STATE OF MICHIGAN

BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

* * * * *

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

TRACY L. KUPSH

FOR

UPPER PENINSULA POWER COMPANY

June 30, 2011

STATE OF MICHIGAN

BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

* * * * *

In the matter of the application of **UPPER PENINSULA POWER COMPANY** for authority to increase retail electric rates.	))))	Case No. U-16417

QUALIFICATIONS
OF
TRACY L. KUPSH
PART I

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

A. My name is Tracy L. Kupsh. My business address is Integrys Energy Group, Inc. ("Integrys"), 700 North Adams Street, P.O. Box 19001, Green Bay, WI 54307-9001. I am the Director – Operations Accounting for Integrys Business Support ("IBS"). I am testifying on behalf of Upper Peninsula Power Company ("UPPCO") in support of UPPCO's application in this proceeding for authority to adjust its electric rates.

Q. Please describe your educational, professional, and utility background.

A. I graduated from Lakeland College of Sheboygan, Wisconsin in 1996 with a Bachelor of Arts degree in Accounting. After spending 19 years working for Unilever, a worldwide consumer goods company, in various cost accounting positions, I obtained my current position with IBS on December 1, 2008.

My duties and experience as Director - Operations Accounting for IBS include the review and approval of monthly financial statements of Integrys' various regulated affiliates, including UPPCO, the coordination and/or participation in the preparation of the affiliates' Operation & Maintenance ("O&M") and Capital budgets, and the analysis of variances between forecasted and actual financial results of the affiliates.

TRACY L KUPSH
DIRECT TESTIMONY
PART II

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

A. The purpose of my pre-filed direct testimony is to:

1. Provide an overview of the basic philosophy and goals of IBS' business operations,

2. Describe the corporate structure of IBS and the services IBS provides to its affiliates, and

3. Describe the various cost allocation methodologies and formulas that determine the costs paid by Integrys affiliates for the services provided by IBS.

Q. Are you sponsoring any exhibits in this proceeding?

A. Yes, I am. I am sponsoring Exhibit A-3 (TLK-1), Schedules C22, C23, and C24.

Q. Were these Schedules C22, C23, and C24 of Exhibit A-3 prepared by you or under your direction and supervision?

A. Yes, they were.

Q. Please describe Exhibit A-3 (TLK-1), Schedule C22.

A. Exhibit A-3 (TLK-1), Schedule C22 is the IBS Master Regulated Affiliated Interest Agreement ("Regulated AIA").

Q. Please describe Exhibit A-3 (TLK-1), Schedule C23.

A. Exhibit A-3 (TLK-1), Schedule C23 describes the various assets owned by IBS.

Q. Please describe Exhibit A-3 (TLK-1), Schedule C24.

A. Exhibit A-3 (TLK-1), Schedule C24 is a summary of IBS software amortization, depreciation, and return on investment charges for UPPCO, all IBS affiliates other

than UPPCO, and Total IBS for the 2010 historic test year, and the 2012 forecasted test year.

Q. Has the Regulated AIA between IBS and its regulated utility affiliates been the subject of a proceeding before the Michigan Public Service Commission ("MPSC") previously?

A. Yes, it has. The Regulated AIA between IBS and its regulated utility affiliates was submitted to the MPSC in connection with UPPCO, WPS Corp, and Michigan Gas Utilities Corporation ("MGUC") seeking waivers from the Code of Conduct and Affiliate Transaction Guidelines in Case No. U-15325.

Q. Have other state commissions approved the cost allocation methodologies established in the Regulated AIA?

A. Yes, they have. The Regulated AIA, including the cost allocation methodologies and formulas established therein, has been approved by the Public Service Commission of Wisconsin in Docket No. 05-UI-111, the Illinois Commerce Commission in Docket No. 07-0361, and the Minnesota Public Utilities Commission in Docket No. G-007,011/AI-07-779.

Q. Does UPPCO seek to recover the costs charged to UPPCO under the Regulated AIA in this rate case proceeding?

A. Yes, it does. The UPPCO 2012 electric revenue requirement includes actual amounts charged in 2010, inflated to 2012, and adjusted for known and measurable changes for the services that IBS provides to UPPCO. These amounts include costs that are directly assigned to UPPCO, costs that are assigned to UPPCO using cost-causal allocators, and costs that are assigned to UPPCO using the general/corporate allocator.

Basic Philosophy and Goals of IBS

Q. Please describe the philosophy and goals underlying the operation of IBS.

A. IBS strives to be a leading service company provider of innovative and cost-effective support services and solutions to its affiliates. IBS focuses on the following four areas:

1. **Customer Focus**: Maintaining and demonstrating an in-depth understanding of Integrys' businesses, developing and delivering innovative, high-value services that address business issues and assisting the businesses in achieving their goals;

2. **Service Delivery**: Delivering high-quality and cost-effective services in a timely manner; proactively developing, in partnership with its business partners, new and innovative services and solutions that address business needs, leveraging technology and process excellence across its various service categories;

3. **Cost Management and Value Creation**: Continually seeking ways to improve processes and reduce costs, opportunities to invest in people, processes and technology that will result in meaningful value creation for our business partners and stakeholders; and

4. **Employee Engagement**: Maintaining a high-performance culture and staff that exhibit strong technical skills, an in-depth knowledge of the business, and a business mindset.

Integrys operates six regulated utilities across four states, and has a number of non-regulated subsidiaries. As a centralized service company, IBS strives to achieve economies of scale by leveraging employees and management across many affiliates and businesses. Such leveraging reduces the holding company's system-wide costs, and allows those costs to be shared among a larger number of affiliates.

IBS Structure and Services Provided

Q. Please briefly describe the various services provided by IBS.

A. Below I show the various IBS functions along with examples of the Administrative & General ("A&G") services offered by each unit:

- **Administrative** -- Facility services, security services, work space management services.

- **Environmental** -- Environmental planning, permitting, licensing, compliance services.

- **CFO Services** -- Accounting, treasury, tax, internal audit and related financial services.

- **Human Resources** -- Payroll processing, labor relations, recruiting and staffing.

- **Information Technology** -- Desktop, website, project, infrastructure and telephony services.

- **Legal Services** -- General legal services, insurance, claims and compliance services.

- **Supply Chain** -- Sourcing, fleet and materials management services.

- **Utility Services Group** -- Gas engineering, gas supply (A&G and ministerial) services, and gas and electric customer relations services such as meter reading, billing, call center operations, customer relations and market research, to the regulated utilities.

- **External Affairs** -- Government and public relations, analysis and formulation of company-wide policies and objectives, rate case management, preparation and dissemination of information for employees, government officials, media and the public.

- **Corporate Functions** -- Executive management and oversight, corporate secretary services, corporate-level human resources services, corporate-level business development services.

Q. Please describe the Regulated AIA, under which IBS provides "shared" or "inter-company" services to the utility operating companies within the Integrys holding company system.

A. Under the Regulated AIA, IBS provides a wide range of services as listed above and in Exhibit B to the Regulated AIA. Generally, these services comprise common A&G business activities that each affiliate would need to provide internally, or procure, in order to operate its business. IBS may also provide additional services that the regulated affiliate may request and that IBS can reasonably provide in a cost-effective manner consistent with applicable law.

IBS recovers all of its costs of providing these services by direct billing the regulated

affiliate whenever practicable. Where direct billing is not practicable, IBS bills affiliates pursuant to the cost allocation factors set forth in Exhibit C of the Master AIA. Services are provided at cost, including direct and indirect labor and overheads, and other cost loaders. The Allocation Factors described in Exhibit C to the Regulated AIA are designed to match the costs of the services performed with the entity or entities for which the services are performed. The basic premise underlying the allocation methodology and factors Integrys developed is to regularly zero-out the allocated IBS costs of each "home center" (a departmental or operational unit of IBS).

The cost of maintaining assets, the associated depreciation expense, and a return on the net assets are based on the factors identified in Exhibit A-3 (TLK-1), Schedule C23.

Q. Does IBS provide services to its non-regulated affiliates?

A. Yes, it does, pursuant to a separate, Non-Regulated AIA that is substantially similar to the Regulated AIA. As explained below, the Gas Engineering and Gas Supply groups within the IBS Utility Services Group provide services only to the regulated operating companies. The Gas Engineering and Gas Supply Group's operations, as required by law, are kept separated from the non-regulated gas and electric business of Integrys Energy Services ("Integrys Energy") and its subsidiaries.

Q. Are the parties to the non-regulated AIA charged "at cost" for services rendered as are the parties to the regulated AIA?

A. Yes, they are. The Allocation Factors relevant to the provision of services by IBS is the same under both AIAs. IBS provides all of its services "at cost," which IBS must regularly justify as part of its annual cost study or study-update work. Therefore, IBS'

billings to non-regulated affiliates are based on either direct or allocated cost, just like its billings to regulated affiliates. The Allocation Factors are the same under both AIAs. The regulated businesses of IBS cannot subsidize its non-regulated affiliates. IBS developed the Allocation Factors to ensure that all costs incurred by IBS are recovered from the entity or entities who originated such costs, and in proportion to their share of the whole.

Q. What services does IBS provide to its regulated affiliates under the Regulated AIA?

A. These are listed and described, by category, in Exhibit B to the Regulated AIA. Generally these services comprise common A&G business activities that each affiliate would need to internally provide or procure to operate its business.

Q. The services on Exhibit B of the Regulate AIA appear to be typical A&G functions, except for some that are provided by the Gas Engineering and Gas Supply Group's. Are there Utility Services Group services provided by IBS to UPPCO?

A. The Gas Groups deliver geospatial services, locate system support, damage prevention, and contract administration to all Integrys regulated gas and electric affiliates, including UPPCO.

<u>AIA Cost Allocation Approach and Methodology</u>

Q. What is the underlying goal that guides the allocation of costs incurred by a centralized service company?

A. The basic premise underlying the allocation methodology and factors we developed is to regularly "zero-out" each IBS "home center" (a departmental or operational unit of IBS) each month. Each month, all operating costs incurred by IBS are recovered, in total, from its regulated and non-regulated affiliates. This occurs by direct billing

whenever appropriate, and otherwise by allocating costs on a cost-causal basis to the service takers within the holding company system.

The Allocation Factors described in Exhibit C to the Regulated AIA are designed to match the costs of the services performed with the entity or entities for which the services are performed. The Allocation Factors only come into play for costs which are not directly billed to an affiliate.

Q. Please describe the process IBS follows when it directly bills its costs to an affiliate.

A. Direct billing involves a full, 100% assignment of the costs associated with a specific service to the customer receiving the service. These costs include overhead charges to reflect the complete cost of providing the service. An example of this would be direct labor charges for an IBS engineer who is assigned to a specific project for one of the affiliates. The costs associated with the engineer's service would be directly charged and billed to that affiliate for each month that the service was being provided.

In cases where direct charging is not appropriate or practical, costs are allocated using cost/causation principles linked to the relationship of that type of service. This allocation methodology reflects operational aspects of the charge, and applies costs in a meaningful and impartial way by allocating costs to the entities receiving or benefitting from the services provided. The remaining allocations are broad based, using the General/Corporate Allocation Factor that I describe later in my testimony.

The primary focus of IBS' cost allocation methodology is to direct charge as many costs as reasonably possible.

Q. Can you give examples of each type of allocation?

A. Yes, I can. I will do so by describing three typical services that IBS provides.

The first service is provided by the Property Accounting home center. Most of the activity in this home center is allocated through direct billing. However, certain activities, such as processing the automated depreciation calculation each month, benefit all companies. Therefore time spent on that activity is recorded in a general departmental activity "bucket" that is allocated based on each company's Property Plant & Equipment ("PP&E") balances.

Most of the costs for services provided by the Accounts Payable home center are allocated through a cost-causal factor: the number of invoices processed. Although invoice processors could technically track their time based on the owner of each invoice, that approach would not be practical because it would require processors to incur unnecessary costs to track their time. Instead, the time spent on invoice processing generally is recorded in the general departmental activity "bucket" and allocated based on each affiliate's number of invoices. If an employee of Accounts Payable works on a significant separate project for one or more affiliates, that time is tracked and billed directly to the project, and those costs are direct billed to the appropriate affiliate. These costs are then excluded from the costs allocated through the cost-causal factor.

Finally, the cost of the Investor Relations activity is allocated via the General/Corporate Allocation Factor. The activities performed by this home center benefit all Integrys affiliates.

Q. Are additional costs loaded into the labor allocations?

A. Yes, there are. With all services, the labor billed to affiliates, whether direct or allocated, includes a labor loading. There are two labor-related loaders. The first is a benefits loader, and includes costs for pension, personal insurance, vacation, disability, payroll taxes and other similar or related costs. The second loader is designed to capture the cost of providing work space for the employees performing the service. These costs include lease costs or operating costs if the space is owned, depreciation expense and return on the building or leasehold improvements, depreciation expense and return on furniture, personal computers, common printers/copiers, etc. If another entity is sharing this space with IBS, then an adjustment would take place prior to calculating a work space overhead.

Q. How are labor costs and related loaders tracked?

A. When the affiliates are billed, labor costs are "loaded" to calculate the average cost per hour actually worked by any given IBS employee. To support this process, all IBS personnel report their time reflecting the actual time worked on each IBS service provided.

Our ultimate goal, consistent with the Federal Energy Regulatory Commission's ("FERC") requirements for centralized service companies, is to be as transparent as possible in accurately reflecting all costs reasonably incurred by or on behalf of IBS in its provisions of services to its customers. This is particularly true with respect to labor costs, which comprise a significant portion of IBS' monthly expenses.

Q. What other costs are allocated to affiliates?

A. In addition to labor and contract labor costs, each home center incurs general costs related to running a department. This includes office supplies, professional licenses,

administrative time and training, among other costs. These costs are allocated to the affiliates in the same proportion as the direct and cost-causal activities that are allocated to them. That is, the costs are accumulated at the higher-level functional categories, and then allocated based on the percentage of billings to each of the affiliates at each of these levels. This results in these "general costs" being charged to the affiliates in a cost-causal manner.

In addition to general use office space and equipment, other assets including systems and special use assets (e.g., print shop assets) are owned and used by IBS to provide services to its affiliates. Depreciation expense and a return on assets, along with the cost to maintain these assets, are allocated based on the factors indicated on Exhibit A-3 (TLK-1), Schedule C23.

Home centers within IBS also provide services for other home centers within IBS. The cost of those activities is charged to an IBS entity level home center. Each month, the total costs charged to a specific IBS home center is allocated to each affiliate based on the ratio of all other charges to that affiliate to the total charges to all affiliates. In this manner, IBS' own internal "cost of doing business" is allocated and charged to the affiliates in a cost-causal manner – in proportion to all other billings in a given month.

In addition to the above costs, a return on working capital is allocated to all affiliates, and IBS may also incur miscellaneous costs not related to specific services. The working capital return, miscellaneous costs, operational home centers not fully "zeroed-out", and any differences between actual overhead costs incurred and overhead costs billed, are allocated to affiliates each month based on the ratio of all other charges to that affiliate to the total charges to all affiliates.

Home centers within IBS may also procure products and services for the benefit of individual affiliates, and in such cases the associated costs are billed directly to the affiliates. Contracted labor and professional services procured to assist a home center in providing services are billed based on work performed, similar to internal labor allocations but excluding labor overhead.

Q. Please describe the General/Corporate Allocator.

A. The General/Corporate Allocation Factor is used for the allocation of costs across the Integrys holding company system in cases where a service provides system-wide benefits, or in any event where the cost is driven by the holding company system as a whole rather than any particular entity.

Q. What cost factors go into calculation of the General/Corporate Allocation Factor?

A. There are two factors that are calculated for each entity within the Integrys holding company system (including IBS):

1. Total assets, and
2. Total non-fuel operations and maintenance ("O&M") costs.

For each factor a percentage is calculated to determine the individual company's portion of the total dollars in that factor. The average of these two percentages for an entity is that entity's allocation percentage, or factor, for the General/Corporate Allocation Factor.

For both the Cost Causal Allocation Factors and the General/Corporate Allocator, a "percentage of the whole" determination is used, such that the percentage charged to an entity is based on that entity's units in the numerator, and the denominator is

the sum total of such units for all entities within the holding company system who take the particular service for which the Allocation Factor is being utilized.

Q. When calculating total assets, how do you account for derivative assets, goodwill and other "non-ordinary" assets?

A. These types of assets are excluded from the total asset amounts for purposes of these calculations. In the case of derivative assets, accounting rules require the valuation of these contracts for each reporting period prior to actual settlement of the contract. As commodity prices change, the value of these assets will also change with no real change in the relative value of each affiliate to the other affiliates. In the same way, certain companies may have booked goodwill due to the fact that they were acquired by Integrys. Other companies may have a similar but unrecorded intrinsic value, therefore such items are excluded from these calculations in order to provide a more appropriate cost allocation.

Q. Please describe the factors that are included in the Non-Fuel O&M calculation.

A. All O&M costs (whether regulated or non-regulated) are included in this category. Examples of such costs include O&M labor, materials, and outsides services. As noted earlier, fuel, cost of goods sold, purchased power and similar costs are not included in these calculations. Additionally, mark-to-market gains or losses recorded in O&M, if any, are excluded.

Q. Why does Integrys believe this methodology is appropriate for the General/Corporate Allocation Factor?

A. There is no "right answer" that works for every holding company system. Instead, the appropriate general allocator depends on the unique facts and circumstances of each holding company system. This is confirmed by FERC's USOA (18 CFR §

367.28), which requires IBS to create a cost accumulation system and identify methods of allocation, but does not prescribe any specific allocation methodology.

The two factors that IBS chose are considered a proxy for the relative size of each affiliate as well as the activities that support each affiliate. While the corporate oversight and compliance required for any individual entity has both fixed and variable aspects, a large asset base can add specific risk and oversight needs as well as access to capital markets. In a similar manner, the overall costs to run a business, such as O&M, require differing degrees of oversight (e.g., larger and more complex contracts, more employees, etc.). Integrys believes that these inputs provide a fair allocation of the costs to be allocated using this Allocation Factor.

Q. How regularly are the various allocation inputs and factors re-calculated?

A. The allocation inputs and factors that will be used in any calendar year are calculated during the preparation of the annual budget for that year. Most of these inputs and factors are based on the most recent month-end balance or last twelve full months of activity, as appropriate. Labor overhead rates, however, are based on projections of labor and overhead costs in the budgeted calendar year.

The factors and inputs are modified during the calendar year only if significant changes in actual or anticipated activity were to occur.

Q. Has IBS made any changes to the services it provides to UPPCO?

A. Yes, it has. During 2010, the services provided to UPPCO were consistent with the 2010 filed Affiliate Interest Agreement.

In 2011, the Customer Relations function moved from Wisconsin Public Service

Corporation ("WPS Corp") to being under IBS. Further, UPPCO financial personnel moved from UPPCO to IBS. These organizational moves will have a zero net cost impact to UPPCO, and will result in similar functions within Integrys, and the associated costs, being under single leadership. Lastly, as a result of these organizational changes, the Integrys "Gas Group" has been renamed "Utility Services". Utility Services will continue to provide the gas Customer Relations services as it has in the past, and expand to include electric Customer Relations.

Q. Are any upgrades planned for IBS systems?

A. Yes, there are. As discussed in Mr. Seth DeMerritt's Direct Testimony in Case No. U-16166, an upgrade to Version 9.0 of IBS's Peoplesoft system was in-progress in 2009 and 2010. This upgrade was completed in May 2010.

Further, during 2012, IBS is scheduled to upgrade both the Peoplesoft Financial system and the Peoplesoft Human Resource system from Version 9.0 to 9.1. This upgrade will allow Integrys to leverage the delivered functionality, and continue to streamline processes through the latest technology and functionality. Staying compliant with the most current releases delivers robust systems to UPPCO and our other business partners.

In the instant general rate case, a Known and Measurable ("K&M") adjustment of $361,138 associated with the software amortization and return on investment charges for these upgrades has been included in the 2012 revenue requirement, as shown on Exhibit A-3 (SSD-3), Schedule C19. This K&M adjustment includes those software amortization and return on investment charges for the 2010 upgrade to Version 9.0 which were not captured in the 2010 historical year, as this upgrade was in-service for only seven months of the historical test year, as well as the 2012

software amortization and return on investment charges associated with the upgrade to Version 9.1.

A summary of IBS software amortization, depreciation, and return on investment charges for UPPCO, all IBS affiliates other than UPPCO, and Total IBS for the 2010 historic test year, and the 2012 forecasted test year, is shown on Exhibit A-3 (TLK-1), Schedule C24.

Q. How does IBS allocate costs for services that it performs for the Integrys holding company itself (e.g., services related to the fact that Integrys is a publicly-traded entity)?

A. For the sake of efficiency, Integrys holding company costs are allocated by IBS to the various Integrys affiliates (including the Integrys holding company itself) because these functions benefit all Integrys affiliates. Another option would be to first charge such costs to the Integrys holding company, and then have the Integrys holding company charge its various subsidiaries. However, this would not be consistent with our centralized service company approach, nor with the structure of our shared services organization, as Integrys holding company officers and personnel are IBS employees.

The Integrys holding company is allocated a portion of all applicable costs through the appropriate Allocation Factor, including the General/Corporate Allocation Factor for many services. These Integrys holding company costs are charged to, and remain at, the Integrys holding company level. Any costs that are not allocable by the Integrys holding company to its subsidiaries, such as most business development costs, are charged to, and remain at, the Integrys holding company.

Q. You indicated that IBS is allocated certain costs as part of the General/Corporate Allocation Formula. Are those costs then re-allocated by IBS to the affiliates, so that IBS can "zero-out" all of its costs? If so, why?

A. Yes, they are. IBS recovers, from its affiliates, all costs allocated to IBS. This is appropriate because IBS was formed to provide cost-effective, inter-company services. IBS allows Integrys customers to optimize the level of net savings and benefits that will result from a centralized service company. Therefore, it is appropriate for IBS to recover all of its reasonably incurred costs from the affiliates.

Q. Please describe the federal regulation of IBS.

A. First, IBS is a "centralized service company" subject to FERC regulation and regulatory requirements, including the USOA promulgated by FERC for such entities. This exhaustive USOA, modeled after that used by utilities, is found in 18 CFR Part 367.

Second, IBS must also follow the detailed record retention requirements promulgated by FERC at 18 CFR Part 368.

Third, as required by 18 CFR Part 369, IBS must annually file FERC Form No. 60, the annual report required of all centralized service companies.

Finally, if necessary to determine the reasonableness of IBS' costs, in addition to FERC's broad authority to request information from IBS and UPPCO, FERC also has supplemental federal statutory authority which provides FERC access to the books and records of companies throughout the Integrys holding company system under section 1265(a) and the Energy Policy Act of 2005.

Conclusions

Q. Is the cost of services rendered by IBS equal to or less than if UPPCO performed the same services on a stand-alone basis?

A. Yes, they are. The services provided by IBS represent activity that any company would need to perform to function as a separate company. With IBS providing the same services to the complete Integrys family, the costs of these activities can be shared among all of the companies. Although some costs are variable based on the size of the company, many of these costs are fixed, and therefore a smaller company would pay a higher amount in proportion to their relative size if the services were provided by an outside party, or if the company was fully staffed at the company to perform the functions.

Q. Is the arrangement between IBS and UPPCO a benefit to UPPCO and its customers?

A. Yes, it is. In addition to the economies of scale described above, UPPCO also receives the benefit of access to in-house experts who can be retained only in larger companies. For example, many of the same requirements that one utility may face from an environmental compliance perspective will impact other companies within the Integrys family. Having one group provide the support and research needed not only lowers the costs, but helps to ensure strong compliance programs.

Q. Based on the IBS cost allocation procedures described in your testimony and documented in the Regulated AIA, are the IBS costs reasonably and equitably allocated among the IBS affiliated companies?

A. Yes, they are. The Regulated AIA to which UPPCO is a party with IBS accurately and transparently assigns and allocates IBS costs to UPPCO and among the other IBS affiliated companies, and provides reasonable assurance to the Commission that costs related to UPPCO operations are fairly and accurately determined.

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

A. Yes, it does.