

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

LISA J. GAST, CPA

FOR

UPPER PENINSULA POWER COMPANY

June 30, 2011

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**QUALIFICATIONS
OF
LISA J. GAST, CPA
PART I**

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

2 A. My name is Lisa J. Gast. My business address is Integrys Business Support, LLC
3 (“IBS”), 700 North Adams Street, P.O. Box 19001, Green Bay, WI 54307-9001. I am
4 Manager, Financial Planning and Analysis in the Treasury Department of Integrys
5 Energy Group, Inc (“Integrys”). Both IBS and Upper Peninsula Power Company
6 (“UPPCO”) are wholly-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 graduated from the University of Wisconsin – Green Bay with a Bachelor’s Degree
13 in Accounting. I received a Masters Degree in Business Administration (“MBA”) from
14 the University of Wisconsin - Oshkosh. My professional designations are Certified
15 Public Accountant (“CPA”) and Certified Treasury Professional (“CTP”). I joined the
16 Treasury Department at Wisconsin Public Service Corporation (“WPS Corp”) in April
17 of 2001. In my current position, I am responsible for the capital structure forecasts
18 for each of Integrys’ regulated utilities.

1

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

3 A. Yes, I have. I have filed testimony before the Michigan Public Service Commission
4 (“MPSC”) on behalf of UPPCO in Case Nos. U-15988 and U-16166, and also on
5 behalf of Michigan Gas Utilities Corporation (“MGUC”) in Case Nos. U-15549 and U-
6 15990. I have also filed testimony before the Minnesota Public Utilities Commission
7 on behalf of Minnesota Energy Resources Corporation (“MERC”) in Docket Nos.
8 G007,011/GR-08-835 and G007,011/GR-10-977, and before the Illinois Commerce
9 Commission on behalf of The Peoples Gas Light and Coke Company (“PGL”) and
10 North Shore Gas Company (“NSG”) in Docket Nos. 11-0280/0281. MGUC, MERC,
11 PGL and NSG are sister companies to UPPCO.

**LISA J. GAST, 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:

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1. Present UPPCO's capital structure and cost of capital for the 2010 historic test year,

2. Present UPPCO's capital structure and cost of capital for the 2012 projected test year,

3. Explain the differences in adjusted common equity between the 2010 historic test year and the 2012 projected test year,

4. Describe the required Common Equity Ratio for the 2012 projected test year, and

5. Describe the required Return on Common Equity ("ROE") for the 2012 projected test year.

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

20 A. Yes. I am sponsoring Schedules D1 through D5 of Exhibit A-4 (LJG-1) for the 2012
21 projected test year, and Schedules D1 through D8 of Exhibit A-14 (LJG-2) for the
22 2010 historic test year.

23

24 **Q. Were these exhibits prepared by you or under your direction and supervision?**

25 A. Yes, they were.

26

27 **Q. Please explain Schedules D1 through D5 of Exhibit A-4 (LJG-1).**

28 A. In general, Schedules D1 through D5 of Exhibit A-4 (LJG-1) support and calculate
29 UPPCO's capital structure, cost of capital, and required rate of return for the 2012
30 projected test year.

31

1 Schedule D1 develops UPPCO's 2012 projected test year overall rate of return of
2 6.8776%, as shown on Line 22, based on UPPCO's 13-month average capital
3 structure, and a 10.75% ROE.

4
5 Schedule D2 develops UPPCO's 2012 projected test year embedded cost of long
6 term ("LT") debt of 6.3302%, based on a 13-month average, as shown on Line 27.
7 This cost assumes the replacement of UPPCO's 9.32% First Mortgage Bonds due in
8 2021 with a new 5 year debt issuance of \$10 million at 3.63% in September of 2011.
9 Integrys will likely be the lender.

10
11 Schedule D3 develops UPPCO's 2012 projected test year cost of short-term ("ST")
12 debt of 1.9691%, based on a 13-month average, as shown on Line 12.

13
14 Schedule D4 indicates that UPPCO has no preferred equity outstanding, as shown
15 on Line 2.

16
17 Schedule D5 develops UPPCO's 13-month average balance of Adjusted Common
18 Equity of \$81,538,153 for the 2012 projected test year, as shown on Line 16.

19 UPPCO requests an 10.75% ROE for the 2012 projected test year in this general
20 rate case proceeding, as supported by Mr. Paul R. Moul's pre-filed direct testimony
21 and exhibits.

22
23 **Q. Please explain Schedules D1 through D8 of Exhibit A-14 (LJG-2).**

24 A. In general, Schedules D1 through D8 of Exhibit A-14 (LJG-2) support and calculate
25 UPPCO's capital structure, cost of capital, and required rate of return for the 2010
26 historic test year.

27

1 Schedule D1 develops UPPCO's 2010 historic test year overall rate of return of
2 7.3671%, as shown on Line 22, based on UPPCO's 13-month average capital
3 structure, and a 10.90% ROE.

4
5 Schedule D2 develops UPPCO's 2010 historic test year embedded cost of LT debt of
6 6.3087%, based on a 13-month average, as shown on Line 29.

7
8 Schedule D3 develops UPPCO's 2010 historic test year cost of ST debt of 0.8340%,
9 based on a 13-month average, as shown on Line 12.

10
11 Schedule D4 indicates that UPPCO has no preferred equity outstanding, as shown
12 on Line 2.

13
14 Schedule D5 develops UPPCO's 13-month average balance of Adjusted Common
15 Equity of \$72,037,367 for the 2010 historic test year, as shown on Line 16.

16
17 Schedule D6 provides the current and historic credit ratings, along with the
18 associated outlooks, for senior unsecured debt, junior subordinated debt, and
19 commercial paper for UPPCO's parent, Integrys, as published by Standard and
20 Poor's ("S&P"), and Moody's Investors Service ("Moody's"). Integrys is not rated by
21 Fitch Ratings, and has no senior secured debt. UPPCO is not rated by any service.

22
23 Schedule D7 provides information for utility corporate bond issuances for the
24 February – July 2010 timeframe. UPPCO's most recent LT debt issuance was
25 completed April 30, 2010 at a rate of 5.041%, and a term of 10 years. This debt
26 issuance was authorized by the Federal Energy Regulatory Commission ("FERC") in
27 Docket No. ES09-40-000. Integrys was the lender.

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Schedule D8 calculates financial metrics on both a financial and ratemaking basis for historic years 2006 – 2010, and the 2012 projected test year, with and without rate relief.

Q. Does UPPCO present any other evidence on cost of capital?

A. Yes, it does. Mr. Paul R. Moul of P. Moul & Associates provides evidence on UPPCO’s cost of equity. He presents analytical studies employing various industry models.

Q. Is UPPCO stock publicly traded?

A. No, it is not. Integrys holds 100% of the common stock of UPPCO. Integrys is traded on the New York Stock Exchange under the symbol “TEG”.

Q. Please explain why UPPCO’s average LT debt increased from \$51,000,000 for the 2010 historic test year to \$55,000,000 for the 2012 projected test year.

A. The net increase in LT debt of \$4,000,000 is primarily due to UPPCO’s recent and forecasted construction expenditures, as further described in the pre-filed direct testimony of Mr. Seth S. DeMerritt.

Q. Please discuss the actual and forecasted activity related to the outstanding 9.32% mortgage bond issuance.

A. UPPCO’s annual \$900,000 sinking fund payment related to this debt was completed in November of 2010. Also, in May of 2010, UPPCO re-purchased \$500,000 of the outstanding bonds with the proceeds from an asset sale. These two payments result in a 13-month average reduction of LT debt outstanding of \$975,000 between 2010 and 2012. The balance of the 13-month average reduction of mortgage debt

1 outstanding is due to the September 2011 re-purchase of the remaining \$9,400,000
 2 of outstanding bonds. The amortization of the loss on this re-purchased LT debt is
 3 included in the calculation of the LT interest rate for the 2012 projected test year, as
 4 shown on Exhibit A-4 (LJG-2), Schedule D2, line 18.

5
 6 **Q. Please discuss the actual and forecasted activity related to new intercompany
 7 LT debt issuances.**

8 A. On April 30, 2010, UPPCO issued \$15,000,000 of LT debt at 5.041%. This issuance
 9 creates a \$4,375,000 increase in the 13-month average LT debt for the projected
 10 2012 test year as compared to the 13-month average LT debt for 2010. The forecast
 11 for the 2012 projected test year also reflects a new LT debt issuance of \$10,000,000
 12 at 3.63% in September 2011 to replace UPPCO's 9.32% First Mortgage Bonds.

	13-month Average Amount Outstanding		
	<u>2012</u>	<u>2010</u>	<u>Change</u>
<u>1st Mortgage Bonds</u>			
9.32% Series	0	10,375,000	(10,375,000)
Subtotal	0	10,375,000	(10,375,000)
<u>Intercompany LT Debt</u>			
5.25% LT Note	15,000,000	15,000,000	0
6.059% LT Note	15,000,000	15,000,000	0
5.041% LT Note	15,000,000	10,625,000	4,375,000
3.63% LT Note	10,000,000	0	10,000,000
Subtotal	55,000,000	40,625,000	14,375,000
Total	\$55,000,000	\$51,000,000	\$4,000,000

13
 14 The weighted average cost of LT debt is forecasted to increase slightly from
 15 6.3087% per annum to 6.3302% per annum.

16
 17 **Q. Is UPPCO's share of the up-front costs of Integrys facilities included in the
 18 cost of LT debt?**

1 A. Yes, the portion of the amortization of Integrys' up-front costs for its credit facilities is
2 included in the cost of LT debt.

3

4 **Q. How are the costs of Integrys' credit facilities allocated to UPPCO?**

5 A. Integrys' amortization of up-front costs for its credit facilities is allocated to its primary
6 subsidiaries based on their proportion of total ST support from Integrys. Total ST
7 support is defined as intercompany ST debt authorized plus average outstanding
8 guarantees utilized. This methodology results in an allocation rate of 1.53% for
9 UPPCO. This allocation rate results in an estimated allocation to UPPCO of
10 \$43,404, which is included in the calculation of UPPCO's LT debt rate of 6.3302% for
11 the 2012 projected test year, as shown on Exhibit A-4 (LJG-1), Schedule D2.

12

13 **Q. Does UPPCO issue LT debt to parties outside of Integrys?**

14 A. No. UPPCO borrows its LT debt from Integrys. Financing via Integrys allows
15 UPPCO to recognize the benefit of Integrys' size, investment grade credit rating, and
16 more frequent debt issuances.

17

18 **Q. Is the 3.63% rate for UPPCO's proposed LT debt issuance in September 2011
19 reasonable?**

20 A. Yes, it is. The LT debt rate is based on United States Treasury rates, plus a risk
21 premium. UPPCO uses a forecast of Treasury rates from Moody's DataBuffet.com
22 and applies a risk premium based on similar issuances at the time of the forecast.
23 DataBuffet.com forecasts rates on 5-year Treasury securities to be 2.30% for
24 issuances during the third quarter of 2011. Based on estimates of all-in spreads for
25 a hypothetical Integrys LT debt issue received from banks prior to the forecast, a
26 spread of 133 basis points was added to the forecasted Treasury rates.

27

1 Prior to actually issuing LT debt at UPPCO, estimates of spreads on a hypothetical
2 Integrys LT debt issuance with similar terms are solicited from three investment
3 banks. The average of the spreads is added to the applicable Treasury rate (i.e. 5yr,
4 10yr, etc.) on the date of issuance to arrive at the interest rate for the new debt.
5

6 **Q. How were interest rates on ST debt forecasted?**

7 A. The monthly ST interest rates are based on forecasted 1-month commercial paper
8 rates from DataBuffet.com as of October 13, 2010. The company has determined
9 that the rates forecasted by Moody's DataBuffet.com closely represent rates on AA
10 rated commercial paper; therefore, the company has added 20 basis points to the
11 interest rate forecast from Moody's DataBuffet.com to approximate the spread
12 between AA and A2/P2 rated commercial paper. Forecasted ST interest rates
13 averaged 1.95% for the 2012 test year.
14

15 **Q. How was the 20 basis point spread between AA and A2/P2 rated commercial
16 paper determined?**

17 A. The 20 basis point spread is the average difference between 30-Day AA and A2/P2
18 commercial paper rates, published by the Federal Reserve, from July 2009 through
19 June 2010.
20

21 **Changes to UPPCO's Adjusted Common Equity from 2010 to 2012**

22 **Q. Please explain why UPPCO's year end adjusted common equity increased
23 from \$78,644,355 at December 31, 2010, to \$84,110,998 at December 31, 2012
24 without rate relief, and to \$83,800,213 at December 31, 2012 with rate relief.**

25 A. Like LT debt, the change in UPPCO's year end adjusted common equity is primarily
26 driven by UPPCO's forecasted construction expenditures. The increase in equity
27 realized via retained earnings, is partially offset by returns of equity to Integrys and

1 increases in utility equity adjustments. A summary of these changes with and
 2 without rate relief is included in the following table.

<u>Common Equity</u>	<u>Without Rate Relief</u>	<u>With Rate Relief</u>
Actual 12/31/10	\$78,644,355	\$78,644,355
Retained Earnings	15,251,301	18,940,515
Equity Returns	(6,500,000)	(10,500,000)
Utility Equity Adjustments	(3,284,657)	(3,284,657)
Projected TY 12/31/12	\$84,110,998	\$83,800,213

3

4 **Q. What is the basis for the Adjusted Common Equity reflected on Schedules D1**
 5 **of Exhibit A-14 (LJG-2) and Exhibit A-4 (LJG-1)?**

6 A. These amounts reflect the average balances in common equity after adjustments for
 7 non-utility investments net of their related deferred income taxes. These investments
 8 are primarily UPPCO's investment in the American Transmission Company
 9 ("ATCLLC"), and its investment in the Escanaba River hydroelectric facilities. These
 10 amounts are being excluded from the Common Equity balances because these
 11 investments are assumed to be funded solely with Common Equity capital. All
 12 UPPCO debt is assumed to support utility operations.

13

14 **Q. What amount of equity in the capital structure do you feel is appropriate for**
 15 **UPPCO?**

16 A. A common equity ratio of 52% to 58% (after considering adjustments related to non-
 17 utility investments, and the impact of ST debt) is required to provide UPPCO the
 18 financial health and flexibility it requires to respond to the changes and challenges of
 19 the utility industry.

20

21 UPPCO is currently targeting a common equity ratio of 54.90% for the 2012
 22 projected test year, including the impact of ST debt, as shown on Exhibit A-4 (LJG-
 23 1), Schedule D1. During the 2010 historic test year, UPPCO maintained an average

1 55.94% common equity ratio, including the impact of ST debt, as shown on Exhibit
2 A-14 (LJG-2), Schedule D1.

3

4 Business risk is greater today than in earlier decades and this increased business
5 risk is reflected in the more stringent benchmarks now being used by the various
6 credit rating agencies. Business risk can be offset somewhat with decreased
7 financial risk by maintaining a lower debt ratio which in turn increases interest
8 coverage.

9

10 **Q. What benefits does a capital structure with a higher equity ratio provide?**

11 A. An adequate equity ratio provides the ability to resist negative financial pressures
12 and creates a buffer to protect against unexpected adverse developments so that
13 distortions can be quickly remedied without impairing either the orderly conduct of
14 the business, or the credit quality of present or future securities issues. This will help
15 ensure that UPPCO has access to capital at reasonable rates when UPPCO needs
16 it, thereby benefiting its customers.

17

18 **Deferred Taxes**

19 **Q. Please explain the increase in the deferred tax balance from the 2010 historical
20 year to the 2012 projected test year?**

21 A. The deferred tax balance increased 45% from the 2010 historical test year to the
22 2012 projected test year. This increase is described in the Direct Testimony of Mr.
23 Seth DeMerritt.

24

25 **Q. What effect does this increase in deferred taxes have on UPPCO's rate of
26 return?**

27 A. Since deferred taxes are accounted for with a zero return on capital a higher
28 deferred tax balance tends to lower UPPCO's required rate of return.

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The Required ROE

Q. What is UPPCO’s recommendation for the cost of equity capital for UPPCO?

A. UPPCO is requesting an 10.75% ROE for the 2012 projected test year as described in the pre-filed direct testimony of Mr. Paul R. Moul.

Q. Is the market responsive to alternative investment opportunities?

A. Yes, it is. Investors have a vast array of investment choices. Investors can choose the stock market or other markets such as bonds, treasury securities, money funds, real estate, etc. If investors choose the stock market, they may elect a utility stock or a stock from one of the many other industries available. If investors prefer utilities, they have many to select from within the utility industry. Therefore, it is imperative to provide a competitive return to the shareholder. The return on a utility's stock must be competitive given its risk profile as compared to other investment alternatives.

An adequate ROE is of major importance and benefit to customers. Adequate returns on UPPCO's common equity would help to ensure continued reliable utility services, and would assure these services are provided at the lowest overall rates through the lowest overall cost of capital. This can only be maintained with an adequate ROE.

Q. What effect would a fair return on common equity have on the other future securities of UPPCO?

A. An adequate ROE would permit UPPCO to raise capital when needed, at reasonable rates, especially during periods of “tight” credit markets. An adequate ROE is a positive way of ensuring UPPCO’s ability to continue to provide safe, reliable and cost effective energy services to its customers.

1 **Q. In summary, what is your recommendation regarding the required common**
2 **equity ratio and the required ROE for the 2012 projected test year?**

3 A. UPPCO recommends that the average common equity ratio be set at 54.90% with an
4 ROE of 10.75%. These values are recommended because:

- 5 1. They are necessary to provide a fair return to investors commensurate
6 with competitive investment vehicles available,
7
- 8 2. There is a notable increase in business risk associated with the increased
9 uncertainty in the utility industry, and
10
- 11 3. They recognize that UPPCO has delivered, and will continue to deliver,
12 reliable service at a reasonable cost to its customers. Therefore, the
13 shareholder should be properly compensated for delivering on its
14 commitment to those customers.
15

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

17 A. Yes, it does.