</b>	<b>December 31,</b>
<b>(Millions)</b>	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
<b>Commodity contracts</b>	<b>\$1.1</b>	<b>\$2.1</b>	<b>\$23.6</b>	<b>\$5.7</b>
<b>Balance Sheet Presentation</b>				
Current	<b>\$1.1</b>	\$2.0	<b>\$22.6</b>	\$5.7
Other long-term	-	0.1	<b>1.0</b>	-
<b>Total</b>	<b>\$1.1</b>	<b>\$2.1</b>	<b>\$23.6</b>	<b>\$5.7</b>

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

NSG uses forward contracts and financial instruments, including commodity swaps and options, to manage volatility in natural gas supply costs. NSG's policy is to use these instruments solely for the purpose of managing volatility and not for any speculative purpose. NSG's tariffs allow for full recovery from its customers of prudently incurred natural gas supply costs, including gains or losses on these

derivative instruments. Therefore, SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation," allows for these mark-to-market derivative gains or losses to be recorded as regulatory assets or liabilities.

FASB Interpretation No. 39, "Offsetting of Amounts Related to Certain Contracts," as amended, provides 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. NSG has elected to present these items on a net basis in its Condensed Balance Sheets. The amounts recognized for cash collateral provided to others that were offset against net derivative liabilities, and the amounts recognized for cash collateral received from others that were offset against net derivative assets were as follows:

<b>(Millions)</b>	<b>September 30, 2008</b>	<b>December 31, 2007</b>
Cash collateral provided to others	<b>\$0.8</b>	\$ -
Cash collateral received from others	-	-

#### **NOTE 4--NATURAL GAS IN STORAGE**

NSG prices natural gas storage injections at the calendar year average of the cost of natural gas supply purchased. Withdrawals from storage are priced on the LIFO cost method. For interim periods, the difference between current projected replacement cost and the LIFO cost for quantities of natural gas temporarily withdrawn from storage is recorded as a temporary LIFO liquidation credit. At September 30, 2008 and 2007, all LIFO layers were replenished and the LIFO liquidation credit balance was zero.

#### **NOTE 5--LONG-TERM DEBT**

In November 2008, NSG issued \$6.5 million of 7.0% 5-year first mortgage bonds. The net proceeds from the issuance of the first mortgage bonds were used for general corporate utility purposes.

#### **NOTE 6--ASSET RETIREMENT OBLIGATIONS**

The following table shows changes to the asset retirement obligations of NSG through September 30, 2008.

<b>(Millions)</b>	
Asset retirement obligations at December 31, 2007	\$23.0
Accretion	0.9
<b>Asset retirement obligations at September 30, 2008</b>	<b>\$23.9</b>

#### **NOTE 7--INCOME TAXES**

NSG's effective tax rates for the three and nine months ended September 30, 2008, were 0% and 36.7%, respectively. NSG's effective tax rates for the three and nine months ended September 30, 2007, were 40.9% and 35.5%, respectively. We calculate our provision for income taxes based on an interim effective tax rate that reflects our projected annual effective tax rate. The effective tax rates for the three and nine months ended September 30, 2008 and 2007 differ from the federal tax statutory rate of 35% primarily due to the quarterly adjustment of the interim effective tax rate to reflect the annual projected effective tax rate, state income taxes, and the impact of certain permanent book to tax return differences.

#### **NOTE 8--COMMITMENTS AND CONTINGENCIES**

##### **Commodity Purchase Obligations and Purchase Order Commitments**

As of September 30, 2008, NSG had obligations related to natural gas supply and transportation contracts with total estimated demand payments of \$45.9 million through 2017. NSG expects to recover these costs in future customer rates. Additionally, NSG has obligations to sell natural gas to customers.

NSG has commitments in the form of purchase orders issued to various vendors. At September 30, 2008, these purchase orders totaled \$3.1 million.

## **Environmental**

### *Manufactured Gas Plant Remediation*

NSG, its predecessors and certain former affiliates operated facilities in the past at multiple sites for the purposes of manufacturing gas and storing manufactured gas. In connection with manufacturing and storing 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, NSG is required to undertake remedial action with respect to some of these materials.

NSG is addressing five manufactured gas plant sites, including one site described in more detail below. Until July 2007, NSG was addressing these five sites under a program supervised by the Illinois Environmental Protection Agency (IEPA). As discussed below, in July 2007, NSG transferred two of these sites to a program administered by the EPA. Investigations have been completed at all or portions of four of the five sites. NSG has determined that cleanup is not required at one of these four sites. Cleanups have not yet been completed at any of the other three sites.

The EPA has identified NSG as a potentially responsible party (PRP) under the Comprehensive Environmental Response, Compensation and Liability Act of 1980, as amended, at the Waukegan Coke Plant Site located in Waukegan, Illinois (Waukegan Site). The Waukegan Site is part of the Outboard Marine Corporation (OMC) Superfund Site. The EPA also identified OMC, General Motors Corporation, and certain other parties as PRPs at the Waukegan Site. NSG and the other PRPs are parties to a consent decree that requires NSG and General Motors, jointly and severally, to perform the remedial action and establish and maintain financial assurance of \$27.0 million (in the form of certain defined net worth levels that NSG has met). The soil component of the remedial action was completed in August 2005. The final design for the groundwater component of the remedial action has been completed, and construction of the groundwater treatment plan was completed in August 2008. Operation of the groundwater treatment unit began in September 2008 and is expected to be up to full capacity during the first quarter of 2009. The EPA reduced the financial assurance requirement to \$21.0 million to reflect completion of the soil component of the remedial action.

In July 2007, NSG transferred two of its largest manufactured gas plant sites that were being addressed under IEPA supervision 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.

NSG is coordinating the investigation and the cleanup of the Illinois manufactured gas plant sites 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.

NSG estimated the future undiscounted investigation and cleanup costs for remaining work to be done at the Illinois manufactured gas plant sites it is addressing (namely, those being addressed by both the IEPA and the EPA) as of September 30, 2008, to be \$92.8 million. This estimate (1) takes into account the transfer of sites to the EPA, which allows for estimates with greater certainty for sediment cleanup and remediation of sites where access to the sites could not previously be obtained under the IEPA program; (2) is based on assumptions and calculation methodology consistent with that used by all Integrys Energy Group utilities in determining investigative and cleanup costs for manufactured gas plant sites; and (3) includes increased construction and operation costs at the Waukegan Site. NSG may adjust these estimates in the future, to reflect remedial technology, regulatory requirements, remedy determinations and the assessment of natural resource damage.

Management believes that any costs incurred for environmental activities relating to former manufactured gas 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 NSG. Accordingly, management believes that the costs incurred in connection with former manufactured gas operations will not have a material adverse effect on the financial position or results of operations of NSG. However, any changes in NSG's approved rate mechanisms for recovery of these costs, or any adverse conclusions by the ICC with respect to the prudence of costs actually incurred, could materially adversely affect NSG's recovery of such costs through rates.

NSG recorded a regulatory asset of \$98.4 million, net of insurance recoveries received of \$8.2 million, related to the recovery of both unrecovered expenditures and estimated future expenditures as of September 30, 2008. Incurred costs are expensed in the statement of income in the same period they are billed to customers and recognized as revenues.

#### Former Mineral Processing Site in Denver, Colorado

In 1994, NSG received a demand for reimbursement, indemnification, and contribution for response costs incurred with respect to the cleanup of a former mineral processing site in Denver, Colorado. The demand from the S.W. Shattuck Chemical Company, Inc. alleges that NSG is a successor to the liability of a former entity that was allegedly responsible during the period 1934 through 1941 for the disposal of mineral processing wastes containing radium and other hazardous substances at the site. In 1992, the EPA issued a Record of Decision (ROD) for the Denver site and remediation work began. The remedy selected in the ROD consisted of the on-site stabilization, solidification, and capping of soils containing radioactive wastes. In 1998, the remedial action under the 1992 ROD was completed. In 2002, the EPA issued an amended ROD that required removing the monolith cap and undertaking additional soil excavation. The work performed under the amended ROD began in September 2002 and was completed in September 2006.

NSG does not believe that it has liability for the costs related to this site, but cannot determine the matter with certainty. At this time, NSG cannot reasonably estimate what range of loss, if any, may occur. In the event that NSG incurs liability, it would pursue reimbursement from insurance carriers and other responsible parties, if any.

### **Natural Gas Charge Reconciliation Proceedings and Related Matters**

#### Natural Gas Charge Settlement

For NSG, the ICC conducts annual proceedings regarding the reconciliation of revenues from the natural gas charge and related natural gas costs. The natural gas charge represents the cost of natural gas and transportation and storage services purchased by NSG, as well as gains, losses, and costs incurred under NSG's hedging program (Gas Charge). In these proceedings, 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 were to find that the reconciliation was inaccurate or any natural gas costs were imprudently incurred, the ICC would order NSG to refund the affected amount to customers through subsequent Gas Charge filings.

The ICC issued orders on March 28, 2006, approving a settlement that resolved all proceedings regarding NSG for fiscal 2001 through 2004 costs. The orders adopted a January 17, 2006, Settlement Agreement and Release among and between NSG, the People of the State of Illinois through the Illinois Attorney General (AG), the City of Chicago (Chicago) and the Citizens Utility Board, as amended by an Amendment and Addendum dated March 6, 2006.

In its orders approving the settlement agreement, the ICC determined that \$4.0 million should be refunded to customers of NSG. In April 2006, the refund was credited to customer accounts. A charge totaling \$4.3 million was allocated to NSG in accordance with the orders.

Amounts refunded in connection with the Gas Charge reconciliation cases for fiscal years 2001 through 2004 relate to specific issues that occurred during that period and NSG does not believe them to be indicative of future actions that may be taken by the ICC with respect to current outstanding and future Gas Charge reconciliation cases.

Pursuant to the settlement agreement, PEC also paid \$5.0 million jointly to Chicago and the AG in 2006, of which \$0.2 million was allocated by management to NSG. Separately, PEC also agreed to pay up to \$5.0 million per year over the next five years (the "Subsequent Payments") toward the funding of conservation and weatherization programs for low and moderate income customers (the "Conservation Programs"). The Subsequent Payments of up to \$5.0 million each will be paid based upon Conservation Programs to be developed by Chicago and/or the AG. NSG will not seek recovery in any future rate or reconciliation cases of any amounts associated with the Conservation Programs. In July 2007, NSG received an itemized estimated cost and request for payment jointly from Chicago and the AG in the amount of \$0.4 million to fund Conservation Programs for the remainder of 2007. NSG management concluded that this estimated cost and request for payment constituted sufficient evidence that Chicago and the AG have established or are taking steps to develop valid Conservation Programs as required under the settlement agreement and that it is probable Chicago and the AG will request similar levels of annual funding through 2011 (Chicago and the AG made no allowance for a partial year in its request for payment for 2007). Consequently, NSG recorded a \$2.0 million liability and related charge to earnings in the quarter ended June 30, 2007, for Subsequent Payments representing its portion of the \$25.0 million in total Subsequent Payments. As of September 30, 2008, \$1.6 million remained unpaid, of which \$0.4 million was included in other current liabilities, and \$1.2 million was included in other long-term liabilities.

The settlement agreement provided that NSG would cooperate with Chicago and the AG to identify those customers of NSG who were not receiving natural gas as of the date of the settlement agreement that were financial hardship cases. The hardship cases were identified by NSG, the AG and Chicago. Following identification, NSG reconnected the hardship cases. NSG forgave all outstanding debt for reconnected customers. Although NSG believes it has fully complied with this provision of the settlement agreement, Chicago and the AG have indicated that they believe the terms of the hardship program are broader than what NSG believes it is obligated to implement. Management continues to believe that it has fully complied with the obligations of the settlement agreement with respect to the hardship program.

In the settlement agreement, NSG agreed to conduct internal and external audits of its natural gas procurement practices. An annual internal audit is required for five years, and the first two are completed. The external audit was performed by a consulting firm retained by the ICC. The ICC staff filed the auditor's report on April 10, 2008. The report included 32 recommendations, most of which are for NSG to prepare various studies and analyses or implement changes to certain practices and procedures. None of the recommendations quantified natural gas costs that the auditor believed should not be recovered by NSG. NSG filed a response to the auditor's report on June 30, 2008, in which it agreed to implement 25 of the recommendations. As of September 30, 2008, NSG had submitted implementation documentation for 20 of these recommendations. The remaining five are expected to be completed by March 31, 2009. The ICC staff may file a reply to NSG's response.

The fiscal 2005 Gas Charge reconciliation case was initiated in November 2005. The settlement of the prior fiscal years' Gas Charge reconciliation proceedings did not affect this case. The ICC staff and intervenor witnesses recommended disallowances. The majority of the recommended disallowances were for adjustments to the amount recorded as transportation customers' bank (storage) natural gas liability balances. For NSG, the ICC issued its order, which accepted the administrative law judges' recommendations and ICC staff's recommended disallowances in their entirety, on January 16, 2008. The natural gas cost disallowance for NSG is \$1.0 million. Prior to the quarter ended September 30, 2007, NSG had recorded a \$0.4 million liability primarily related to the ICC staff's proposed disallowance associated with the Gas Purchase and Agency Agreement that was at issue in the fiscal 2001-2004 cases (and in effect for only one month after 2004), which NSG stated in its rebuttal testimony it was not contesting and which was inclusive of accrued interest. In the quarter ended September 30, 2007, NSG recorded additional expense of \$0.7 million (including interest). On

February 14, 2008, NSG filed for rehearing on one of the two bank (storage) natural gas liability issues. The ICC denied rehearing on February 27, 2008, and NSG did not appeal this matter. Pursuant to the ICC order, NSG refunded customers \$1.1 million, including interest, during the nine months ended September 30, 2008.

The fiscal 2006 Gas Charge reconciliation case was initiated on November 21, 2006. NSG filed its direct testimony on April 10, 2007. On May 16, 2007, the ICC initiated a Gas Charge reconciliation case for the period of October 2006 through December 2006 to cover the gap created by NSG's move to a calendar year reconciliation period. The ICC staff moved to consolidate the new case with the fiscal 2006 case, and the administrative law judge granted the motion in July 2007. NSG's direct testimony for the October through December period was filed on October 17, 2007. On July 22, 2008, the ICC staff and intervenors (the AG and the Citizens Utility Board, filing jointly) each filed testimony recommending a disallowance for a bank (storage) natural gas liability adjustment similar to that addressed in the fiscal 2005 Gas Charge reconciliation case. On August 29, 2008, NSG filed rebuttal testimony in which it agreed not to contest the bank (storage) natural gas liability proposal. The amount recorded at NSG at September 30, 2008, related to the bank (storage) natural gas liability was not significant. The ICC staff and intervenors' rebuttal testimony is due November 6, 2008, and NSG's surrebuttal testimony is due December 2, 2008. A hearing is set for December 11, 2008.

The ICC initiated the calendar year 2007 Gas Charge reconciliation case on November 28, 2007. NSG filed direct testimony on April 15, 2008. A status hearing is scheduled for January 13, 2009.

#### Class Action

In February 2004, a purported class action was filed in Cook County Circuit Court against NSG, PEC, and PGL by customers of NSG and PGL, alleging, among other things, violation of the Illinois Consumer Fraud and Deceptive Business Practices Act related to matters at issue in the utilities' fiscal year 2001 Gas Charge reconciliation proceedings. In the suit, Alport et al. v. Peoples Energy Corporation, the plaintiffs seek unspecified compensatory and punitive damages. NSG and PGL have been dismissed as defendants and the only remaining counts of the suit allege violations of the Consumer Fraud and Deceptive Business Practices Act by PEC and that PEC acted in concert with others to commit a tortious act. PEC denies the allegations and is vigorously defending the suit. On July 30, 2008, the plaintiffs filed a motion for class certification and PEC responded in opposition of this motion. There is a status hearing scheduled for November 17, 2008.

#### **Builders Class Action**

In June 2005, a purported class action was filed against NSG by Birchwood Builders, LLC in the Circuit Court of Cook County, Illinois alleging that NSG was fraudulently and improperly charging fees to customers with respect to utility connections, disconnections, reconnections, relocations, extensions of natural gas service pipes, extensions of distribution natural gas mains, and failing to return related customer deposits. NSG filed two motions to dismiss the lawsuit. On January 25, 2007, the judge entered an order dismissing the complaint, but allowing the plaintiffs the option of filing an amended complaint (except as to the plaintiffs' claim for declaratory relief, which was dismissed with prejudice). The judge also ruled that the plaintiffs could file their claims directly with the ICC. On June 28, 2007, plaintiffs filed a second amended complaint with the Circuit Court. NSG responded by filing a motion to dismiss on August 31, 2007. This motion was granted on April 16, 2008, and this matter was dismissed. The plaintiffs filed a motion for reconsideration of the dismissal and this motion was denied on August 4, 2008. The plaintiffs filed a notice of appeal with the Illinois appellate court on August 25, 2008. The plaintiffs also have the right to file individual complaints with the ICC, but NSG does not know if, or when, any such complaints will be filed. In October 2008, the parties agreed to the terms of a settlement and are currently finalizing the settlement documents. Based upon the terms agreed to, the amount of the settlement will not be material to NSG.

## NOTE 9--EMPLOYEE BENEFIT PLANS

On September 30, 2008, the PEC Service Annuity System was merged into the PEC Retirement Plan, which was then renamed the Integrys Energy Group Retirement Plan. The merger had no effect on the level of plan benefits provided to participants or the management of plan assets.

The following table shows the components of NSG's share of net periodic benefit cost for benefit plans sponsored by PEC for the three and nine months ended September 30, 2008, and 2007:

(Millions)	Pension Benefits				Other Postretirement Benefits			
	Three Months Ended		Nine Months Ended		Three Months Ended		Nine Months Ended	
	September 30 2008	2007	September 30 2008	2007	September 30 2008	2007	September 30 2008	2007
Service cost	\$0.3	\$0.3	\$0.9	\$1.0	\$0.2	\$0.2	\$0.6	\$0.5
Interest cost	0.4	0.4	1.3	1.3	0.3	0.2	0.7	0.6
Expected return on plan assets	(0.3)	(0.3)	(0.9)	(0.9)	-	-	(0.1)	(0.1)
Amortization of transition obligation	-	-	-	-	-	-	0.1	0.1
Amortization of prior service cost	-	0.1	0.1	0.1	-	-	-	-
Amortization of net actuarial loss	-	0.1	0.1	0.2	-	-	0.1	0.1
<b>Net periodic benefit cost</b>	<b>0.4</b>	<b>0.6</b>	<b>1.5</b>	<b>1.7</b>	<b>0.5</b>	<b>0.4</b>	<b>1.4</b>	<b>1.2</b>
Effect of lump sum settlements upon retirement	0.1	(0.1)	0.2	0.3	-	-	-	-
<b>Net benefit cost</b>	<b>\$0.5</b>	<b>\$0.5</b>	<b>\$1.7</b>	<b>\$2.0</b>	<b>\$0.5</b>	<b>\$0.4</b>	<b>\$1.4</b>	<b>\$1.2</b>

Retiring employees have the option of receiving retirement benefits in the form of an annuity or a lump sum payment. During the three and nine months ended September 30, 2008, and 2007, a portion of each pension plan's projected benefit obligation was settled by the payment of lump sum benefits, resulting in a settlement cost under SFAS No. 88, "Employer's Accounting for Settlements and Curtailments of Defined Benefit Plans and for Termination Benefits."

NSG records transition obligations, prior service costs, and net actuarial losses that have not yet been recognized as a component of net periodic benefit cost as net regulatory assets, pursuant to SFAS No. 71.

Contributions to the plans are made in accordance with legal and tax requirements and do not necessarily occur evenly throughout the year. For the nine months ended September 30, 2008, \$1.0 million and \$0.1 million of contributions were made to the pension and other postretirement benefit plans, respectively. NSG does not expect to contribute additional amounts to its pension benefit plans during the remainder of 2008. NSG expects to contribute \$0.3 million to its other postretirement benefit plans during the remainder of 2008.

NSG adopted the change in measurement date transition requirements of SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)," effective January 1, 2008 by remeasuring plan assets and benefit obligations as of that date. Previously, NSG used a September 30 measurement date for its defined pension and other postretirement benefit plans. As a result of the change in measurement date, a \$1.0 million pre-tax reduction to retained earnings was recognized on January 1, 2008.

## NOTE 10--FAIR VALUE

Effective January 1, 2008, NSG adopted SFAS No. 157, "Fair Value Measurements." This standard defines fair value and requires enhanced disclosures about assets and liabilities carried at fair value. As of September 30, 2008, these additional disclosures are required only for financial assets and liabilities measured at fair value and for nonfinancial assets and liabilities measured at fair value on a recurring basis, following the guidance in FASB Staff Position FAS 157-2, "Effective Date of FASB Statement No. 157."

According to SFAS No. 157, 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). However, as permitted under SFAS No. 157, NSG utilizes a mid-market pricing convention (the mid-point price between bid and ask prices) as a practical expedient for valuing the majority of its derivative assets and liabilities.

SFAS No. 157 establishes 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 defined by SFAS No. 157 are 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.

As required by SFAS No. 157, financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. The following table shows NSG's financial assets and liabilities that were accounted for at fair value on a recurring basis as of September 30, 2008, categorized by level within the fair value hierarchy.

<i>(Millions)</i>	Level 1	Level 2	Level 3	Total	Netting*	Balance Sheet Presentation
Assets						
Risk management assets	\$ -	\$47.3	\$ -	\$47.3	\$46.2	\$ 1.1
Liabilities						
Risk management liabilities	-	70.6	-	70.6	47.0	23.6

\* FASB Interpretation No. 39, as amended, permits the netting of risk management assets and liabilities when a legally enforceable netting agreement exists, and requires the netting of related cash collateral positions against the net derivative positions.

The risk management assets and liabilities listed in the above table include swaps, options, and natural gas purchase contracts used to manage volatility in natural gas supply costs. Certain derivative instruments are valued using broker quotes or prices for similar contracts at the reporting date, which are Level 2 inputs. The valuation of certain contracts also includes an adjustment related to transportation, and NSG's financial fixed price options are valued using a model, incorporating mid-market prices obtained from the NYMEX. These contracts are also classified in Level 2. All of NSG's risk management assets and liabilities are offset by regulatory assets or liabilities, pursuant to SFAS No. 71, as NSG's tariffs allow for full recovery from customers of prudently incurred natural gas supply costs.

## NOTE 11--REGULATORY ENVIRONMENT

### 2008 Rate Case

On February 5, 2008, the ICC issued a final written order requiring a retail natural gas rate decrease of \$0.2 million for NSG. The new rates for NSG reflect a 9.99% return on common equity and a common



equity ratio of 56% in its regulatory capital structure. The order included approval of a VBA decoupling mechanism, effective March 1, 2008, as a four-year pilot program, which will allow NSG to adjust rates going forward to recover or refund the difference between the actual and authorized delivery charge components of revenue. Legislation was introduced at the Illinois state legislature to roll back decoupling but never reached a vote. This legislation may be introduced again. NSG is actively supporting the ICC's decision to approve this rate setting mechanism. The order also approved an Enhanced Efficiency Program, which will allow NSG to recover \$1.1 million of energy efficiency costs. NSG filed tariffs in compliance with the order on February 8, 2008, and the new rates became effective February 14, 2008.

On March 26, 2008, the ICC denied NSG's request for rehearing of its rate order, and all but one such request from intervenors. On April 28, 2008, NSG filed a Notice of Appeal with the Illinois appellate court regarding the ICC's order denying rehearing on certain issues. On April 30, 2008, the ICC submitted a letter to the Illinois appellate court stating that rehearing is pending before the ICC and, while the ICC would not file to dismiss the NSG appeal as premature, it requested that the court hold the due date for the ICC to file the record with the court. On May 2, 2008, two intervenors each separately filed a Notice of Appeal. On June 6, 2008, several parties filed a stipulation to resolve the single issue on which the ICC granted rehearing, but the resolved issue only affects PGL. On July 30, 2008, the ICC approved the stipulation as well as a rehearing order. The approved stipulation took effect on November 1, 2008. Subsequent to the approval of the stipulation, NSG filed an appeal in the second district of the Illinois appellate court and after that, four other parties filed appeals in the first district of the Illinois appellate court. On September 29, 2008, the ICC asked the Illinois Supreme Court to vacate the second district's transfer of the appeal to the first district, and the Illinois Supreme Court denied the ICC's motion. On appeal, parties may only raise issues on which they sought rehearing at the ICC. These issues include the VBA decoupling mechanism. No decision on the appeal is expected until at least the second half of 2009.

#### **NOTE 12--SEGMENTS OF BUSINESS**

NSG has two business segments. NSG's results of operations, including allocations for corporate activities, are reported in the Natural Gas Utility segment, with non-utility operations reported in the Other segment. No items were reported in the Other segment for any of the periods presented.

#### **NOTE 13--NEW ACCOUNTING PRONOUNCEMENTS**

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities - an amendment of FASB Statement No. 133." SFAS No. 161 requires enhanced disclosures about (1) how and why an entity uses derivative instruments, (2) how derivative instruments and related hedged items are accounted for under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended, and (3) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. SFAS No. 161 is effective for NSG during the quarter ending March 31, 2009. We are currently evaluating the impact that the adoption of SFAS No. 161 will have on our financial statements and disclosures.

## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion should be read in conjunction with the accompanying Condensed Financial Statements and related Notes and our Annual Report on Form 10-K for the year ended December 31, 2007.

### **INTRODUCTION**

NSG, an indirect wholly owned subsidiary of Integrys Energy Group, is a regulated utility that purchases, stores, distributes, sells, and transports natural gas to about 158,000 customers in 54 communities in northeastern Illinois.

#### **Strategic Overview**

The focus of NSG's business plan is the creation of long-term value for Integrys Energy Group's shareholders and for NSG's customers through growth, operational excellence, customer focus, asset management, risk management, and a continued emphasis on reliable, competitively priced, and environmentally sound natural gas services. A discussion of the essential components of NSG's business strategy is set forth below.

**Maintain and Grow a Strong Regulated Utility Base** – A strong regulated utility base is important in order to maintain a strong balance sheet, predictable cash flows, a desired risk profile, and quality credit ratings, which are critical to NSG's success. NSG continues to upgrade its natural gas distribution facilities, related systems, and processes, seeking to enhance safety, reliability, and value for NSG's customers and Integrys Energy Group's shareholders.

**Integrate Resources to Provide Operational Excellence** – NSG is committed to integrating resources and finding the most efficient processes while adhering to any and all applicable regulatory and legal requirements. Through innovative ideas, embracing change, leveraging individual capabilities and expertise, and utilizing creative solutions to meet and exceed its customers' expectations, NSG strives to provide value to Integrys Energy Group's shareholders and NSG's customers and assist in lowering costs for certain activities. NSG believes the following activities have helped, and will continue to help, integrate resources to provide operational excellence and customer focus:

- Integrys Business Support, LLC, a wholly owned subsidiary of Integrys Energy Group, was formed to achieve a significant portion of the cost synergies anticipated from the PEC merger through the consolidation and efficient delivery of various support services and to provide more consistent and transparent allocation of costs throughout Integrys Energy Group and its subsidiaries.
- "Competitive Excellence" and project management initiatives are being implemented at NSG to improve processes, reduce costs, and manage projects within budget and timeline constraints to provide more value to customers.

**Place Strong Emphasis on Asset and Risk Management** – NSG's risk management strategy includes the management of market, credit, and operational risk through the normal course of business. Forward purchases of natural gas, as well as financial derivative contracts, allow opportunities to secure prices in a volatile market. NSG's asset management strategy calls for the continuous assessment of its existing assets, including the disposition of assets which are no longer needed for ongoing operations.

**Continued Emphasis on Safe, Reliable, Competitively Priced, and Environmentally Sound Natural Gas Services** – NSG's mission is to provide customers with the best value in natural gas services. By effectively operating its natural gas distribution facilities, while maintaining or exceeding environmental standards, NSG seeks to provide a safe, reliable, and value-priced service to its customers. NSG

concentrates its efforts on improving and operating efficiently and effectively in order to reduce costs and maintain a low risk profile. NSG works to manage its operations to reduce the impact it might have on the environment.

## RESULTS OF OPERATIONS

<i>(Millions)</i>	Three Months Ended		% Increase (Decrease)	Nine Months Ended		% Increase (Decrease)
	September 30 2008	September 30 2007		September 30 2008	September 30 2007	
Net income (loss)	<b>\$(0.4)</b>	\$(1.3)	(69.2)%	<b>\$5.0</b>	\$4.9	2.0%

NSG's net loss decreased \$0.9 million quarter-over-quarter. As discussed in more detail below, this decrease in net loss was driven by a \$2.9 million (\$1.7 million after-tax) increase in natural gas margin, partially offset by a \$0.6 million (\$0.4 million after-tax) increase in operating and maintenance expenses and a \$0.6 million (\$0.4 million after-tax) increase in depreciation and amortization expense.

NSG's net income increased \$0.1 million during the nine months ended September 30, 2008, compared with the same period in 2007. The increase was primarily driven by a \$5.3 million (\$3.2 million after-tax) increase in natural gas margin and by the positive period-over-period impact of a \$2.0 million (\$1.2 million after-tax) natural gas charge settlement recorded in 2007, partially offset by a \$6.2 million (\$3.7 million after-tax) increase in operating and maintenance expenses and a \$0.9 million (\$0.5 million after-tax) increase in depreciation and amortization expense.

As part of the regulatory approval for the merger between Integrys Energy Group and PEC, Integrys Energy Group formed a service company, Integrys Business Support, LLC, on January 1, 2008. As a result, the methodology used to allocate certain costs to NSG in 2008 is based on an affiliated interest agreement filed and approved in Illinois and is different than the methodology used prior to January 1, 2008. This methodology will be reviewed annually and will be adjusted, if necessary, with the approval of the applicable regulatory bodies.

NSG's results of operations for the periods ended September 30 are shown in the following table:

<i>(Millions, except heating degree days)</i>	Three Months Ended			Nine Months Ended		
	September 30		% Increase	September 30		% Increase
	2008	2007	(Decrease)	2008	2007	(Decrease)
Revenues	<b>\$33.2</b>	\$22.9	45.0%	<b>\$215.6</b>	\$192.6	11.9%
Natural gas purchased for resale	<b>20.8</b>	13.4	55.2%	<b>163.5</b>	145.8	12.1%
Margins	<b>12.4</b>	9.5	30.5%	<b>52.1</b>	46.8	11.3%
Operating and maintenance expense	<b>9.3</b>	8.7	6.9%	<b>35.0</b>	28.8	21.5%
Natural gas charge settlement	-	-	-%	-	2.0	(100.0)%
Depreciation and amortization expense	<b>2.0</b>	1.4	42.9%	<b>5.3</b>	4.4	20.5%
Taxes other than income taxes	<b>0.5</b>	0.8	(37.5)%	<b>1.5</b>	2.0	(25.0)%
Operating income (loss)	<b>0.6</b>	(1.4)	-%	<b>10.3</b>	9.6	7.3 %
Miscellaneous income	<b>0.1</b>	0.3	(66.7)%	<b>0.7</b>	1.1	(36.4)%
Interest expense	<b>(1.1)</b>	(1.1)	-%	<b>(3.1)</b>	(3.1)	-%
Other expense	<b>(1.0)</b>	(0.8)	25.0%	<b>(2.4)</b>	(2.0)	20.0%
Income (loss) before taxes	<b>(0.4)</b>	(2.2)	(81.8)%	<b>7.9</b>	7.6	3.9%
Provision (benefit) for income taxes	-	(0.9)	-%	<b>2.9</b>	2.7	7.4%
Net Income (loss)	<b>\$(0.4)</b>	\$(1.3)	(69.2)%	<b>\$ 5.0</b>	\$ 4.9	2.0%
<b>Throughput in therms</b>						
Residential	<b>14.1</b>	13.5	4.4%	<b>139.3</b>	133.4	4.4%
Commercial and industrial	<b>2.9</b>	2.9	-%	<b>30.2</b>	29.2	3.4%
Transport	<b>21.0</b>	20.6	1.9%	<b>98.2</b>	91.8	7.0%
Total sales in therms	<b>38.0</b>	37.0	2.7%	<b>267.7</b>	254.4	5.2%
<b>Weather</b>						
Heating degree days	<b>53</b>	55	(3.6)%	<b>4,220</b>	3,863	9.2%

### ***Third Quarter 2008 Compared with Third Quarter 2007***

#### **Revenue**

Revenues increased \$10.3 million for the quarter ended September 30, 2008, compared with the same quarter last year. The major factors contributing to the quarter-over-quarter change in revenues were as follows:

- The per-unit cost of natural gas increased 48.6% in the third quarter of 2008 compared with the same period in 2007. This drove a \$6.7 million increase in revenues, as increases in natural gas commodity costs are passed directly through to customers in rates.
- Revenues increased \$1.9 million due to a change in the rate design related to the rate order effective February 14, 2008. The new rate design incorporates higher fixed customer charges and lower volumetric rates.
- Revenues increased \$0.4 million due to NSG's recovery of higher quarter-over-quarter expenditures related to the cleanup of former manufactured gas plant sites. This increase in revenues was offset by an increase in operating expenses due to the amortization of the related regulatory asset.

### Margin

NSG's margin increased \$2.9 million for the quarter ended September 30, 2008, compared with the same quarter in 2007, primarily due to the \$1.9 million impact of the new rate design and the \$0.4 million impact of increased quarter-over-quarter recovery of environmental costs in rates.

### Operating Income

Operating income increased \$2.0 million, driven by the \$2.9 million increase in margin discussed above, partially offset by a \$0.6 million increase in operating and maintenance expenses.

The increase in operating and maintenance expenses was driven by a \$0.4 million increase in the amortization of the regulatory asset related to cleanup costs of manufactured gas plant sites, as well as combined amortization expense of \$0.3 million related to costs to achieve merger synergies and costs pertaining to the 2007/2008 rate case, which were initially deferred as regulatory assets.

### Other Expense

Other expense increased \$0.2 million quarter-over-quarter, primarily due to decreased interest income on cash investments.

### ***Nine Months 2008 Compared with Nine Months 2007***

### Revenue

Revenues increased \$23.0 million for the nine months ended September 30, 2008, compared with the same period last year. The major factors contributing to the period-over-period change in revenues were as follows:

- Weather that was 9.2% colder than last year led to a \$12.2 million increase in revenues compared with the same period last year.
- The per-unit cost of natural gas increased 7.2% during the nine months ended September 30, 2008, compared with the same period in 2007. This drove an \$11.0 million increase in revenues.
- Revenues increased \$1.8 million due to NSG's recovery of higher period-over-period expenditures related to the cleanup of former manufactured gas plant sites. This increase in revenues was offset by an increase in operating expenses due to the amortization of the related regulatory asset.
- Revenues increased \$2.1 million due to a change in the rate design under the rate order effective February 14, 2008. The new rate design incorporates higher fixed customer charges and lower volumetric rates.
- Partially offsetting the increases discussed above was a decrease in revenues of \$3.4 million resulting from a decrease in natural gas throughput volumes, excluding the impact of weather, which we believe is primarily due to customer conservation efforts related to higher energy prices.

### Margin

NSG's margin increased \$5.3 million for the nine months ended September 30, 2008, compared with the same period in 2007, primarily due to the \$2.1 million impact of the new rate design, the \$1.8 million impact of increased recovery of environmental costs period-over-period, and the \$0.9 million positive impact of colder period-over-period weather conditions prior to the implementation of NSG's VBA decoupling rider on March 1, 2008. This rate rider substantially offsets the impact of weather conditions after that date.

### Operating Income

Operating income increased \$0.7 million, driven by the \$5.3 million increase in margin discussed above and by the positive period-over-period impact of a \$2.0 million natural gas charge settlement recorded in 2007, partially offset by a \$6.2 million increase in operating and maintenance expenses. The increase in operating and maintenance expenses primarily related to:

- A \$3.5 million increase in various operating costs, driven by increases in legal and external affairs expenses, customer call center expenses, and intercompany service costs.
- An increase of \$1.8 million in the amortization of the regulatory asset related to cleanup costs of manufactured gas plant sites. These costs are recovered from customers in rates after expenditures are made.
- A \$0.8 million increase in the combined amortization expense related to costs to achieve merger synergies and costs pertaining to the 2007/2008 rate case, which were initially deferred as regulatory assets.

### Other Expense

Other expense increased \$0.4 million for the nine months ended September 30, 2008, compared with the same period in the prior year, primarily due to decreased interest income on cash investments.

### **Provision for Income Taxes**

	<b>Three Months Ended September 30</b>		<b>Nine Months Ended September 30</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Effective Tax Rate	- %	40.9%	<b>36.7%</b>	35.5%

Quarter-over-quarter changes in the effective tax rate occur as a result of adjustments required by generally accepted accounting principles (GAAP) to ensure the year-to-date effective tax rate reflects the projected annual effective tax rate. The third quarter 2008 effective tax rate was impacted by a reduction in management's annual estimate of permanent book to tax return differences as a percentage of pre-tax income, combined with the impact of changes in uncertain tax positions.

The increase in the year-to-date effective tax rate is primarily due to the impact of lower tax benefit amounts estimated by management, offset slightly by the impact of expected lower annual pre-tax income in 2008 compared with 2007.

## LIQUIDITY AND CAPITAL RESOURCES

NSG believes that its cash balances, liquid assets, operating cash flows, and available borrowing capacity (related party and third party) provide adequate resources to fund ongoing operating requirements and future capital expenditures. However, NSG's operating cash flows and access to capital markets can be impacted by macroeconomic factors outside of its control. In addition, its borrowing costs can be impacted by short-term and long-term debt ratings assigned by independent credit rating agencies.

### Operating Cash Flows

During the nine months ended September 30, 2008, net cash provided by operating activities was \$17.1 million, compared with \$16.2 million for the same period in 2007. The period-over-period increase was largely driven by an increase in net income adjusted for non-cash items during the nine months ended September 30, 2008, compared with the same period in 2007. This increase was partially offset by a \$7.4 million decrease in cash provided by working capital during the nine months ended September 30, 2008, compared with the same period in 2007. This decrease was primarily the result of an increase in cash used to purchase natural gas inventories due to an increase in natural gas prices and an increase in the amount of natural gas injected into storage during the nine months ended September 30, 2008, compared with the nine months ended September 30, 2007.

### Investing Cash Flows

Net cash used for investing activities was \$6.4 million during the nine months ended September 30, 2008, which is consistent with the \$6.4 million used for investing activities during the same period in 2007.

### Financing Cash Flows

Net cash used for financing activities increased \$6.1 million, from \$4.6 million during the nine months ended September 30, 2007, to \$10.7 million during the nine months ended September 30, 2008, primarily due to the repayment of related party loans in 2008, partially offset by a reduction in dividends paid on common stock. The repayment of related party loans was made possible by cash provided by operating activities.

### *Credit Ratings*

The current credit ratings for NSG are listed in the table below.

	Standard & Poor's	Moody's
Issuer credit rating	A-	n/a
Senior secured debt	A	A1

NSG believes these ratings continue to be among the best in the energy industry and allow us to access borrowings. Credit ratings are not recommendations to buy and are subject to change, and each rating should be evaluated independently of any other rating. None of NSG's credit ratings changed since NSG filed its 2007 Annual Report on Form 10-K.

## Future Capital Requirements and Resources

### *Contractual Obligations*

The following table shows the contractual obligations of NSG as of September 30, 2008:

(Millions)	Total Amounts Committed	Payments Due By Period			
		2008	2009- 2010	2011 - 2012	2013 and Thereafter
Long-term debt principal and interest payments <sup>(1)</sup>	\$108.1	\$1.7	\$ 6.6	\$ 6.6	\$ 93.2
Commodity purchase obligations <sup>(2)</sup>	45.9	4.9	14.3	9.2	17.5
Purchase orders <sup>(3)</sup>	3.1	3.1	-	-	-
Minimum pension funding	11.3	-	4.4	4.2	2.7
Total contractual cash obligations	\$168.4	\$9.7	\$25.3	\$20.0	\$113.4

<sup>(1)</sup> Represents bonds issued by NSG. NSG records all principal obligations on the balance sheet.

<sup>(2)</sup> The costs of commodity purchase obligations are expected to be recovered in future customer rates.

<sup>(3)</sup> Includes obligations related to normal business operations and construction obligations.

The table above does not reflect any payments related to the manufactured gas plant remediation liability of \$92.8 million at September 30, 2008, as the amount and timing of payments are uncertain. See Note 8, "*Commitments and Contingencies*," for more information. Also, the table does not reflect any payments for the September 30, 2008, liability for uncertain tax positions. See Note 7, "*Income Taxes*."

### *Capital Requirements*

NSG makes large investments in capital assets. Net construction expenditures are expected to be \$40.3 million in the aggregate for the 2008 through 2010 period. The largest of these expenditures relates to NSG's natural gas pipe distribution system. Although not anticipated, NSG would be able to postpone certain construction expenditures based on credit market and economic conditions.

### *Capital Resources*

NSG has the ability to borrow up to \$50.0 million from PEC and to loan to or borrow from PGL up to \$50.0 million. As of September 30, 2008, there were loans of \$4.8 million from PEC to NSG.

NSG's indenture relating to its first mortgage bonds contains provisions and covenants restricting the payment of cash dividends and the purchase or redemption of capital stock. At September 30, 2008, such restrictions amounted to \$6.9 million of NSG's total retained earnings of \$77.5 million. As of September 30, 2008, NSG was in compliance with all of the covenants under its credit facilities and other obligations. For the period 2008 through 2010, NSG plans to use internally generated funds, debt financings, and equity infusions to fund capital requirements. Management believes NSG has adequate financial flexibility and resources to meet its future needs.

## Other Future Considerations

### *Impact of Financial Market Turmoil*

As widely reported, the financial markets and overall economies in the United States and abroad are currently undergoing a period of significant uncertainty and volatility. As a result of recent events, NSG's



management has placed increased emphasis on monitoring the risks associated with the current credit market environment. While the impact of continued market volatility and the extent and impacts of any economic downturn cannot be predicted, management currently believes that NSG has sufficient operating flexibility and access to funding sources to maintain adequate amounts of liquidity.

The recent volatility in global capital markets has led to a reduction in the current value of NSG's share of long-term investments held in the pension and other postretirement benefit plan trusts sponsored by PEC. The recent decline in asset value of the plans, if it continues for any length of time, could result in higher pension and other postretirement benefit expenses, and additional future funding requirements.

#### *Illinois Sales Tax Increases*

The Regional Transportation Authority approved a 0.25% sales tax rate increase in Cook County, Illinois, and a 0.50% sales tax rate increase in DuPage, Kane, Lake, McHenry, and Will Counties. These increases in sales taxes occurred on July 1, 2008, and will impact the cost of certain goods and services purchased by NSG for use in its operations.

#### *Reserve for Uncollectible Accounts*

The reserve for uncollectible accounts reflects NSG's best estimate of probable losses on its accounts receivable balances. The reserve is based on known troubled accounts, historical experience, and other currently available evidence. Provisions for bad debt expense are affected by changes in various factors, including the impacts of natural gas prices and weather.

The impact of higher natural gas prices and a declining economic environment on customers could cause more of NSG's accounts receivable to be uncollectible. Higher levels of uncollectible balances from customers would negatively impact NSG's results of operations and could result in higher working capital requirements.

#### *Decoupling*

In the current political, economic, and regulatory environment, the focus on energy efficiency can lead to the implementation of VBA decoupling mechanisms. Decoupling was approved by the ICC on a four-year trial basis on February 5, 2008. Under decoupling, NSG is allowed to adjust rates going forward to recover or refund the difference between the actual and authorized delivery charge components of revenue. Interveners, including the Illinois Attorney General, oppose decoupling and have appealed the ICC's approval. NSG is actively supporting the ICC's decision to approve decoupling. See Note 11, "*Regulatory Environment*," for more information.

### **CRITICAL ACCOUNTING POLICIES**

NSG has reviewed its critical accounting policies for new critical accounting estimates and other significant changes. NSG found that the disclosures made in its Annual Report on Form 10-K for the year ended December 31, 2007, are still current and that there have been no significant changes.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

None.

**Item 4. Controls and Procedures****Evaluation of Disclosure Controls and Procedures**

As of the end of the period covered by this Quarterly Report on Form 10-Q, NSG's management, with the participation of NSG's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of NSG's disclosure controls and procedures (as defined in the Securities Exchange Act of 1934 Rules 13a-15(e) and 15d-15(e)) and has concluded that, as of the date of such evaluation, NSG's disclosure controls and procedures were effective in accumulating and timely alerting them to information relating to NSG as appropriate to allow timely decisions regarding required disclosure to be included in its periodic SEC filings, particularly during the period in which this Quarterly Report on Form 10-Q was being prepared.

**Changes in Internal Controls**

There were no changes in NSG's internal controls over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934) that occurred during the quarter ended September 30, 2008, that have materially affected, or are reasonably likely to materially affect, its internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

See Note 8, "*Commitments and Contingencies*," and Note 11, "*Regulatory Environment*," for discussions pertaining to environmental matters, proceedings at the ICC, a purported class action filed against NSG by its customers alleging violation of the Illinois Consumer Fraud and Deceptive Business Practices Act, and other events and proceedings.

### Item 1A. Risk Factors

There were no material changes to the risk factors pertaining to NSG as presented in the NSG Annual Report on Form 10-K for the fiscal year ended December 31, 2007.

### Item 6. Exhibits

The following documents are attached as exhibits:

<u>Exhibit Number</u>	<u>Description of Document</u>
12	Ratio of Earnings to Fixed Charges
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 North Shore Gas Company
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 North Shore Gas Company
32	Written Statement of the Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 for North Shore Gas Company

## **SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, the registrant, North Shore Gas Company, has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

North Shore Gas Company

Date: November 5, 2008

/s/ Diane L. Ford

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Diane L. Ford

Vice President and Corporate Controller

(Duly Authorized Officer and  
Chief Accounting Officer)

**NORTH SHORE GAS COMPANY  
EXHIBIT INDEX TO FORM 10-Q  
FOR THE QUARTER ENDED SEPTEMBER 30, 2008**

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North Shore Gas Company  
Ratio of Earnings to Fixed Charges

			Three-Month Transition				
(Millions)	2008 9 months	Year Ended 12/31/2007	Period Ended 12/31/2006	Years Ended September 30			
				2006	2005	2004	2003
EARNINGS							
Earnings on common stock	\$5.0	\$7.9	\$4.4	\$6.7	\$11.4	\$11.1	\$14.6
Federal and state income taxes	2.9	5.2	2.6	3.8	6.7	6.7	8.7
Net pretax income	7.9	13.1	7.0	10.5	18.1	17.8	23.3
Fixed charges	3.1	4.2	1.1	4.1	3.8	3.7	3.6
Total earnings as defined	\$11.0	\$17.3	\$8.1	\$14.6	\$21.9	\$21.5	\$26.9
FIXED CHARGES							
Interest on long-term debt, including related amortization	\$2.7	\$3.5	\$0.9	\$3.6	\$3.6	\$3.6	\$3.4
Other interest	0.4	0.7	0.2	0.5	0.2	0.1	0.2
Fixed charges	\$3.1	\$4.2	\$1.1	\$4.1	\$3.8	\$3.7	\$3.6
Ratio of earnings to fixed charges	3.5	4.1	7.4	3.6	5.8	5.8	7.5

Due to a number of factors, including the seasonality of NSG's business and market price volatility, the current year-to-date earnings should not be considered indicative of the results to be expected for the year as a whole.

**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**

I, Lawrence T. Borgard, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of North Shore Gas Company;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an Annual Report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 5, 2008

/s/ Lawrence T. Borgard  
Lawrence T. Borgard  
Chief Executive Officer

**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**

I, Joseph P. O'Leary, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of North Shore Gas Company;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an Annual Report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 5, 2008

/s/ Joseph P. O'Leary  
Joseph P. O'Leary  
Senior Vice President and Chief Financial Officer



**Written Statement of the Chief Executive Officer and Chief Financial Officer  
Pursuant to 18 U.S.C. Section 1350**

Solely for the purposes of complying with 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, we, the undersigned Chief Executive Officer and Chief Financial Officer of North Shore Gas Company (the "Company"), hereby certify, based on our knowledge, that the Quarterly Report on Form 10-Q of the Company for the quarter ended September 30, 2008 (the "Report") fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934 and that information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Lawrence T. Borgard  
Lawrence T. Borgard  
Chief Executive Officer

/s/ Joseph P. O'Leary  
Joseph P. O'Leary  
Senior Vice President and Chief Financial Officer

Date: November 5, 2008