PSC REF#:229719

Public Service Commission of Wisconsin
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BEFORE THE
PUBLIC SERVICE COMMISSION OF WISCONSIN

Application of Wisconsin Energy Corporation	)	
For Approval of a Transaction by which	)	
Wisconsin Energy Corporation Would Acquire	)	Docket No. 9400-YO-100
All of the Outstanding Common Stock of	)	
Integrys Energy Group, Inc.	)	

DIRECT TESTIMONY OF RICHARD S. HAHN ON BEHALF OF THE CITIZENS UTILITY BOARD OF WISCONSIN

January 14, 2015

I. Introduction

Q. What is your name and business address?

A. My name is Richard S. Hahn. I am employed by La Capra Associates, Inc. ("La Capra") as a Principal Consultant. My business address is One Washington Mall, Boston, MA 02108.

Q. On whose behalf are you testifying in this proceeding?

A. I am testifying on behalf of the Citizens Utility Board of Wisconsin ("CUB").

Q. Please describe your education and employment background.

A. I received my Bachelor's in Science, Electrical Engineering, in 1973, and my Master's in Science, Electrical Engineering, in 1974, both from Northeastern University. I received my Master's in Business Administration from Boston College in 1982. Since joining La Capra, I have worked on many projects related to mergers and acquisitions, investments in energy infrastructure, energy markets, forecasts of wholesale market prices, utility resource planning projects, electric transmission projects, and asset valuations. Prior to joining La Capra, I worked at NSTAR Electric & Gas (formerly Boston Edison Company) from 1973 to 2003. Throughout my career, I have gained and demonstrated considerable experience and expertise in many utility-related matters. I am a registered professional electrical engineer in the Commonwealth of Massachusetts.

Q. Please summarize La Capra and its business.

A. La Capra provides consulting services in energy planning, market analysis, and regulatory policy in the electricity and natural gas industries. We serve a national and international clientele from our offices in Boston, Massachusetts, Portland, Maine, and Essex Junction, Vermont providing consulting services to a broad range of organizations involved with energy markets, including renewable energy producers, private and public utilities, transmission owners, energy producers and traders, energy consumers and consumer advocates, regulatory agencies, and public policy and energy research organizations. Our technical skills include power market forecasting models and methods, economics, management, planning, rates and pricing, energy procurement and contracting, and reliability assessments. Our experience includes detailed analyses of energy and environmental performance of the electric systems, economic planning for transmission and distribution, and market analytics. As shown in detail on my resume attached hereto as Ex.-CUB-Hahn-1, I have testified as a witness in several public utility merger or acquisition cases.

Q. Have you previously testified before the Public Service Commission of Wisconsin (“PSC” or “the Commission”)?

A. I have testified in several proceedings before this Commission. My testimonies have covered the reasonableness of projected fuel costs for Wisconsin Electric Power Company (“WEPCO”), Wisconsin Public Service Corporation (“WPSC”), Northern States Power – Wisconsin (“NSPW”), and Madison Gas and Electric Company (“MGE”). I also testified regarding the appropriateness of environmental upgrades to Wisconsin power plants at the Edgewater, Columbia, and Oak Creek stations. I testified in the proceeding to review the proposed biomass-fired cogeneration plant in Rothschild, Wisconsin and in the proceeding to review the proposed 345 KV transmission line from Minnesota to La Crosse. I also filed testimony on behalf of CUB in Docket No. 6690-CE-198 which reviewed WPSC’s application for approval of its System Modernization and Reliability Project and in the proceeding where WEPCO applied for authority to convert the Valley Power Plant from coal to natural gas. On December 10, 2014, my direct testimony was filed in Docket No. 137-CE-166 regarding the Application of American Transmission Company, LLC ("ATC") seeking authority to construct the North Appleton to Morgan transmission upgrade.

Q. What is the purpose of your testimony in this proceeding?

A. The purpose of my testimony is to address the following issues:

- Whether the acquisition is required to achieve the stated objectives.
- The appropriateness of ring-fencing provisions.
- The level of potential synergies if the acquisition is approved.
- Whether the acquisition complies with the Wisconsin standard for holding company acquisitions.
- The status of proceedings in Illinois and Michigan that are analyzing the proposed acquisition.
- If the acquisition is to be approved, identifying conditions to approval that should be established to protect customers of both WEPCO and WPSC.

Q. What exhibits are you sponsoring?

A. In addition to this direct testimony, I am sponsoring seven exhibits:

- Ex.-CUB-Hahn-1, - Resume of Richard S. Hahn.
- Ex.-CUB-Hahn-2, - Excerpts from 2013 Form 10K Report for Integrys Energy Group, Inc. ("Integrys" or "TEG").
- Ex.-CUB-Hahn-3, - Moody's Report 2002 for NiSource.
- Ex.-CUB-Hahn-4, - Moody's Report 2008 for NiSource.
- Ex.-CUB-Hahn-5, - List of Transaction Conditions Proposed in Illinois.
- Ex.-CUB-Hahn-6, - Wisconsin Energy Corporation ("WEC") Form 8k Report, November 12, 2014.
- Ex.-CUB-Hahn-7, - Michigan Governor Press Release, January 13, 2015.

Q. Does your testimony contain information claimed to be confidential?

A. Yes. My testimony contains information claimed to be confidential by WEC and Integrys. Information that is claimed by WEC to be WEC Confidential – Attorney/Reviewer Eyes Only is shaded in blue and information that is claimed by Integrys to be Integrys Confidential – Attorney/Reviewer Eyes Only is shaded in green.

II. Summary of Conclusions

Q. Please summarize your conclusions and recommendations regarding the issues addressed in your testimony.

A. Based upon my review, I offer the following conclusions:

- No quantifiable benefits to Wisconsin ratepayers have been identified to occur as a result of this acquisition.
- The primary objective of the acquisition is to create a larger company with improved access to capital markets. However, no evidence has been provided by WEC or Integrys to show that a larger company will actually have such improved access. To the contrary, I have performed an independent assessment which shows that larger companies do not necessarily result in improved access to capital markets.
- The acquisition is not required to achieve the other stated objectives of the proposed transaction.
- There is a potential for the acquisition to cause harm to Wisconsin ratepayers.
- The conditions identified in WEC's application in this proceeding ("the Application") are inadequate to protect Wisconsin ratepayers from potential harm.

Based upon these conclusions, I find that because there are no identified benefits that will accrue to Wisconsin ratepayers, the proposed transaction is not in the public interest and does not meet the standard for approving WEC's proposed acquisition of Integrys. Therefore, the transaction as proposed should not be approved. However, if the Commission should approve the proposed transaction, it should impose additional conditions - as described in detail in this testimony – in order to adequately protect Wisconsin ratepayers.

III. Overview of the Proposed Transaction

Q. Please briefly describe the proposed transaction.

A. WEC proposes to acquire all of the outstanding common stock of TEG. Each existing share of TEG stock will be exchanged for 1.128 shares of WEC common stock plus $18.58 in cash. The transaction was announced on June 23, 2014. The post-acquisition holding company would be called Wisconsin Energy Group, Inc. ("WEG").

Q. What is the approximate value of this transaction?

A. According to TEG's 2013 SEC Form 10K report, TEG had about 79.5 million shares of common stock outstanding. The closing stock prices for WEC and TEG just prior to the proposed transaction announcement were $46.47 and $60.33 per share respectively. The total value of cash consideration to be paid by WEC for each TEG share is about $1.48 billion.[1] The value of 1.128 WEC shares exchanged for each TEG share is about $4.17 billion,[2] bringing the total consideration received by TEG shareholders to $5.64 billion, or $71.00 per share. The value of the TEG shares being surrendered is about $4.80 billion, or $60.33 per share. Thus, WEC is paying about $840 million or a 17% above-market premium to acquire TEG. WEC will also assume TEG's existing debt of about $3.38 billion,[3] bringing the approximate total value of the transaction to more than $9 billion, excluding any transaction fees. Any transaction fees paid by WEC to consummate the proposed acquisition will increase this figure. Excerpts from the 2013 Form 10K report for TEG are provided as Ex.-CUB-Hahn-2.

Q. What is the stated purpose of the proposed transaction?

A. According to the Application, the transaction is in the best interests of utility consumers, investors, and the public because it will:[4]

- create a larger and financially stronger Midwestern utility company with greater liquidity and improved access to capital markets;

[1] 79.5 million TEG shares multiplied by $18.58 per share.
[2] 79.5 million TEG shares multiplied by 1.128 multiplied by $46.47 per share.
[3] See Ex.-CUB-Hahn-2, TEG's 2013 SEC Form 10K report. *See also* Direct-WEC-Lauber-4 stating $3.3 billion of transaction value is for assumed Integrys debt.
[4] See Ex.-WEC-Lauber-1, pp. 1-2.

- strengthen each of the WEC Energy Group operating companies including its Wisconsin electric and gas utilities, by integrating best practices in areas such as distribution operations, large capital project management, gas supply, system reliability and customer service;
- maintain WEC's and Integrys' long tradition of making significant contributions to regional economic development and generous support of educational, cultural, and charitable activities in the communities they serve;
- create a more diversified generation portfolio with a larger geographic footprint;
- facilitate continued prudent investment in needed utility infrastructure, including the ability to use the strong cash flow of the combined companies to fund future investments without issuing new equity; and
- position the combined entity for continued growth.

Also according to the Application, the Transaction will benefit the customers of WEPCO, Wisconsin Gas LLC ("WG") and WPSC over time by creating opportunities to achieve savings through:

- enhanced purchasing power;
- economies of scale;
- joint resource planning over a larger and more diverse system;
- the adoption and implementation of best practices;
- other efficiencies in operations and maintenance and project management; and
- sharing administrative and other service costs over a larger organization.

Q. Has the Applicant quantified any of these claimed benefits?

A. No. The testimony of Mr. Reed on behalf of the Applicant states that typical merger/acquisition savings can range from 3% to 5% of non-fuel O&M. However, WEC states that synergies have not been quantified, nor have such potential savings been considered in assessing the impact of WEC's proposed acquisition of TEG. Thus, the primary justification for the acquisition appears to be the creation of a bigger company that WEC believes will have better access to capital markets. No quantifiable benefits to

Wisconsin ratepayers have been estimated, projected, or considered when assessing the impact of this proposed transaction.

IV. The Wisconsin Standard for Acquisition of Public Utility Holding Companies

Q. What is the standard of approval for the Application?

A. According to the Application, the transaction requires the Commission's approval under § 196.795(3), Wis. Stat., ("Section 3") which requires that the acquisition of a Wisconsin holding company (in this case, Integrys) be "in the best interests of utility consumers, investors and the public."[5]

Q. How do you interpret this standard?

A. Given the requirement that the acquisition must be in the "best interests" of customers, I interpret this standard to mean that the acquisition should provide benefits to Wisconsin ratepayers.

V. Company Size vs. Access to Capital Markets

Q. Has WEC provided any analysis that shows that a larger company has better access to capital markets?

A. No, WEC has not provided any such analysis.

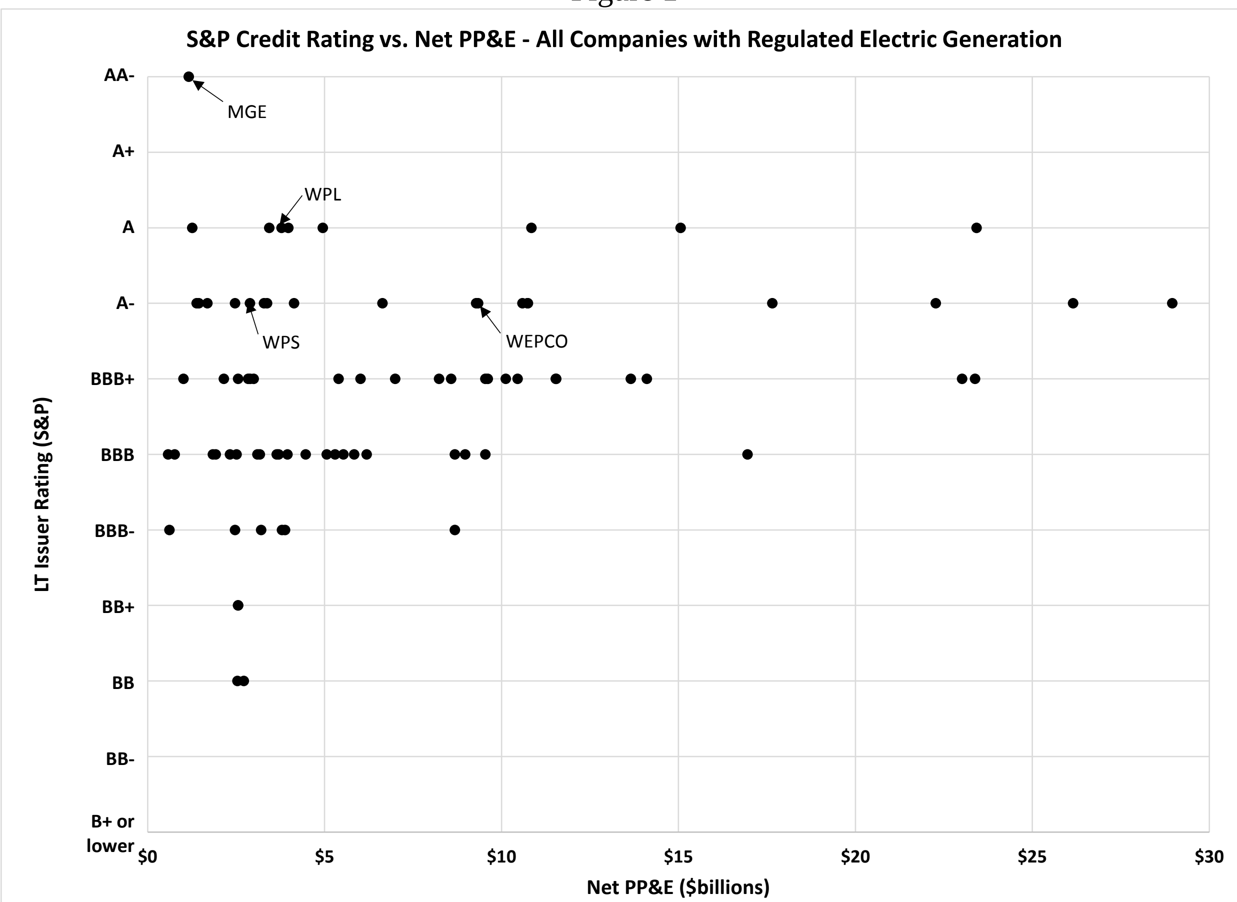
Q. Were you able to assess whether larger companies have greater access to capital markets?

A. Yes. The key determinant of a company's ability to access capital markets is that company's credit rating. The better a credit rating, the easier and less expensive it is to borrow money. I compared the credit rating of electric and natural gas companies versus size. The credit rating I used was the Standard & Poor's ("S&P") Long Term Credit

[5] Ex.-WEC-Laubuer-1, p. 10.

Rating, and company size was measured by net property, plant, and equipment ("PP&E"). The companies chosen in this comparison are all regulated electric and gas companies listed in the SNL database. Figure 1 below provides a scatter diagram of credit rating versus size for companies with regulated electric generation. There is no indication in this data that larger companies have higher credit ratings than smaller companies. In fact, the company with the highest credit rating is Madison Gas & Electric ("MGE"), a company that is much smaller than either WEPCO or WPSC.

Figure 1



Q. Were you able to make other, similar comparisons?

A. I performed two other comparisons of credit rating versus size; one for companies with natural gas distribution and another for parent companies with regulated subsidiaries. Figures 2 and 3 below provide these comparisons. These additional comparisons confirm the observation that there is no indication that larger companies have higher credit ratings than smaller companies.

Figure 2

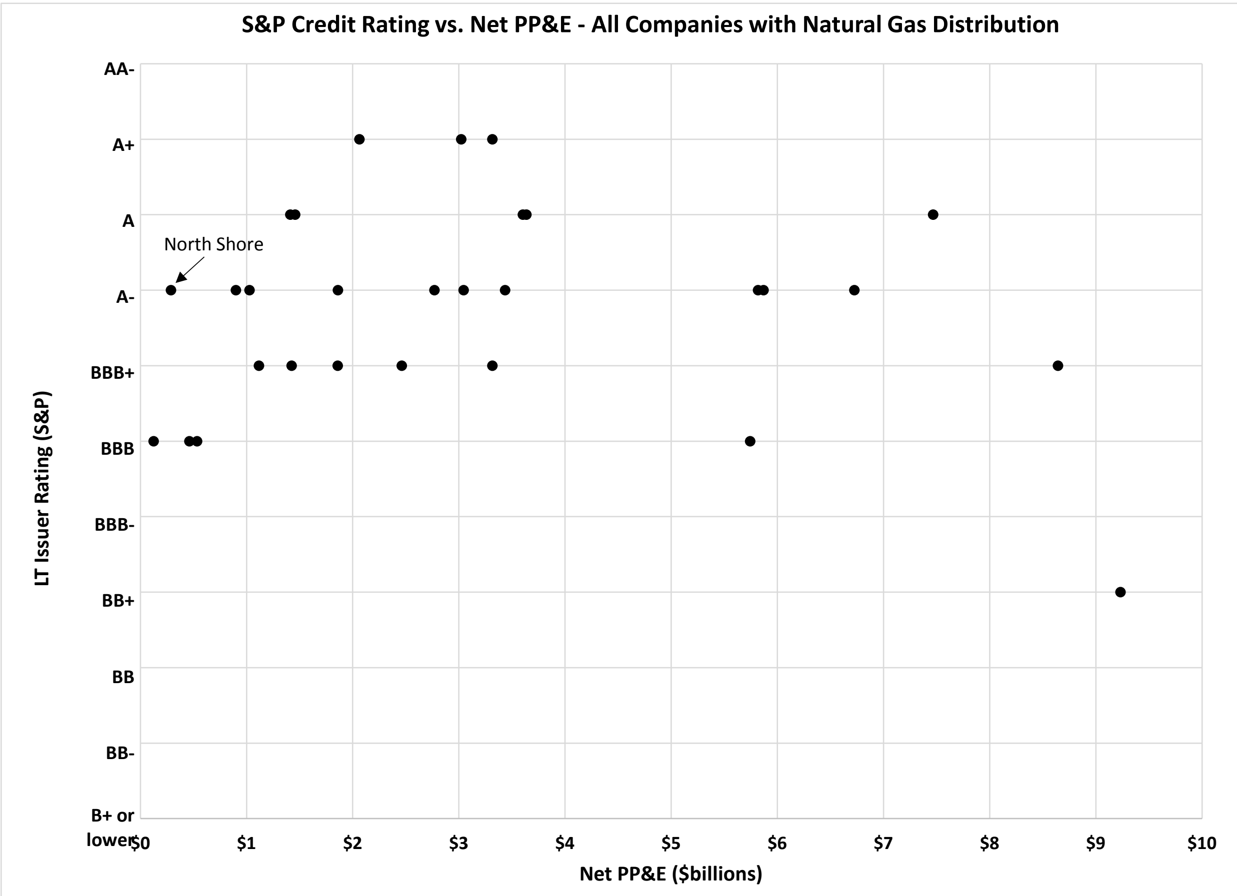
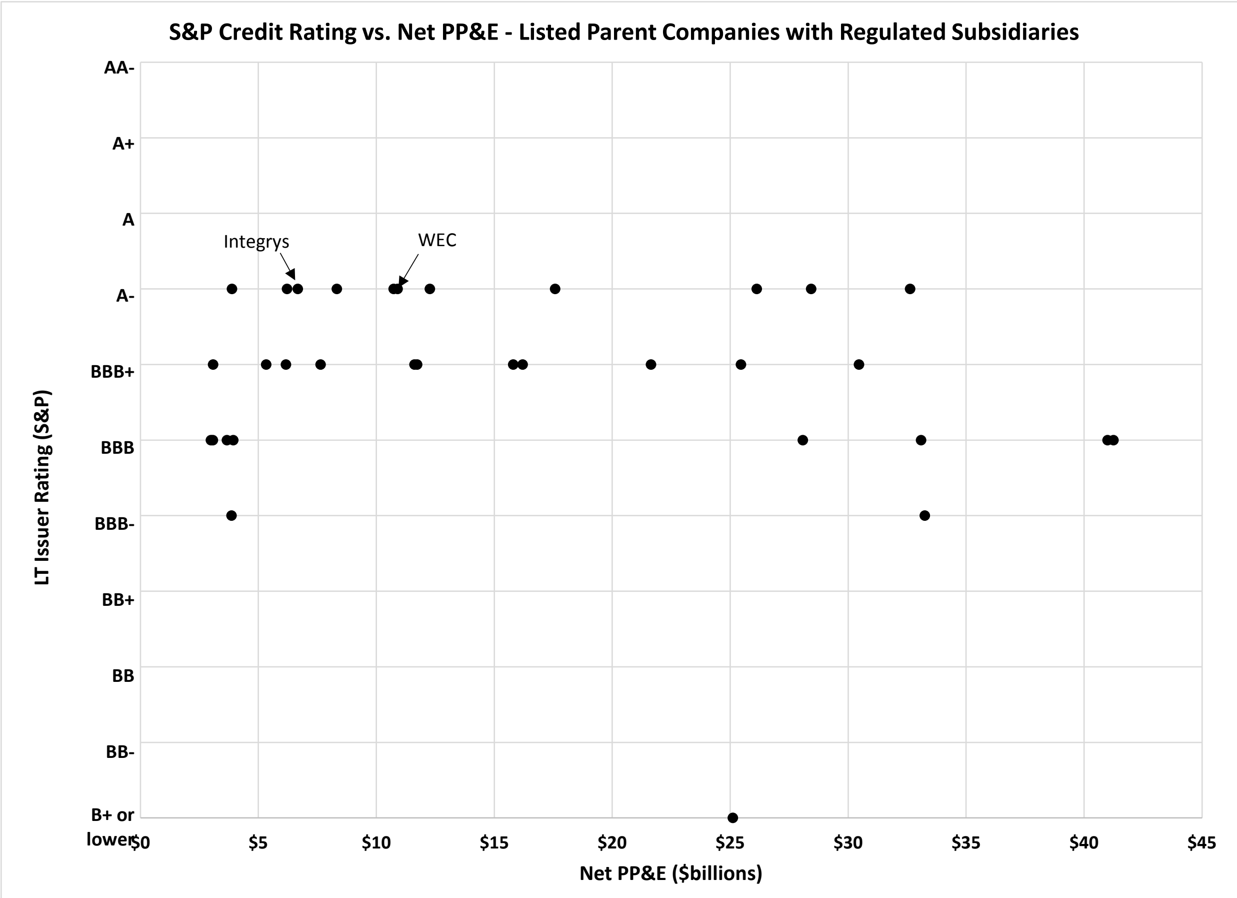


Figure 3



Q. Have either WEC or TEG asserted that they cannot access capital markets unless the transaction is approved?

A. No. According to the response to 2-CUB/Inter-6, neither "WEC nor Integrys contends that if the transaction is not approved, it would be unable to invest prudently in needed infrastructure."

Q. What do you conclude from this analysis?

A. The Applicant has provided no quantifiable analysis to support the contention that larger companies have improved access to capital markets. Comparative data on credit ratings versus size suggests that bigger companies do not have higher credit ratings. I conclude that being a bigger company does not necessarily result in improved access to capital markets, so this asserted benefit from the proposed transaction has not been demonstrated and should not be relied upon to justify the proposed transaction.

VI. Assessment of Other Reasons for the Proposed Transaction

Q. Given that creating a larger company will not necessarily result in a financially stronger entity and that no quantifiable benefits to ratepayers have been identified, is the acquisition needed to achieve the other stated goals that the Applicant offers for the proposed transaction?

A. The proposed transaction does not appear to be needed to achieve the stated goals other than to create a larger company. For example, the acquisition is not required to "maintain WEC's and Integrys' long tradition of making significant contributions to regional economic development and generous support of educational, cultural, and charitable activities in the communities they serve." Without the acquisition, each company would be able to continue to make such contributions. The acquisition is not required to "create a more diversified generation portfolio with a larger geographic footprint," as WEPCO and WPSC will remain separate operating companies and each will utilize its existing portfolio of resources to serve its customer base. The acquisition is not needed to "facilitate continued prudent investment in needed utility infrastructure." As noted in their response to 2-CUB/Inter-6, both WEC and TEG haves stated that they would be able to invest in needed infrastructure if the transaction is not approved.

VII. What Concerns Should the Wisconsin Commission Have Regarding the Proposed Transaction?

Q. The proposed transaction is an acquisition by a parent utility holding company of another parent utility holding company. How will this transaction affect companies regulated by the Commission?

A. The Applicant has stated that it will not combine any of the companies regulated by the Commission without Commission approval. The Applicant has also stated that it has not estimated any savings or synergies due to the proposed transaction. Thus, the companies regulated by the Commission may not be immediately affected by the transaction.

Q. **If the companies regulated by the Commission may not be immediately affected by the transaction, why should the Commission be concerned about the proposed transaction?**

A. The Wisconsin utility holding company acquisition standard requires that the transaction be "in the best interests of utility consumers, investors and the public." Without any identified savings to ratepayers of WEPCO, WPSC, or WG, it is difficult to see how this acquisition could benefit ratepayers and be in the public interest. Moreover, WEC is paying an above-market premium to acquire TEG. Investors providing funds to WEC to pay this above-market premium are expecting an adequate return. Post-transaction, the proposed post-acquisition holding company, WEG, will generate most of its earnings and profits from its regulated subsidiaries, the largest of which are companies regulated by the Commission, especially since TEG has already sold Integrys Energy Services, an unregulated subsidiary.[6] <u>If the acquisition is approved</u>, WEG will need to generate increased earnings, profits, and cash at the parent company level to fund the above-market premium. To do this, WEG would likely need to extract higher earnings, profits, and cash flow from its regulated subsidiaries, including WEPCO, WG, WPSC, and ATC. Without sufficient synergies or savings that can be shared equitably between shareholders and ratepayers, these higher earnings and profits will need to come from higher rates at regulated subsidiaries. Thus, it is possible that ratepayers could be harmed by the proposed transaction if it is approved as proposed. The Commission should be very concerned about this possibility, especially given the lack of synergies identified by the Applicant.

Q. **Can you illustrate this concern in more detail?**

A. Prior to the acquisition (assuming for purposes of this illustration that the acquisition is approved) the revenues, net income, and cash flow of WEC and TEG supported their respective stock prices. After the acquisition but without any synergies, the post-

[6] Constellation completed its acquisition of IES on November 3, 2014.

acquisition revenues, net income, and cash flow of WEC and TEG will be the sum of the separate pre-acquisition values, but the post-acquisition entity will have more debt and more shares of stock to support financially. For example, the new debt issued to fund a portion of the acquisition price is $[redacted].[7] Assuming an interest rate for new debt of 5%, the interest on this incremental debt will be about $[redacted] annually. All else being equal, pre-tax expenses will increase by $[redacted], resulting in lower net income and lower cash flow from operations. Thus, the post-acquisition company could be financially weaker than the separate companies pre-acquisition.

Q. Has the credit rating of the Applicant been affected by the acquisition announcement?

A. On June 23, 2014, Moody's downgraded WEC's ratings outlook to negative from stable after the announcement that WEC would acquire TEG. Moody's expectation is that the transaction will be detrimental to WEC's credit rating because it is acquiring "a company with a weaker credit rating in a leveraged transaction." [8] S&P downgraded outlooks for WEC, TEG and subsidiary companies North Shore Gas and Peoples Gas from stable to negative following the announcement of WEC's acquisition of TEG. S&P expects "that the incremental debt associated with this transaction will weaken WEC's financial measures. Therefore, we believe that the company's consolidated financial risk profile could fall toward the lower end of our 'significant' financial risk profile category, leaving little room for underperformance relative to our forecast." [9] Fitch had a similar response to the announcement placing WEC's rating on Rating Watch Negative on June 24, 2014. According to Fitch, "The proposed acquisition results in a meaningful increase in consolidated leverage compared to WEC's current and projected pre-acquisition financial position." Further, the agency said it is concerned about "the aggressive dividend policy adopted by management," adding that it "expects leverage metrics of the combined entities to be weak for the current rating category and significantly weaker than WEC's

[7] *See* the document entitled "[redacted]", p. 2 "S&U" that WEC produced in discovery in this docket. WEC deems this document highly confidential and filed it via ERF as "IL WEC City 6.01 Attach 01 CONFIDENTIAL & PROPRIETARY."
[8] Applicant filed the ratings reports from Moody's (June 23, 2014), S&P (June 23, 2014), and Fitch (June 24, 2014) with its public response to Data Request No. PSCW-01.26.
[9] *Id*.

stand-alone credit profile."[10] Thus, the ratings agencies appear to support my observation that absent any synergies, the post-acquisition entity could be financially weaker than the individual pre-acquisition companies.

Q. In the above example, why did you assume a 5% interest rate for new debt?

A. In May 2014, WEPCO issued $250 million in new 30-year debt at a rate of 4.25% and in November 2013, WPSC issued $450 million in new 30-year debt at an interest rate of 4.75%.[11] In 2015, the assumed year of issuing new acquisition debt, it is expected that interest rates will be higher. Since the announcement, WEC's outlook has been downgraded, which could result in higher borrowing rates. Under these circumstances, the 5% interest rate for new acquisition debt used in my illustrative example above is a reasonable assumption.

Q. Could synergies offset these higher costs of supporting the acquisition premium?

A. In theory, a transaction could yield enough synergies to offset or exceed the higher acquisition costs and still provide benefits to both shareholders and ratepayers. However, in this case, that may be difficult. The high end of Mr. Reed's savings estimate is 5% of non-fuel O&M costs. Not all O&M costs are avoidable. In addition to fuel expenses, purchased power and transmission of electricity by others are costs that are generally not controllable or avoidable due to an acquisition or merger transaction. These costs will still be incurred after the proposed transaction. The remaining O&M costs are candidates for synergies. I would expect that most of the savings would come from WEPCO and WPSC, as these are the largest regulated subsidiaries and their respective service territories are intermingled, which affords the greatest opportunity for savings. Figure 4 below provides a summary of controllable O&M costs for WEPCO and WPSC of almost $1.5 billion. Five percent of this amount is approximately $73.6 million. So, even if all of these savings went to shareholders and none to ratepayers, these savings would not offset the higher annual debt costs identified above.

[10] *See Id.*
[11] *See* WEC's Response to Data Request 2-CUB/RFP-13, p. 2 (PSC REF#: 225013) for WEPCO, and Ex.-CUB-Hahn-2, p. 77 for WPSC.

Figure 4

2013 O&M Expenses			
	($millions)		
Item	**WEPCO**	**WPS**	**Sum**
Total O&M Expense	$2,449.3	$935.4	$3,384.7
less: Fuel	$502.2	$235.5	$737.7
less: Purchased Power	$545.3	$253.3	$798.7
less: Transmission of Electricity by Others	$259.1	$118.4	$377.5
Controllable O&M	$1,142.6	$328.2	$1,470.9

Source: 2013 FERC Form 1 Reports

It is important to note that the above example does not represent a complete analysis of the potential impact of the proposed transaction. It is intended to simply illustrate how a post-acquisition entity could be financially weaker than its pre-acquisition components. Lastly, I note that the combined 2013 revenues of WEPCO and WPSC are about $5.42 billion.[12] If all of the $73.6 million in synergies went to ratepayers, it would represent less than a 1.4% rate reduction.

Q. Have you seen other estimates of savings in documents provided in this proceeding?

A. Yes. [redacted][13] [redacted] proposed transaction.

Q. If the acquisition were to be approved as proposed, how could post-acquisition WEC extract higher earnings, net income, and cash flow from the regulated operating subsidiary level to the parent company level?

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[12] See the 2013 FERC Form 1 Reports for WEC and TEG.

[13] *See* TEG's Response to Data Request No. PSCW-13.12 (PSC REF#: 224863) which directs to TEG's response to Data Request No. PSCW-10.02 (PSC REF#: 223823). The data responsive to PSCW-10.02 is considered "Highly Confidential" by TEG and TEG saved to an e-room. This confidential portion of testimony is based on documents TEG saved to the e-room.

A. One way to achieve this outcome would be to increase dividend payments to the parent. This means the regulated subsidiaries would retain less cash than would be otherwise used to invest in utility infrastructure. Another possible mechanism would be to hold regulated rates at current levels and reduce costs. This will result in higher net income and facilitate higher cash dividends to the parent. Another mechanism would be to increase the expansion of the ATC system. Transmission companies such as ATC are regulated by FERC, and often achieve higher returns on equity ("ROEs") than do companies with generating and distribution assets whose rates are regulated at the state level. Post-acquisition, ATC's transmission investments could be increased above the levels that were expected or planned prior to the acquisition, generating higher earnings, net income and cash flow to the parent company. The acquisition will facilitate this outcome because WEC will own a controlling interest in ATC, [redacted][14] These are just a few examples, and there are undoubtedly other means that the applicant could use to achieve this outcome. Any of these mechanisms for extracting higher earnings, net income, and cash flow from the regulated subsidiaries could adversely affect Wisconsin ratepayers.

Q. Has the Applicant provided an assessment of the financial impact of the proposed transaction?

A. [redacted][15] [redacted]

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[14] *See* [redacted]. The document was provided by TEG as a highly confidential Attorney/Reviewer Eyes only document saved to the Integrys e-room in response to Data Request No. PSCW 10.06 and titled [redacted]

[15] *See* the document entitled "[redacted]" that WEC produced in discovery in this docket. WEC deems this document highly confidential and filed it via ERF as "IL WEC City 6.01 Attach 01 CONFIDENTIAL & PROPRIETARY."

Figure 5 – WEC CONFIDENTIAL & PROPRIETARY

Q. WEC has stated that the proposed transaction will be accretive,[16] meaning that WEC's earnings per share will be higher after the acquisition than before the acquisition. If the proposed transaction is accretive, does that mean that the proposed transaction will produce a financially stronger company?

A. Not necessarily. According to the 2013 SEC 10K reports for WEC and TEG, the respective earnings per share were $2.54 and $4.40. Since TEG's earnings per share is

[16] See WEC's response to Data Request No. PSCW-01.13, the public version of which is PSC REF#: 219081.

much higher than WEC's, the averaging of the earnings per share figure will result in WEC having a higher post-acqusition earnings per share figure, even with a higher number of shares issued and some loss of net income due to recovery of acquisition costs. Figure 6 below illustrates this point. Being accretive does not necessarily mean a financially stronger entity.

Figure 6
Post-acquisition Accretion Example

	Pre-acquisition		Post-acquisition		
	WEC	**TEG**	**WEC adj**	**TEC adj**	**WEC post-acquisition**
Net income	$577.4	$350.0	($53.5)		$873.9
# of shares	227.6	79.5	89.7	(79.5)	317.3
EPS	$2.54	$4.40			$2.75

Q. If the proposed transaction is to be approved, how can the Commission protect ratepayers from adverse outcomes?

A. It is probably not feasible to completely protect against 100% of potential adverse outcomes. One way to mitigate the impact of potential adverse outcomes to ratepayers is to establish ring-fencing provisions that become binding conditions of any approved acquisition. A ring-fencing provision is a condition that creates a ring or a fence around regulated subsidiaries that protects that entity from the activities and actions of its parent company and other affiliates. For example, as a condition of approving the proposed transaction, the Commission could prohibit a regulated subsidiary from loaning money to or borrowing from its parent. Ring-fencing provisions are discussed more fully in a later section of this testimony. Ring-fencing provisions are very common in mergers and acquisitions that involve regulated subsidiaries and affiliates.

Q. Are you aware of any other acquisitions and/or mergers where the lack of ring-fencing provisions became an issue for a regulated subsidiary?

A. Yes.

Q. Please describe an example.

A. NiSource Inc. ("NiSource") experienced two major mergers in the late 1990s to early 2000s. First, Bay State Gas Company ("Bay State"), a Massachusetts gas distribution company, became an affiliate of NIPSCO in 1998 following a merger with Northern Indiana Public Service Company and NIPSCO Acquisition Company. NIPSCO subsequently changed its name to NiSource.

Two years later, NiSource agreed to merge with another holding company, Columbia Energy Group ("Columbia"). To finance the merger with Columbia, NiSource intended to sell $1 billion in assets and assume up to $6 billion in debt. Cash payments to Columbia shareholders were estimated to be between $3.9 billion, assuming a 30% exchange of stock, and $5 billion, assuming no exchange for NiSource stock. NiSource would also assume $2.4 billion of Columbia's outstanding debt after the merger.

Q. What was the impact of the Columbia/NiSource merger on the credit ratings of NiSource and its subsidiaries?

A. Ex.-CUB-Hahn-3 and Ex.-CUB-Hahn-4 include two Moody's credit reports relevant to this issue. Ex.-CUB-Hahn-3 is a Moody's report from February 2002, two years after the completion of the merger. At that time, Moody's downgraded the debt ratings of NiSource and its subsidiaries, "all with negative outlooks." NiSource senior secured debt and premium income equity securities ratings were downgraded to Baa3 and NiSource subsidiaries' senior unsecured debt (Bay State, Columbia, Indianapolis Water Company, NIPSCO) were downgraded to Baa2.

Q. Why were they downgraded?

A. Moody's explained the downgrades:

> The downgrades reflect higher-than-expected debt levels and weaker-than-expected cash flow from [NiSource's] subsidiaries… With market capital of roughly $4 billion, it will be a challenge to issue enough equity to offset over $8 billion of debt on its balance sheet…The two-notch downgrades for Columbia and NIPSO and the three-notch downgrades for Bay State and Indianapolis Water Company align the ratings of the subsidiaries and bring them closer to the parent. The change in notching reflects the subsidiaries' financial and operational integration with the parent and lack of regulatory ring-fencing.

The report attributed the worsening credit ratings of the subsidiaries to the lack of ring-fencing provisions that allowed NiSource to require increased dividend payments from its affiliates.

Q. Did NiSource and its subsidiaries continue to receive weak credit ratings from lack of regulatory ring-fencing provisions?

A. Yes. Ex.-CUB-Hahn-4 provides a Moody's report from October 2008, six years after the first report. The second report stated that NiSource subsidiaries would receive higher ratings as standalone "if it were not for the substantial parent obligations they help to support." The report explicitly stated that the lack of ring-fencing provisions failed to insulate the subsidiaries from their parent debt. The lack of ring-fencing provisions was still an issue eight years after NiSource assumed the enormous debt from the Columbia merger.

> Their ratings are notched closely to the parent's debt Baa3 rating because of the centralized cash management and little ring-fencing restriction against the parent upstreaming cash and potentially putting more debt at the subsidiaries.[17]

It is important to note that I do not state that such adverse outcomes <u>will</u> occur with the proposed transaction. I cite this example to show what <u>might</u> happen and illustrate why the Commission needs to establish adequate ring-fencing provisions if the proposed transaction is to be approved.

[17] Ex.-CUB-Hahn-4, p. 9.

VIII. Review of the Proposed Transaction in Illinois

Q. Has an application relating to the proposed transaction been filed with the Illinois Commerce Commission ("ICC")?

A. Yes. WEC, TEG, Peoples Energy LLC., the Peoples Gas Light and Coke Company ("Peoples Gas"), North Shore Gas Company ("North Shore"), ATC Management Inc., and American Transmission Company, LLC filed a joint application and testimony on August 6, 2014 in Docket Number 14-0496.

Q. What is the status of Illinois Docket Number 14-0496?

A. On January 2, 2015, the People of the State of Illinois by the Illinois Attorney General and the City of Chicago filed a motion to extend the schedule in the case. On January 8, 2015, the Administrative Law Judge issued a Notice of Continuance of Hearing and scheduled a status hearing for January 20, 2015. Staff and Intervenor Direct testimony and applicant Rebuttal testimony have been filed.

Q. What's the upcoming schedule for Illinois Docket Number 14-0496?

A. Before the motion to extend the schedule was filed, the schedule was:

Staff and Intervenor Rebuttal Testimony	January 15, 2015
Applicant Surrebuttal Testimony	January 29, 2015
Pretrial Motions	February 11, 2015
Evidentiary Hearings	February 18-20, 2015
Briefs	March 18, 2015
Reply Briefs	April 3, 2015
Draft Orders/Statements of Positions	April 8, 2015
Deadline for Commission Action	July 6, 2015

Q. Who are the intervenors in ICC Docket Number 14-0496?

A. Retail Energy Supply Association ("RESA"), the Illinois Attorney General on behalf of the People of the State of Illinois, ICC Staff, the City of Chicago, Utility Workers of America Local 18007 and the Illinois Citizens Utility Board have all filed testimony.

Q. Did the intervenors suggest any conditions for approval of the joint application?

A. Yes. A full list of conditions unedited from their original versions is provided in Ex.-CUB-Hahn-5. I developed this list from testimony filed in Illinois and have summarized below a few conditions that were either proposed by more than one intervenor or could be relevant to the Wisconsin proceeding. The following are examples of issues raised by the intervenors.

Christopher Wheat for the Illinois Citizens Utility Board and City of Chicago, David Effron for the Illinois Attorney General's Office, and Eric Lounsberry from ICC Staff all raise concerns about the Joint Applicants' commitment to keep 1,952 full time employees in Illinois for two years after the closing of the proposed transaction. The Illinois intervenors note that these numbers are short 5-7% of the forecasted levels of employment in the ongoing rate cases of the Peoples Gas and North Shore gas companies (collectively, "Gas Companies"), Docket Nos. 14-0224/0225. Therefore, either the Gas Companies are seeking to recover salaries for staffing levels that they do not expect to meet or they intend to reduce staffing levels thereby putting safe and reliable service at risk. These intervenors reached similar conclusions with respect to FTE levels after the proposed transaction, and have testified that the Joint Applicants must address and update the appropriate levels of FTE as condition of acquisition approval.[18]

Illinois intervenors have also been concerned with the completion of Peoples Gas' Accelerated Main Replacement Program ("AMRP"). William Cheaks Junior and Michael Gorman for the Illinois Citizens Utility Board and the City of Chicago, Sebastian Coppola for the Illinois Attorney General, and Eric Lounsberry from ICC Staff all discuss Peoples Gas' inadequate execution and commitment to the AMRP. They suggest additional measures for oversight over the program and note WEC's lack of a thorough due diligence review of the AMRP, which could impose risk given continual escalation in construction costs and delays. Furthermore, Michael Gorman states that for approval of

[18] ICC City/CUB Exhibit 1.0, Direct Testimony of Christopher Wheat, ICC AG Exhibit 1.0, Direct Testimony of David Effron, and ICC Staff Exhibit 2.0, Direct Testimony of Eric Lounsberry, available on the ICC website.

the transaction, the joint applicants should accept ring-fencing provisions in order to ensure that Peoples Gas funds the AMRP in a timely manner and is not impacted by holding company debt following the acquisition.[19]

Lastly, I highlight the testimony of ICC Staff witness Michael McNally. Mr. McNally suggests five conditions that could be described as ring-fencing provisions. These conditions are meant to insulate the Gas Companies from their non-utility affiliates and mitigate effects of a potential WEC downgrade on the Gas Companies.[20]

IX. Review of the Proposed Transaction in Michigan

Q. Has an application relating to the proposed transaction been filed with the Michigan Public Service Commission ("MPSC")?

A. Yes. WEC, TEG, WPSC, Michigan Gas Utilities Corporation, and WEPCO filed a joint application and testimony on August 6, 2014 in Case Number U-17682.

Q. What is the status of MPSC Case Number U-17682?

A. Staff and Intervenor testimony was originally scheduled to be filed on October 31, 2014 with a hearing set for November 19, 21, 24 and 25, 2014, but a revised scheduling order issued on October 30, 2014 added a significant amount of time to the schedule.

Q. What is the current schedule for MPSC Case Number U-17682?

A. A revised scheduling order issued on October 30, 2014 set the following schedule:

Staff and Intervenor Testimony	February 2, 2015
Rebuttal Testimony	February 12, 2015
Motions to Strike	February 17, 2015
Responses to Motions	February 20, 2015

[19] ICC AG Exhibit 2.0 Direct Testimony of Sebastian Coppola, ICC City/CUB Exhibit 4.0, Direct Testimony of Michael P. Gorman, ICC Staff Exhibit 2.0, Direct Testimony of Eric Lounsberry and ICC City/CUB Exhibit 3.0, Direct Testimony of William Cheaks Junior, available on the ICC website.

[20] ICC Staff Exhibit 7.0, Direct Testimony of Michael McNally, available on the ICC website.

Cross Exam Hearing	February 23-26, 2015
Briefs	March 19, 2015
Reply Briefs	April 2, 2015
PFD Target Date	May 7, 2015
Exceptions	May 14, 2015
Replies to Exceptions	May 20, 2015

Q. Who are the intervenors in MPSC Case Number U-17682?

A. Entities that have intervened include: the Michigan Attorney General, MPSC Staff, Cloverland Electric Cooperative, Inc., Citizens Against Rate Excess, Tilden Mining Company, Empire Iron Mining Partnership, Fibrek, and Verso Paper.

Q. Are you able at this time to assess conditions for approval of the acqusition that have been proposed in Michigan?

A. Because testimony is not scheduled to be filed until February 2, 2015, it is not possible at this time to assess any acquisition conditions that might be proposed in Michigan.

X. Wisconsin Ratepayer Protections

Q. Do WEC and TEG have any existing ring-fencing provisions that they must abide by?

A. Data request 2-CUB/Inter-2 asked WEC and TEG this question. WEC responded that pursuant to a recent rate order, WEPCO had restrictions placed on its dividends to WEC, as follows.

> As part of the 2013 Wisconsin rate case order issued by the Public Service Commission of Wisconsin (PSCW) in December of 2012, Wisconsin Electric Power Company (WEPCO) was ordered to maintain a financial capital structure common equity ratio range between 48.5% and 53.5%. WEPCO may not pay dividends above the test year level if doing so would cause the company to fall below the midpoint of the authorized levels of common equity (51.0%). See pages 61 through 63 of the 2013 Wisconsin rate case order, which is attached hereto.

TEG responded that WPSC had a similar provision.

> As part of the 2014 Wisconsin rate case order issued by the Public Service Commission of Wisconsin (PSCW) in December of 2013, WPSC was ordered to maintain a financial capital structure common equity ratio range between 49% and 54%. Further, WPSC shall not pay, without Commission approval, normal dividends greater than 103 percent of the prior year's common dividend. WPSC shall notify the Commission if any special dividend is contemplated. No special dividend that might cause the common equity, on a financial basis as calculated in the rate case order, to drop below the projected calendar year average of 51.00 percent or the dollar amount of equity reflected in the test year, is permitted without Commission approval. See pages 35 through 39 of the 2014 Wisconsin rate case order, which is attached hereto.

Both responses also cite provisions under the Wisconsin Holding Company Act, Wis. Stat. § 196.795, which places restrictions on activities between the utility and its affiliates.

Q. Given the potential risks to Wisconsin ratepayers and the acquisition conditions proposed thus far in other jurisdictions reviewing the proposed transaction, do you think that the existing ring-fencing provisions and the approval conditions identified in the Application are adequate?

A. No. The existing ring-fencing provisions and the conditions of approval identified in the Application are not adequate. They do not address the potential adverse outcomes that I identified earlier in this testimony. For example, assume that WEPCO has a capital structure that has a 54% equity ratio. WEPCO could send dividends to WEC in the amount of $400 million and still have an equity ratio of 51%, as shown in Figure 7 below. WEPCO's 2013 net income was $360 million, so a $400 million dividend would exceed this level of net income by a significant margin, resulting in a payout ratio of more than 100% and the extraction of cash out of the regulated subsidiary to the parent company. I believe that such an action should require Commission approval, but Commission approval would not be necessary under the current ring-fencing provisions described by WEC and TEG.

Figure 7

WEPCO Dividend Example

	Before dividend			After dividend	
	$ (millions)	%	Dividend $ (millions)	$ (millions)	%
Equity	$3,500	54%	$400	$3,100	51%
Debt	$3,000	46%		$3,000	49%
Total	$6,500	100%		$6,100	100%

Q. If the proposed transaction is to be approved, what ring-fencing provisions would you recommend be established by the Commission?

A. The following conditions are necessary to protect Wisconsin customers from harm caused by the proposed transaction:

- Require that each Wisconsin regulated subsidiary maintain its own credit rating and portfolio of debt that is independent of the post-acquisition parent.
- Prohibit each Wisconsin regulated subsidiary from loaning funds to or borrowing funds from the post-acquisition parent or other regulated subsidiaries.
- Restrict dividends from Wisconsin regulated subsidiaries to the parent company. For example, in any future year, the payout ratio should not exceed each company's average payout ratio for the most recent four years without Commission approval.
- Identify all transaction, transition, and acquisition premium costs in an accounting system.
- Deny recovery of all transaction costs regardless of whether incurred before or after the transaction closes.
- Deny deferral of and recovery of all transition costs.
- Deny direct and indirect recovery of the acquisition premium.

The first two conditions listed above will help insure that the debt costs paid by Wisconsin ratepayers are just and reasonable, market-based, and not adversely affected by the performance of the parent company or any affiliates. The third condition will help prevent the extraction of excessive cash from Wisconsin regulated companies to the parent company. The last four conditions will prevent Wisconsin ratepayers from paying for the costs of the merger of parent companies.

Q. **If the proposed transaction is to be approved, are there any other conditions you would recommend?**

A. Yes. The ring-fencing provisions proposed above are the minimum necessary to reduce the potential for harm to Wisconsin customers from the proposed transaction. I understand that other parties to this proceeding may be proposing additional conditions, and I reserve the right to supplement this list after my review of those conditions.

Additional conditions providing quantifiable benefits to customers are also necessary in order for the transaction to be deemed to be in the "best interests" of customers. The total amount of the acquisition, including equity purchase price, assumed net debt, and transaction costs and fees is $[redacted].[21] The amount of transaction costs and fees (i.e., the amount to be paid to bankers, lawyers, etc.) to consummate the transaction is $[redacted].[22] Given the dollar amounts at issue in this transaction, I recommend the following:

- An earnings cap on the annual actual earnings of WEPCO, WG, and WPSC that would return to customers any earnings above each company's authorized return on equity (currently 10.2%, 10.3%, and 10.2%, respectively).

- Permanent write off of WEPCO's transmission escrow costs, thereby excluding these costs from rates.

The first additional condition listed above will benefit Wisconsin ratepayers by returning excess profits to customers. The second additional listed condition above will provide a direct benefit by lowering electric rates in the future.

[21] *See* the document entitled "[redacted]", p. 2 "S&U" that WEC produced in discovery in this docket. WEC deems this document highly confidential and filed it via ERF as "IL WEC City 6.01 Attach 01 CONFIDENTIAL & PROPRIETARY."
[22] *Id*.

Determining appropriate benefits conditions is not a scientific process, but conditions like these are reasonable and comparable to conditions for other acquisitions and mergers, given the size of the proposed transaction.

Also, it is my understanding that if the proposed transaction is approved, new generation WPSC has proposed to construct at the Fox Energy Center would be delayed given WEPCO's capacity surplus.[23] WEC should clarify whether it is offering this as a condition of the proposed transaction.

Q. Are you aware of anything else that impacts your analysis in this proceeding?

A. Yes. On January 13, the day before this testimony was due, I reviewed a press release from the Michigan Governor's office announcing that progress had been made on an energy solution for the Upper Peninsula of Michigan. A copy of this release is attached as Ex.-CUB-Hahn-7. I have not had sufficient time to consider the impacts of this new proposal and reserve my right to amend, withdraw, or supplement this testimony at a later date based on this new information.

Q. It is possible that proceedings in Illinois and Michigan could establish acquisition conditions after the record has closed in this proceeding that could have an impact on Wisconsin?

A. Yes.

Q. Is there a way for the Commission to protect against any adverse impacts to Wisconsin ratepayers from those proceeding?

A. Assuming the Commission approves the proposed transaction, this Commission could require that that Applicant offer to Wisconsin any conditions that are ordered or part of a settlement in any other jurisdiction that reviews the proposed transaction. This condition

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[23] See WEC's 8k filed with the SEC on November 12, 2014, p. 9, attached hereto as Ex.-CUB-Hahn-6 ("Lazard's intrinsic value analysis did not take into account value associated with enhanced dividend, selected transaction benefits (e.g., multiple expansion, capital reallocation, etc.) or the value impact of breakage costs (e.g., regulatory concessions associated with transaction approval, *delay of Integrys generation investment given Wisconsin Energy's capacity surplus*, etc.)." (emphasis added) See also, [redacted] ")

would be equivalent to a “most favored nation’s clause” and would ensure that Wisconsin ratepayers are afforded at least the same level of benefits and protections that are provided to ratepayers in other states; however this condition on its own should not take the place of the other conditions discussed in this testimony.

XI. Conclusion

Q. Does this conclude your testimony?

A. At this time, yes, it does. If additional, relevant information becomes available, I will supplement this testimony as appropriate.