

STATE OF MICHIGAN

BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

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In the matter of the application of)
UPPER PENINSULA POWER COMPANY)
for authority to increase retail electric rates.)
_____)

Case No. U-16417

DIRECT TESTIMONY AND EXHIBITS OF
CHRISTINE M. PHILLIPS, CPA
FOR
UPPER PENINSULA POWER COMPANY

STATE OF MICHIGAN

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**QUALIFICATIONS
OF
CHRISTINE M. PHILLIPS, CPA
PART I**

1 **Q. Please state your name, position and business address.**

2 A. My name is Christine M. Phillips. My business address is Integrys Business Support
3 (“IBS”), 130 East Randolph Drive, Chicago, Illinois 60601. I am Manager - Benefits
4 Accounting in the Benefits Accounting Department of Integrys Energy Group, Inc.
5 (“Integrys”). Both IBS and Upper Peninsula Power Company (“UPPCO”) are wholly-
6 owned subsidiaries of Integrys.

7

8 **Q. For whom are you providing testimony?**

9 A. I am providing testimony on behalf of UPPCO.

10

11 **Q. Please describe briefly your educational, professional, and utility background.**

12 A. I have a Bachelor of Science Degree from Illinois Wesleyan University with a major
13 in Accounting. I am registered in the State of Illinois as a Certified Public Accountant
14 (“CPA”) and have been employed by IBS or its predecessors since May of 1990. In
15 my current position in the Benefits Accounting Department, my primary duties
16 include the accounting for the costs of the employee benefit plans, coordinating the
17 forecasting done by the actuaries, and ensuring accounting and legal compliance of
18 the employee benefit plans and trusts for Integrys and its subsidiaries, including

1 UPPCO.

2

3 **Q. Have you previously testified before any regulatory agency?**

4 A. Yes, I have. I have testified before the Illinois Commerce Commission on behalf of
5 The Peoples Gas Light and Coke Company, and North Shore Gas Company in
6 Docket Nos. 09-0240/0241 and 11-0280/0281. I have submitted testimony before
7 the Michigan Public Service Commission on behalf of UPPCO in Case Nos. U-15988
8 and U-16166, and on behalf of Michigan Gas Utilities Corporation in Case U-15990.
9 I have also submitted testimony before the Public Service Commission of Wisconsin
10 in Docket Nos. 6690-UR-119 and 6690-UR-120.

**CHRISTINE M. PHILLIPS, CPA
DIRECT TESTIMONY
PART II**

1 **Q. What is the purpose of your pre-filed direct testimony?**

2 A. The purpose of my pre-filed direct testimony is to explain the methodologies used to
3 determine UPPCO's forecast of 2012 employee benefit costs.

4

5 **Q. Are you sponsoring any exhibits in this proceeding?**

6 A. Yes, I am. I am sponsoring Exhibit A-3 (CMP-1), Schedules C25 and C26.

7

8 **Q. Were Schedules C25 and C26 of Exhibit A-3 prepared by you or under your
9 direction and supervision?**

10 A. Yes, they were.

11

12 **Q. Please describe Exhibit A-3 (CMP-1), Schedule C25.**

13 A. Exhibit A-3 (CMP-1), Schedule C25 is a summary, by sub-account, of employee
14 benefit costs for UPPCO employees for the 2010 historic year, and the 2012
15 projected year, inclusive of UPPCO's allocation of employee benefit costs from IBS.

16

17 **Q. Please describe Exhibit A-3 (CMP-1), Schedule C26.**

18 A. Exhibit A-3 (CMP-1), Schedule C26 is a summary, by sub-account, of IBS employee
19 benefit costs for the 2010 historic year, and the 2012 projected year. This exhibit
20 also calculates UPPCO's allocation of employee benefit costs from IBS.

21

22 **Q. What is the current forecast of employee benefit costs for UPPCO for 2012?**

23 A. The current forecast of employee benefit costs for UPPCO, on a corporate basis, for
24 the 2012 projected year is \$7,385,990, inclusive of UPPCO's allocation of employee

1 benefit costs from IBS. This compares to \$5,202,102 for the 2010 historic year, on a
2 corporate basis. This is an increase of \$2,183,888 over a two-year period, or 42.0%.
3 This 42.0% increase over two years corresponds to an increase of 19.16% per year.
4

5 **Forecasting Methodologies**

6 **Q. How was the forecast of employee benefit costs for UPPCO for 2012**
7 **developed?**

8 A. As shown on Exhibit A-3 (CMP-1), Schedule C25, UPPCO divided the forecast of
9 employee benefit costs into three categories. These categories were:

- 10 1. Forecasted 2012 costs that were determined by UPPCO estimates,
- 11 12 2. Forecasted 2012 costs that were determined by inflating 2010 actual
13 costs, and
- 14 15 3. Forecasted 2012 costs that were determined through actuarial analysis.

16

17 **Employee Benefit Costs that were Estimated by UPPCO**

18 **Q. Please describe the process used to determine the forecasted 2012 employee**
19 **benefit costs that were determined by UPPCO estimates.**

20 A. There are three. The total impact of these three items is a net increase of \$388,230
21 from 2010 to 2012.

22

23 First, as shown on Exhibit A-3 (CMP-1), Schedule C25, line 1, regarding the costs
24 recorded in Account 926080 A&G Dental Benefits, UPPCO estimates the 2012 costs
25 to be \$116,551. The overall increase in 2012 costs as compared to 2010 costs is
26 \$10,836. Projected dental costs were calculated by using a 5% annual inflation rate
27 based on preliminary renewal results and trend information received from UPPCO's
28 independent actuary, Towers Watson.

29

30 Second, as shown on Exhibit A-3 (CMP-1), Schedule C25, line 2, regarding the costs

1 recorded in Account 926090 A&G Medical Benefits, UPPCO estimates the 2012
2 costs to be \$1,501,713. The overall increase in 2012 costs as compared to 2010
3 costs is \$214,236. Projected medical costs for 2012 were calculated by using an 8%
4 annual inflation rate based on preliminary renewal results and trend information
5 received from UPPCO's actuary, Towers Watson.

6
7 Third, as shown on Exhibit A-3 (CMP-1), Schedule C25, line 3, regarding the costs
8 recorded in Account 926300 IBS Billed Benefits, UPPCO estimates the 2012 costs to
9 be \$1,158,805. The overall increase in 2012 costs as compared to 2010 costs is
10 \$163,157. The primary drivers behind this increase are higher costs determined by
11 actuarial analysis, and higher medical and dental costs for IBS active employees.

12
13 **Q. How were IBS employee benefit cost projections calculated?**

14 A. IBS employee benefits cost projections relied on the same assumptions, actuarial
15 analyses, and methodologies used for UPPCO employee benefit costs, as described
16 in this testimony.

17
18 Detail regarding the IBS employee benefits costs is shown on Exhibit A-3 (CMP-1),
19 Schedule C26, line 34.

20
21 **Employee Benefit Costs that were Determined by Inflating 2010 Actual Costs**
22 **Q. Please describe the process used to determine the forecasted 2012 employee**
23 **benefit costs that were determined by inflation.**

24 A. As shown on Exhibit A-3 (CMP-1), Schedule C25, for the sub-accounts shown on
25 lines 11 through 26, UPPCO inflated 2010 actual costs by the inflation factors
26 developed by UPPCO witness Mr. Seth DeMerritt in his Exhibit A-7 (SSD-4). The
27 overall decrease in costs forecasted by inflating 2010 costs to 2012 was \$9,955, or

1 3.4%. This 3.4% decrease over two years corresponds to 1.7% per year.

2

3 **Employee Benefit Costs that were Determined by Actuarial Analysis**

4 **Q. Please describe the process used to determine the forecasted 2012 employee**
5 **benefit costs that were determined by actuarial analysis.**

6 A. As shown on Exhibit A-3 (CMP-1), Schedule C25, for six sub-accounts, UPPCO
7 relied on an actuarial analysis to determine forecasted 2012 employee benefit costs.

8 The specific methods and assumptions employed are described below. The overall
9 increase in costs from 2010 to 2012 forecasted by actuarial analysis is \$1,805,614,
10 or 58.1%. This 58.1% increase over two years corresponds to 25.7% per year.

11

12 The 2012 employee benefit costs that were determined by actuarial analysis are
13 related to:

- 14 1. Sick Leave,
- 15 2. Pension,
- 16 3. Post Retirement Medical,
- 17 4. Pension Restoration and Supplemental Pension,
- 18 5. Post Retirement Life, and
- 19 6. Long Term Disability.

20

21 **Sick Leave**

22 **Q. Please describe the development of the sick leave expense shown on line 29**
23 **of Exhibit A-3 (CMP-1), Schedule C25.**

24 A. The sick leave expense is determined using actuarial analysis in accordance with
25 Statement of Financial Accounting Standards ("SFAS") No. 87. The plan is only
26 available for UPPCO union and Presque Isle Plant employees. UPPCO was part
27 owner and operator of the Presque Isle Plant prior to its sale to Wisconsin Electric
28 Power Company ("WEPCO"). The Plan has frozen hours and rate balances that will

1 be paid at retirement or death. The plan has been frozen since May 1, 1995, and
2 any new hires after 1995 are not eligible to participate in the plan. At retirement or
3 death, a member's current sick time at the frozen rate is compared to their frozen
4 1995 balance, and the lesser amount is paid. For valuation purposes, the sick leave
5 balance paid at the assumed retirement age equals the lesser of:

- 6 1. The May 1, 1995 frozen sick pay balance, or
- 7
8 2. The 1995 frozen hourly rate multiplied by the participant's current balance
9 of sick pay hours accrued as of the valuation date (or termination date for
10 terminated vested participants).
- 11

12 This amount was \$24,670 in 2010, and is projected to be \$20,835 in 2012, which is a
13 decrease of \$3,835.

14
15 **Employee Pension Expense**

16 **Q. Please describe the development of the pension expense shown on line 30 of**
17 **Exhibit A-3 (CMP-1), Schedule C25.**

18 A. Pension expense is determined using actuarial analysis, which is performed in
19 accordance with SFAS No. 87. UPPCO follows Generally Accepted Accounting
20 Principles ("GAAP") for its financial statements. Under the provisions of GAAP,
21 SFAS No. 87 describes the methodologies and assumptions used to calculate and
22 account for pension expense. SFAS No. 87 requires an annual determination of the
23 pension expense for the year. This expense is determined by the actuary each year
24 based upon:

- 25 1. Employee census data,
- 26 2. Current plan provisions,
- 27 3. Plan asset performance, and
- 28 4. Certain other actuarial assumptions.
- 29

30 For the SFAS No. 87 pension expense, UPPCO's actuary, Towers Watson

1 ("Towers"), performs the calculations required by this accounting standard annually
2 to determine UPPCO's pension expense. UPPCO's external auditors, Deloitte &
3 Touche ("D&T"), review the actuarial assumptions used to ensure consistency with
4 GAAP.

5

6 There are four components of the SFAS No. 87 pension expense. They are:

- 7 1. Service cost,
- 8
- 9 2. Interest cost,
- 10
- 11 3. Expected earnings on plan assets, and
- 12
- 13 4. Amortization of gains and losses, prior service costs, and any transitional
- 14 amounts.
- 15

16 Service cost represents one-year's pro-rata share of the expected benefits earned
17 during the year by current active employees.

18

19 Interest cost represents interest on the plan's benefit obligation (its liabilities) due to
20 the passage of time.

21

22 There is also an assumption regarding the expected return on assets for the year,
23 which is measured against the actual returns for the period. This rate of return
24 assumption is intended to be a long-term assumption of the return on plan assets.

25

26 The final component represents the amortization of various plan experiences that
27 were not anticipated by actuarial assumptions.

28

29 In order to calculate the plan's total benefit obligation and annual SFAS No. 87
30 expense, the actuary uses a number of assumptions including:

- 31 1. Mortality tables,

- 1 2. Retirement rates from UPPCO,
- 2 3. Anticipated salary increases,
- 3 4. Interest crediting rate, and
- 4 5. Discount rate.

5

6 Integrays management, as well as UPPCO's external auditor, D&T, reviews these
7 assumptions for reasonableness. A rate of return on assets of 8.25%, and a
8 discount rate of 5.65%, were used to forecast the 2012 pension expense.

9

10 The actuary then calculates the annual SFAS No. 87 pension expense for UPPCO.
11 This amount was \$1,507,771 in 2010, and is projected to be \$2,884,145 for 2012.
12 This is an increase of \$1,376,374.

13

14 **Q. What actions has UPPCO taken to help control pension costs?**

15 A. During 2007, UPPCO made changes to the retirement benefits provided to nonunion
16 employees. The most significant change was a shift from the traditional "defined
17 benefit" pension plan to a "defined contribution" model integrated with the existing
18 401K plan.

19

20 Effective January 1, 2008, the defined benefit pension plan was closed to
21 administrative (non-union) new hires. Those administrative employees participating
22 in the defined benefit pension plan as of January 1, 2008 will continue to accrue
23 pension benefits through December 31, 2012, and the pay rate used in the
24 calculation of pension benefits will be frozen after December 31, 2017. On and after
25 January 1, 2013, pension benefits will no longer accrue under the defined benefit
26 pension plan, and all administrative employees will only have an annual contribution
27 made to their 401K account. Employees hired on and after January 1, 2008 do not

1 participate in the defined benefit pension plan, and will only have an annual
2 contribution made to their 401K account.

3
4 Effective April 19, 2009, the defined benefit pension plan was closed to union new
5 hires. New union employees will only have an annual contribution made to their
6 401K account.

7
8 In addition, on December 31, 2008, the Wisconsin Public Service Corporation
9 Retirement Plan was merged into the Integrys Energy Group Retirement Plan, and a
10 new funding policy was developed. Under the new funding policy, the goal is to have
11 each Integrys subsidiary in the Integrys Energy Group Retirement Plan be funded at
12 105% of the Accumulated Benefit Obligation (“ABO”) over time, and for each
13 subsidiary to reach this goal at approximately the same time.

14
15 UPPCO funded \$7.5 million to the pension plan in 2009, \$16.5 million in 2010, and
16 \$1.9 million in 2011. As a result of these contributions to UPPCO’s pension plan,
17 there are higher plan assets. The higher plan assets result in higher expected
18 earnings, thus decreasing pension expense. These \$25.9 million of pension
19 contributions reduced the overall pension expense by roughly \$2.1 million in 2012.

20

21 **Q. Are other U.S. utilities funding their pension and Other Post Employment**
22 **Benefits (“OPEB”) plans similarly to UPPCO?**

23 A. Yes, they are. In fact, on May 19, 2009, Standards & Poor issued a report entitled
24 “Funding Shortfall of U.S. Utility Pension and Postretirement Benefits Adds to
25 Industry’s Cost Pressure Woes.”

26

27 Based on this report, it is clear that many U.S. utilities are funding their pension and

1 OPEB plans similarly to UPPCO. Also, the report highlights the fact that most state
2 regulators authorize rate recovery of the associated costs.

3
4 Due to copyright restrictions, a copy of this report cannot be electronically filed with
5 this case. However, UPPCO will provide a hardcopy of this report to Commission
6 Staff and to the parties in this proceeding.

7

8 **Post Retirement Medical**

9 **Q. Please describe the development of the post retirement medical expense
10 shown on line 31 of Exhibit A-3 (CMP-1), Schedule C25.**

11 A. The expense for retirees is determined using actuarial analysis, which is performed
12 in accordance with SFAS No. 106. As stated above, UPPCO follows GAAP for its
13 financial statements. Under the provisions of GAAP, SFAS No. 106 describes the
14 methodologies and assumptions used to calculate and account for retiree health
15 care expense.

16

17 The actuary performs the calculations required by this accounting standard annually
18 to determine UPPCO's SFAS No. 106 expense. D&T reviews the actuarial
19 assumptions used to ensure consistency with GAAP.

20

21 SFAS No. 106 requires an annual determination of the retiree health care expense
22 for the year, also referred to as OPEB expense or Post Employment Benefits other
23 than Pension ("PBOP"). This expense is determined by the actuary each year based
24 upon:

- 25 1. Employee census data,
26 2. Current plan provisions,
27 3. Plan asset performance, and

1 4. Certain other actuarial assumptions.

2

3 There are four components of SFAS No. 106 expense:

4 1. Service cost,

5

6 2. Interest cost,

7

8 3. Expected earnings on plan assets, and

9

10 4. Amortization of gains and losses, prior service costs, and any transitional
11 amounts.

12

13 These are the same four components that are used in the calculation of pension
14 expense, although different assumptions are used for health care.

15

16 In order to calculate the plan's total benefit obligation and annual SFAS No. 106
17 expense, the actuary uses a number of assumptions including:

18 1. Health care inflation trend rates,

19 2. Mortality tables,

20 3. Retirement rates from UPPCO,

21 4. Actual retiree health care claims experience specific to UPPCO, and

22 5. A discount rate.

23

24 Integritys management, as well as UPPCO's external auditor, D&T, reviews these
25 assumptions. A rate of return on assets of 8.25%, and a discount rate of 5.80%,
26 were used to forecast the 2012 post retirement medical expense.

27

28 The actuary then calculates the annual SFAS No. 106 expense component for each
29 year, which was \$1,396,330 for the 2010 historic test year, and is projected to be
30 \$1,824,223 for the 2012 projected test year which includes the estimated impact of
31 Federal Health Care Reform mentioned below. This is an increase of \$427,894.

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The calculation reflects UPPCO's acceptance of the government subsidy available under the Medicare prescription drug legislation. The calculation also reflects the impact of Federal Health Care Reform enacted in 2010 which will impact SFAS No. 106 cost beginning in 2011.

Also included on Line 31 of Exhibit A-3 (CMP-1), Schedule C25 is expense of \$30,210 for both 2010 and 2012 related to the amortization shown on page 1 of Exhibit A-3 (SSD-1), Schedule C12, as authorized by the Commission's December 8, 1992 Opinion and Order in Case No. U-10040.

Q. Have the underlying health care costs for retirees increased?

A. Yes, they have. Consistent with the national trend, underlying health care costs for retirees have increased, and are projected to continue to increase, for UPPCO each year. This trend of higher health care cost increases is expected to continue for the following reasons.

First, health care claim costs continue to rise sharply, still outpacing general inflation.

There are a number of reasons for this rapid rise in costs:

1. The covered population in the health plans is aging and living longer, and therefore use more health services,
2. New, expensive medical technology continues to become available, driving up costs,
3. The government continues to shift costs from government sponsored plans to the private sector,
4. Provider malpractice liability costs continue to soar, and are reflected in service prices, and
5. New, expensive prescription drugs continue to enter the market, prescription drug prices continue to rise and prescription usage is increasing.

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Second, SFAS No. 106 requires the use of a discounting process to set a value on all future benefit payments. The discount rate is the interest rate selected as of the expense measurement date used to determine the present value of the future outflow of retiree health care payments. The discount rate selected needs to reflect current economic conditions at the time the expense is determined. Lower discount rates create higher expenses under the SFAS No. 106 accounting for expense, as was seen under the SFAS No. 87 accounting for pension expense explained above. A discount rate of 5.80% was used to forecast the 2012 post retirement medical expense.

Finally, costs related to the impact of Federal Health Care Reform enacted in 2010 are included in the 2012 projected test year SFAS No. 106 accounting for expense.

Pension Restoration and Supplemental Pension

Q. Please describe the development of the pension restoration and supplemental pension plan expense shown on line 32 of Exhibit A-3 (CMP-1), Schedule C25.

A. The pension restoration and supplemental pension plan expense is calculated in accordance with SFAS No. 87 accounting rules, identical in nature to the pension expense described above. This amount was \$80,358 in 2010, and is projected to be \$66,358 for 2012, which is a decrease of \$14,000.

Post Retirement Life

Q. Please describe the development of the post retirement life benefit plan expense shown on line 33 of Exhibit A-3 (CMP-1), Schedule C25.

A. The post retirement life insurance expense is calculated in accordance with the requirements of SFAS No. 106, consistent with the post retirement medical expense described above. This amount was \$65,755 in 2010, and is projected to be \$91,503

1 in 2012. This is an increase of \$25,748.

2

3 **Long Term Disability**

4 **Q. Please describe the development of the long term disability benefit plan**
5 **expense shown on line 34 of Exhibit A-3 (CMP-1), Schedule C25.**

6 A. The Long Term Disability (“LTD”) Plan expense is actuarially determined and is
7 performed in accordance with SFAS No. 112. Under SFAS No. 112, benefit
8 obligations are accrued from the date the participant commences benefit payments.
9 Annual SFAS No. 112 expense is based on the benefit obligations calculated using a
10 roll forward of prior year valuation results, adjusted for any plan changes or events.
11 The expense is related only to participants that were disabled prior to April 1, 2008.
12 Benefits under this LTD Plan typically will continue until the earlier of the date of
13 recovery, death, attainment of age 65, or retirement. The actuarially determined
14 SFAS No. 112 expense was \$3,612 for the 2010 historic test year, and is projected
15 to be (\$2,955) for the 2012 projected test year, a decrease of \$6,567.

16

17 **Q. Will UPPCO provide updated actuarial analyses when available?**

18 A. Yes, it will. Upon request, UPPCO will provide an updated actuarial analysis to
19 Commission Staff and to the parties in this proceeding if one is completed during the
20 pendency of this proceeding.

21

22 **Q. Does this complete your pre-filed direct testimony?**

23 A. Yes, it does.