BEFORE THE
PUBLIC SERVICE COMMISSION OF WISCONSIN

Application of Wisconsin Energy Corporation for Approval to Acquire the Outstanding Common Stock of Integrys Energy Group, Inc.

DIRECT TESTIMONY
OF MARK N. LOWRY ON BEHALF OF GREAT LAKES UTILITIES

Q. Please state your name, affiliation and business address.
A. My name is Mark Newton Lowry. I am the President of Pacific Economics Group (“PEG”) Research LLC. My business address is 22 East Mifflin Street, Suite 302, Madison, WI 53703.

Q. Please describe your academic background.
A. I attended Princeton University and earned a BA in Ibero-American Studies and a PhD in Applied Economics from the University of Wisconsin - Madison.

Q. What is your professional experience in the energy industry?
A. Energy economics has been my chief professional focus for more than thirty years. During my years in graduate school I was a staff economist at Madison Consulting Group, working chiefly on gas market issues. The firm was founded by Charles Cicchetti, former chairman of the Public Service Commission of Wisconsin (“PSCW”). I then worked for several years as an Assistant Professor of Mineral Economics at the Pennsylania State University. My research and teaching there was chiefly in the energy economics field.

In 1989, I returned to Madison and took a job as a Senior Economist at Christensen Associates. During my nine years there I became a Vice President. I
rejoined Dr. Cicchetti in 1998 as a full partner at Pacific Economics Group (“PEG”) and managed its office on Capitol Square in Madison. Since 2009 I have been President of PEG Research LLC, which is based at the same location.

Q. Please discuss your consulting industry work.

A. My twenty-five years of work as a consultant has focused on the economics of energy utilities. I have done extensive statistical research and testimony on energy utility cost and service quality. This research, which has extensively considered both vertically integrated electric utilities (“VIEUs”) and natural gas distributors, has been used chiefly in studies of energy utility performance but has also routinely addressed cost structure issues such as economies of scale and scope.

I have also done extensive research and testimony on energy utility regulation. My specialty in this field is approaches to regulation such as revenue decoupling, cost trackers, multiyear rate plans, and forward test years which help utilities cope with changing business conditions. This “alternative regulation” (aka “Altreg”) work has greatly familiarized me with recent utility industry challenges and the appropriate regulatory solutions.

I am recognized internationally as an authority in both of these fields. Work for a mix of utilities, regulators, and consumer advocates have given me a reputation for objectivity and dedication to good regulation. I have published numerous papers in both areas and have spoken extensively on my research, chairing numerous conferences. Ex.- GLU-Lowry-1 provides further details of my professional experience.
Q. Please identify your client and explain their interest in this proceeding.

A. I am submitting testimony on behalf of Great Lakes Utilities ("GLU"). GLU provides a range of services to municipal utilities, including procurement of wholesale power. Some GLU members, like the City of Marshfield, also make their own bulk power purchases. Most member utilities serve small municipalities in north central and northeast Wisconsin. Most power supplies are purchased in bulk and delivered to members by the American Transmission Company ("ATC"). Some members have small ownership shares in ATC. Large quantities of power are purchased from Integrys Energy Group ("Integrys") and Wisconsin Energy Corporation ("WEC") through their electric utility subsidiaries, Wisconsin Public Service Corporation ("WPSC") and Wisconsin Electric Power Company ("WEPCO"). GLU members need low cost, reliable access to power on competitive terms from diverse sources. Achieving this goal can help the economies of the communities they serve to flourish.

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

A. The purpose of my testimony is to provide my perspective as an energy economist on the proposed acquisition of Integrys by WEC. WEC owns and operates Wisconsin’s largest gas and electricity utilities. WPSC is the state’s second largest gas and electric service provider. Integrys also owns gas distributors in other states. The largest of these, Peoples Gas Light and Coke ("Peoples Gas"), serves the city of Chicago. In my view, the Applicants (Integrys and WEC) have not adequately demonstrated that the proposed acquisition will materially benefit Wisconsin ratepayers or the public.
Q. Please summarize your testimony.

A. Wisconsin statute § 196.795(3) provides that:

No person may take, hold or acquire, directly or indirectly, more than 10% of the outstanding voting securities of a holding company, with the unconditional power to vote those securities, unless the commission has determined, after investigation and an opportunity for hearing, that the taking, holding or acquiring is in the best interests of utility consumers, investors and the public [italics added].

Applicants’ direct evidence has fallen far short of this standard. The problem with this particular acquisition is that, while it may benefit shareholders of one or two Wisconsin companies, there are material potential disadvantages to ratepayers and the public. Electric rates of retail and wholesale customers in north central and northeast Wisconsin would rise materially if rates of the two utilities were levelized. The independent voice of north central and northeast Wisconsin in the management of ATC would be lost. The acquisition would also exacerbate a problem of concentration that already exists in Wisconsin’s bulk power market. ATC can play a critical role in alleviating this problem by ensuring strong transmission ties to other MISO regions. However, its ownership is dominated by the same utilities that own most generation capacity on its system.

The potential for cost savings that could offset these problems with the acquisition are modest. Prospects for realization of scale and scope economies are limited. WEPCO is not a good cost manager and, if it continues its normal practice of filing frequent rate cases, this will discourage it from pursuing potential cost savings aggressively.

Applicants have not made an energetic case for the acquisition despite the lack of clear net benefits. For example, no serious quantification of merger
benefits has been undertaken. The discussion of risk reduction benefits from the
merger is vague and unpersuasive, due in large measure to the fact that both
Applicants enjoy low regulatory risk.

Absent an obvious need for the acquisition and evidence of material
benefit, the proposal could reasonably be rejected for its lack of convincing
positive argument and the considerable risk of detriment to Wisconsin ratepayers.
Should the PSCW nonetheless wish to approve the merger, it should be
conditioned on measures that rectify foreseen problems and thereby improve the
delicate balance of costs and benefits. I believe that these conditions should
include a restriction on the ability of the two independent utility subsidiaries to
consolidate, and an opportunity for GLU members and other municipal and
cooperative utilities in the state to purchase a larger share of ATC and secure an
additional position on its Board of Directors. Other conditions may also be
appropriate to address the concerns of other stakeholders in this proceeding.

Q. How is your testimony organized?

A. I first discuss some concerns I have about the current state of Wisconsin’s bulk
power markets and power transmission industry. There follows a detailed
discussion of the likely net benefits of the proposed acquisition. I conclude with a
discussion of some conditions for approval of the acquisition.

Q. What are your concerns about Wisconsin’s bulk power markets?

A. Competition in Wisconsin’s bulk power market is inadequate. In its latest State
of the Market Report the independent market monitor (“IMM”) of the Midwest
System Operator (‘‘MISO’’) describes capacity ownership in the Wisconsin and
Upper Michigan system (“WUMS”) as “highly concentrated” because vertically integrated utilities in the MISO that have not divested generation tend to have substantial market shares. The WUMS is also one of the few Narrow Constrained Areas (“NCAs”) in the Midwest region of the MISO. NCAs are described in the report as “chronically constrained areas that raise more severe potential local market power concerns.” To qualify as an NCA, an area must experience binding transmission constraints for more than 500 hours in the prior 12 months and one or more suppliers must be frequently pivotal. Despite construction of new transmission capacity in recent years, there are still flowgates subject to congestion both within WUMS and between WUMS and other MISO regions.

The heart of the problem is geography. The WUMS is bordered on two sides by Great Lakes. Underwater transmission cables that could provide links to other markets are costly. The problem has been exacerbated by a shortage of capacity to deliver power to eastern Wisconsin from adjacent MISO markets.

Fortunately, IMM analyses of individual market participants shows little evidence of attempts to manipulate markets. I am nonetheless concerned that, in addition to the possibility of market manipulation down the road when market conditions tighten, municipal and cooperative utilities in eastern Wisconsin have few choices today when it comes to securing long-term power purchase.

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2 Another NCA in the MISO region is Minnesota.
3 MISO IMM, op cit, p. 65.
agreements. The salient opportunities are to purchase power from the handful of utilities in the WUMS under formulaic cost-based tariffs that weaken the performance incentives of these utilities and can be well above the prices that could be possible in a more competitive bulk power market. It would be desirable to broaden choices by having the option to obtain long-term power purchase contracts with reliable delivery from suppliers in other MISO markets. The already limited choices for long-term supply contracts would be further limited if the acquisition goes forward and there is no longer an option to choose between WPSC and WEPCO. Inadequacy of ties to other MISO markets also strengthens the rationale for Wisconsin utilities to self generate even if this involves higher cost.

Q. Please discuss your concerns about Wisconsin’s transmission outlook.

A. I have concerns in two general areas.

  o Transmission service in most of Wisconsin is provided by ATC. Eighty-eight percent (88%) of the shares of ATC are held by private companies with power generation capacity in its footprint. These owners have incentives to increase the transmission rate base, but to do so in a way that doesn’t compromise opportunities for generation earnings. We might expect, for example, that over its years of operation ATC would place a relatively low priority on increasing capacity to receive low-cost power from facilities to the west of its footprint, including low-cost wind and hydro power. A transmission company without generation ties would, in contrast, seek to maximize use of its system even if that involved large
power inflows from low cost upstream sources. The current ownership structure of ATC thus makes the company vulnerable to biases that jeopardize its independence in making operation and planning decisions, vulnerability which will only increase if the proposed acquisition is approved without appropriate remedies.

- ATC’s cost management is another concern. Exhibit 2 (Ex.-GLU-Lowry-2) shows that the ATC’s transmission revenue requirement has more than doubled in the 13 years since 2001. The formula rate regulatory system under which ATC operates has facilitated needed investments, but also weakens its incentive for cost containment.

- It would be desirable for both reasons to increase the ownership share of ATC by parties whose overriding concerns are for a competitive bulk power market, low bulk power prices, and efficient transmission service.

Q. Does the proposed acquisition exacerbate the problems you describe?

A. Yes. The combination would greatly increase concentration of generation capacity ownership in the WUMS. GLU’s choices for obtaining long term power supplies with firm transmission delivery would shrink. This increases the importance of reliable transmission ties to adjacent MISO markets.

The combined company would also own 60% of ATC and its corporate manager, ATC Management Inc. This raises concerns that the company would use its increased share of ATC to institute policies that benefit it at the expense of

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4 It would also reduce potential competition from unregulated affiliates in the emerging markets for distributed solar generation and miscellaneous energy services. For example, there would be no Integrys Solar seeking distributed generation customers in southeast WI.

5 GLU members, by contrast, hold less than 2%.
the public interest. Interests of minority owners could be more easily overruled. With greater generation ownership concentration WEC would have more incentive to secure ATC policies that favor its generation interests and have an easier time implementing such policies.

Q. Please discuss the Applicant’s proposal to remedy the ATC control problem.

A. Applicants acknowledge a potential problem from concentration of ATC’s ownership since they propose to exercise independently only 34% of their ATC voting rights on most issues, including, and perhaps most significantly, election and removal of directors on ATC's Board of Directors. The remaining 26% would be voted in a manner consistent with the consensus of other ATC owners, effectively giving these owners more control. Applicants would reserve use of their full voting rights for "certain fundamental corporate matters necessary to protect the value of their investment." These matters would include the sale of ATC, a merger, or a major acquisition.

Q. What is your view of these proposed mitigation measures?

A. I have several concerns.

- The commitment is overly vague. For example, no clear mechanism has been proposed for enforcing the Applicants’ voting commitment.
- The exception for "fundamental corporate matters" include issues such as an initial public offering (“IPO”), which matter greatly to GLU.
- The preponderance of the residual ownership is held by other privately held companies that, in addition to owning substantial WUMS generation capacity, chiefly serve south central and southwest WI.
The diversity of ATC management can still decline. I believe that the current diversity of the Board of Directors, which has representatives of four investor-owned utilities, with their unique experiences and perspectives, as well as four independent directors and a representative of a municipal electric company, encourages sensible decisions and should be enhanced, not diminished as a consequence of this acquisition.

Where the Company does vote 34% of its shares independently it will reflect the interests of the *combined* company. The heart of the new company’s electric service territory will be the more urban southeast region of WI. The independent voice of WPSC, with its fortunes tied to the economic vitality of northeast and north central Wisconsin, would be lost in ATC deliberations over operations, planning, and cost allocations. An independent WPSC would more frequently champion policies that benefit customers in its service territory. The acquisition could thus affect GLU and other WPSC customers adversely with respect to transmission construction priorities, cost allocations, and other matters.

Q. Are there instances in which the Applicants have disagreed on transmission policy issues?

A. Yes. An example is the Applicants’ positions on the System Support Resource costs of WEC’s Presque Isle station in FERC Docket EL 14-34. In that proceeding, the two companies differed on how those costs should be allocated to transmission customers under the MISO tariff. WEPCO/Wisconsin Energy advocated for a more granular approach based on a breakdown of which
customers benefited from the continued operation of the power plant.

Integrys/WPSC advocated for a broader pro rata allocation throughout the ATC footprint similar to how the costs for transmission upgrades are allocated under the applicable tariff. Unsurprisingly, the two positions would result in very different impacts on transmission customers, with WEC/WEPCO's approach benefiting customers in southeastern Wisconsin and WPSC/Integrys's approach benefiting customers in the northeast and north central areas of the state.6

Q. Do you have other concerns about the proposed combination?

A. Yes. Electric rates charged by WPSC are lower than those of WEPCO. GLU, for example, has cost-based wholesale requirements contracts with both Applicants, and buys more power from WPSC than from WEPCO. Rates paid in these contracts to WPSC are materially lower than those paid to WEPCO. This is discussed further in an Affidavit prepared by rate consultant Gary Price that is attached to the testimony of GLU witness Nilaksh Kothari. Wholesale rates of the two utilities may eventually be “levelized,” depriving WPS electric customers of the benefits of their utility’s lower unit cost of service. Electric rates paid by WPS retail customers are also materially lower than those paid by WEPCO customers.

Applicants pledge that any levelization of retail rates between the utilities would only be proposed when and if it can be shown to be in the best interests of all affected customers. However, assurances made by the Applicants with respect

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6 Shortly before completing this testimony, I became aware of a proposed transaction intended to address this issue whereby WEPCo would sell its generation and utility business assets in the Upper Peninsula to The Upper Peninsula Power Co. I have not had an opportunity to assess the impact of that transaction on the instant filing, but such a sale would not diminish my concern for independence and diversity of the ATC Board.
to insulating \textit{wholesale} customers from adverse consequences of the transaction are vague, hold them harmless only from merger-related costs, and expire after five years. No commitment has been made as to whether and when rates might be levelized for wholesale customers, which potentially means increased costs for GLU members.

I am also concerned that a combined utility might be less attentive to special needs of WPSC customers. Municipal and large industrial customers, for instance, have demands for electric service (and also gas distribution service) that are unusually sensitive to the price and quality of service. Market-responsive rates and services help these customers and the communities they are based in to prosper.

A utility immersed in the challenges of managing gas and electric service to a sprawling region may not make sure that special needs of these customers are met. Management of the accelerated main replacement program ("AMRP") of Peoples Gas in Chicago would be a particular distraction. This is a typical problem in large organizations.

Q. \textbf{Are there potential offsetting benefits from the acquisition?}

A. Yes. Consolidation has some potential to improve operating performance, and this improvement could in principle be large enough to offset the disadvantages I have discussed. However, there is mixed evidence on the potential for improved performance from this particular combination. For example, savings are more likely if the performance of the acquiring company is superior to that of the acquired company. However, WPSC has lower rates for both wholesale and retail
electric service. My company’s statistical cost research over the years has found WEPCO to be a mediocre cost performer. WEPCO’s most recent major generation initiative, the Elm Road Generating Station (“ERGS”), is not auspicious.

Q. You are an expert on scale and scope economies. What are the prospects for cost savings from these sources?

A. There are no scope economies to be realized from combining local gas and electric operations because each company has already consolidated these operations in its service territory. Cost savings are possible from realization of scale economies. However, a number of considerations call into question the potential for incremental scale economies in this case.

- Transmission operations of the Applicants are already consolidated.
- Savings from joint dispatch of generating units are a common benefit from the merger of vertically integrated electric utilities (“VIEUs”) like WPSC and WEPCO but are impossible from the proposed acquisition because MISO already dispatches the generation of the Applicants.
- Economies in A&G expenses are often emphasized in merger proposals as an area where scale economies can be realized. However, these can be offset by an inability to manage a larger company effectively.

Q. Please discuss the Applicants’ representation of the benefits.

A. The Company is not touting scale or “synergy” economies as a leading motivation for the merger (Direct-WEC-Lauber-5). The Applicants have not even undertaken a pre-merger synergy study. They state in response to data request
GLU-01.04 that Mr. Reed has never personally undertaken a pre-merger synergy study for any client. In response to data request 01-GLU-08, the Applicants note that “Mr. Reed has not authored or coauthored any articles on economies of scale and merger benefits.” Mr. Reed nonetheless ventures the claim that the acquisition will produce 3-5% savings in non-fuel O&M expenses in 5-10 years (Direct-WEC-Reed-34). This claim is substantiated by a compilation of more than ten merger savings estimates. However, all but one of these is a forecast rather than an estimate of savings actually achieved. Notwithstanding the shakiness of this evidence, WEC states in response to data request GLU-01.04 that “Mr. Reed does not believe that a detailed merger savings study would have been any more informative than that which he has presented in his testimony.”

Q. How important is a 3-5% reduction in nonfuel O&M expenses to ratepayers?

A. For a VIEU like Wisconsin Electric Power, this is roughly tantamount to a 1-2% reduction in its total cost. This would have a negligible impact on rates. So modest a benefit might be an acceptable return in some mergers and acquisitions but, as I have said, this particular acquisition has material downside risk for many Wisconsin ratepayers since it involves issues of potential rate levelization and power market concentration.

Q. Does independent research provide strong support for the benefits of mergers?

A. No. The topic has not received a great deal of attention in the scholarly literature but the results of available studies are decidedly mixed. A paper by Raymond Hartman shows that pre-merger predictions of cost savings from utility mergers
are often incorrect, and that most mergers are unsuccessful. Benefits are often overestimated and difficulties of integrating merged firms are underestimated.

A study by S.R. Rajan and Martin Ellis found that about half of utility mergers surveyed hurt the stockholders of the acquiring companies. The author concluded that Acquiring firms will continue to pursue accounting earnings, reducing the value of their shares in most mergers, and fail to deliver the operating performance implied in the premiums they pay over market value. Merger negotiation and integration will distract utility management from the serious business of improving their operating and capital efficiency, and changing the “guaranteed rate of return” mentality of their employees.

Q. Do regulatory commissions always approve proposed utility mergers and acquisitions?

A. No. The report by Moody’s Investor Service that Applicant witness Reed cites (Direct-WEC-Reed-14) states that an “initial round of utility M&A was unsuccessful mostly for regulatory reasons.” It lists the following eight M&A initiatives that were terminated or withdrawn due, in whole or in part, to regulatory issues.

- Exelon - PSEG
- FPL – Constellation
- Exelon – Illinois Power
- NW Natural – Portland General Electric
- Sierra Pacific - Portland General Electric
- Allegheny – DQE
- Baltimore G&E – Pepco
- Wisconsin Energy – Northern States Power
- PNM Resources – Western Resources

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Q. What evidence is provided by the Applicants of other cost savings?

A. Applicants’ witnesses discuss possible savings in fuel and capital cost, and in energy efficiency, low income, and conservation programs. These discussions are entirely speculative, and most energy efficiency programs are provided by independent agencies in Wisconsin.

Consolidation can also sometimes produce “pecuniary” scale economies from the ability to purchase inputs on more favorable terms. Applicants’ witness Lauber touts the potential of the acquisition to reduce financing costs as the leading motivation for the merger (Direct-WEC-Lauber-5).

Q. Are the arguments about financing cost savings persuasive?

A. No. Given the emphasis placed on this motivation for the acquisition, I would say that the arguments the witnesses advance on this issue are surprisingly weak. Witness Reed, for example, emphasizes the ability of the acquisition to relieve financial stress caused by non-revenue producing capital spending at a time when slow volume growth makes it more difficult to self finance cost growth (Direct-WEC-Reed-5). This has been a problem for some utilities in recent years, most notably gas distributors in need of accelerated system modernization but facing declines in gas use per customer. The problem is conventionally addressed by reforms in rate regulation such as revenue decoupling, forward test years, and capital cost trackers. I do not believe that this problem is the primary motivation for many utility mergers. The Applicants, in any event, are not facing acute financial stress that compels their combination.

Q. Please explain this point further.
A. Applicant utilities operate under regulatory systems that have unusually low risk. I have already mentioned that ATC operates under formula rates. This regulatory system causes revenue to closely track cost. Similar formulas are used in the wholesale power contracts of both Applicants. The Applicants use forward test years in their retail rate cases. The low-risk ratemaking treatment of the ERGS attracted the envy of utilities nationally. In addition, revenue decoupling is sanctioned in Wisconsin, and has previously been approved for both the gas and electric operations of WPSC. The Commission recently approved marked increases in the fixed charges of both WEPCO and WPSC. Applicants stated in response to data request GLU 01.13 that “[company witness] Reed agrees that the regulatory environment in Wisconsin is generally viewed as constructive from an investment perspective.”

Q. What about Illinois regulation?

A. Illinois has traditionally been a riskier jurisdiction for utilities than Wisconsin but has recently been much more accommodating. Peoples Gas and North Shore Gas both operate under revenue decoupling and can file rate cases with forward test years. A recent change in Illinois law sanctioned capital cost trackers for large gas distributors. Peoples Gas now has one, and Applicants stated in response to data request 01-GLU-19 that “Capital costs for Peoples Gas’ principal projects – gas main replacements – are recoverable through a rider.”

Q. Is regulation more risky in the states where mergers that Mr. Reed discussed took place?

10 Public Act 098-0057.
A. Yes. There are many American states where utilities still operate under historical test years. Revenue decoupling, high fixed charges, and capital cost trackers have not always been allowed. Useful evidence of the difference between states can be found in the appraisals of credit agencies. In a November 2008 Standard & Poor’s Report, “Assessing U.S. Utility Regulatory Environments,” for example, Wisconsin was rated “More credit supportive, Nevada was “Credit supportive,” Washington was “Less credit supportive, and Arizona and New Mexico were “Least credit supportive.” In a 2014 Utility Regulatory Assessment, S&P rated Wisconsin regulation “Strong” and Illinois regulation “Strong/Adequate”. A Morningstar Analyst Report on the merger recognizes Wisconsin as a state that has a long history of favorable regulation.

Q. Are there other circumstances that reduce the operating risk of the Applicants?

A. Yes. Witness Reed stresses the importance of slow volume growth in increasing risk. However, this is more of a concern for energy distributors than for VIEUs at present. The combination of slow volume growth, ample generating capacity, and the current cost-competitiveness of gas-fired generation has reduced the need for either Applicant to construct additional costly and controversial solid fuel generating units. Gas-fired generating capacity is more modular and involves less capital cost, and the forecasted cost of gas consumed is trued up in ratemaking

13 Applicants note in response to data request GLU-01.14 that “[Company witness] Reed agrees that slow growth will tend to reduce a utility’s need to build additional generation capacity.”
to the actual. Meanwhile, depreciation of the large recent generating plant additions is slowing growth in the Applicants’ costs, contributing to the cash flow that is available to fund capex.

Under similar circumstances, many other VIEUs are also today experiencing slow cost growth. Any need for environmental mitigation investments can usually be addressed by capital cost trackers. One indication of the lack of risk is that some VIEUs are proposing multiyear rate plans (“MRPs”) that reduce the frequency of rate cases and actually increase their risk. Xcel Energy, for example, has announced the goal of securing MRPs in all of the states in which it operates.

I should also note that the Applicants have taken other steps to reduce the riskiness of their businesses. WEC is already quite focused on utility operations. On September 18, 2014 Moody’s Investors Services upgraded its credit rating for Integrys. According to the agency, “The upgrade of Integrys’ senior unsecured rating reflects our view that the upcoming sale of its retail energy services business will markedly improve the company’s business risk profile and result in more reliable and stable operating cash flows going forward.”\(^\text{14}\) Both applicants have exited the risky nuclear generation business.

Q. Are the credit ratings of the Applicants consistent with your assessment?

A. Yes. For all of the reasons I have discussed the current credit ratings of both Applicants are excellent. Table 1 compiles recent ratings.

In view of these ratings, it is misleading for Mr. Reed to state (Direct-WEC-Reed-10) that the acquisition will “enable [the combined company] to continue providing its customers with safe, reliable, and affordable utility service.” Such continuity is highly likely with or without the proposed acquisition.

Table 1

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Q. Have credit ratings of the Applicants improved since announcement of the acquisition?
A. No they have not. Ratings agencies have “reaffirmed” their current ratings but are considering downgrades.

- On June 23, 2014 Moody’s announced it was changing the ratings outlook for WEC to negative. Their negative outlook considers the expected deterioration in WEC’s consolidated key credit metrics.

- Standard & Poor’s also revised its credit outlooks on WEC and Integrys to negative from stable following the announcement of the proposed merger on June 23, 2014. They expect that the incremental debt associated with this transaction will weaken WEC’s financial measures.

- Fitch Ratings placed WEC’s credit rating to Rating Watch Negative on June 24, 2014 following the acquisition announcement. Fitch expects leverage metrics of the combined entities to be weak for the current rating category and significantly weaker than WEC’s stand-alone credit profile.

Q. Are credit agencies always supportive of utility mergers?

A. No. Some credit analysts have questioned the benefit of mergers for bondholders. Peter Rigby, a director for Standard and Poor’s, has stated that “Some companies merge on the hope that there will be synergies that result in cost savings, but history has shown that they often aren’t achievable,” adding that “With some mergers years have passed and we are still looking for the cost savings that were promised.”

In another article, Rigby stated that “utility M&A is like my new puppy dog. When we’re walking him in the park he’s incredibly seductive – everyone wants to look at him. But the reality is, it’s a whole lot harder to take

care of this dog than we ever thought, and the outlook is uncertain at best.” Rigby goes on to state in this article that “Electric utilities by and large are not growing industries for which M&A makes sense.”

Q. If there was some reduction in financing costs due to the proposed acquisition, how would it be used?

A. The Applicants tout the potential of the acquisition to reduce financing costs for a capex plan of Integrys. However, a sizable share of the planned capex is slated for the Accelerated Main Replacement Program of Peoples Gas in Chicago, which is scheduled to continue for more than a decade. WEC stated in response to data request 01-GLU-01 that only 40% of Integrys’ capex planned in the next five years is slated for WPSC. John Reed’s Illinois testimony for the Applicants touts the ability of the combination to finance investments there.

Q. The Applicants also stress the benefits of diversification for risk management. What is your view?

A. The discussion of the risk benefits of diversification is vague and poorly supported. Acquisition of a riskier company may not reduce overall risk. Illinois Commerce Commission (“ICC”) staff witness Lounsberry calls the AMRP “the most risky capital project undertaken by a utility in Illinois since Commonwealth Edison Company and Illinois Power Company began constructing their nuclear powered generation plants” on p. 24 of his testimony in the companion Illinois proceeding to approve the acquisition. Some Wisconsin utilities (e.g., Alliant) have had bad diversification experiences. Diversification of some Wisconsin

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16 “S&P unsure utility mergers are new trend, but they sure are bad for bondholders,” Electric Utility Week, June 6, 2005, p.1.
banks into Sun Belt real estate increased their operating risk greatly. The sale of
M&I Bank to the Bank of Montreal was triggered in part by this problem.

Q. Do you have other concerns about the potential for cost savings?
A. Yes. Savings are more likely to the extent that the Applicants have strong
incentives to realize potential economies from the transaction. However, both
Applicants file frequent rate cases that discourage good cost performance. In
addition to reducing the likelihood that the Applicants have best practices to share,
this reduces the likelihood that the Applicants will fully exploit available synergy
opportunities.

No promise of cost savings is, in any event, being made to customers. For
example, there has been no pledge to reduce the frequency of Wisconsin rate
cases. Other merger agreements have featured multiyear rate freezes or other
tangible customer benefits.

Q. The Applicants have ventured some other arguments in support of the
acquisition. For example, they imply that the combined company would be
less vulnerable to acquisition by out of state interests. What is your view?
A. A combined company would be more challenging for out of state companies to
acquire, but would not be too big to acquire. Examples of large utility companies
that have been acquired include Progress Energy (which owned Carolina Power &
Light and Florida Power), Central and Southwest (which owned several utilities in
the South Central states), New Century Energy (which owned Public Service of
Colorado and Southwestern Public Service), and Cinergy (which owned

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17 Applicants stated in response to data request 01-GLU-19 that “WEPCO and WG intend to maintain a rate
case schedule dictated by business and regulatory demands whether or not the application is approved.
WEC has not proposed a “stay out in any jurisdiction other than Illinois.”
Cincinnati Gas and Electric and Public Service of Indiana). The firmness with which the combined company would resist overtures that are made is, in any event, uncertain. After all, both Applicants have already sold their nuclear generation operations in Wisconsin to out of state interests while companies in most neighboring states (e.g., MN, IA, IL, and MO) have not.

Q. What of the argument that the transaction is “supportive of environmental stewardship”?

A. This is a surprising claim. After all, both companies have recently built large new coal-fired generating units that prolong their traditionally heavy reliance on coal. The ERGS was built in the Milwaukee/Racine area over the objections of local business interests. I have already noted that most conservation programs in Wisconsin are undertaken by an independent agency. Utilities can complement the efforts of this agency with rate designs that encourage conservation. However, both Applicants recently secured large increases in fixed charges for retail service which discourage conservation as well as distributed generation.

Q. What then in your view is the Applicants’ main motivation for the acquisition?

A. I believe that the main motivation for the acquisition is the opportunity for WEC to grow earnings from regulated utility investments in a period when major investments are not needed on its own system. WEC stated in response to data request 01-GLU-15 that the proposed transaction between WEC and Integrys is expected to result in higher projected earnings growth rates for the combined company, as well as an increased dividend for WEC shareholders at closing. In announcing the merger to investors in June 2014, WEC and Integrys
indicated that earnings for the combined company are expected to grow at an annual rate of 5-7%, compared to 4-6% for WEC absent the merger.”

WEC acknowledged in response to data request 01-GLU-07 that earnings growth in an era of slow sales volume growth “has been one consideration among many with respect to the proposed transaction, and has been one reason for ongoing consolidation in the industry more generally.”

Q. **Witness Reed suggests that the proposed transaction is part of a wave of new mergers and acquisitions driven by financing considerations. Do you agree?**

A, No. The Moody’s article he cites gives a long list of reasons for recent M&A activity. These include “generate financing efficiencies/better capital markets access” and “diversify business and operating risks.” However, they also include “grow earnings,” “build scale and scope,” “spread fixed costs over a larger platform,” “capture economies of scale/synergies/operating efficiencies” and “combine complementary operations.” In my opinion, these are different ways of describing a desire to grow earnings by getting larger and seeking economies of scale and scope where possible. Companies that are superior operating performers have a better chance of succeeding at this game.18

Q. **Has Applicants’ witness Reed opposed mergers in previous proceedings?**

A. Yes. He opposed the merger of Pacificorp and Utah Power and Light (“UP&L”) in 1988 testimony for AMAX Magnesium. AMAX was an interruptible customer and feared worsening terms of service due to UP&L’s improved opportunities to make sales for resale. Firm service customers had, in contrast, been offered a 2% cost reduction within two months of the merger’s approval. Reed’s arguments

18 Moody’s Investor Service *op cit* p. 24.
against the merger are illuminating, and could well be applied to the current proceeding. Here are some pertinent quotes.

- The Applicants have conducted no studies or analyses to determine the impact of the proposed merger on an entire class of existing customers of UP&L: special contract interruptible customers…As part of its public interest determination, however, the Commission must consider the impact of the merger on all classes of customers. (Direct Testimony p. 2)

- The merger will cause affirmative harm and discrimination to a class of existing customers, which would require its rejection by this Commission. (Direct Testimony p. 3)

- Mr. Boucher [a UP&L witness] testified that his “expectation would be that more efficient operation of the system will produce an incremental [cost] that is lower than what you experience today”. In light of Mr. Boucher’s “expectation” it is not unreasonable to ask the Applicants to stand behind it. (Direct Testimony p. 14)

- While assurances are welcome, the critical issues of the cost of power is limited to a “belief” that costs will be lower after the merger. Interruptible customers remain the only class of customers whose likely impact is subject to the beliefs and subsequent actions of the Applicant. (Surrebuttal Testimony p. 7)

- Leaving these matters to future negotiations results in a lessening of this Commission’s ability to utilize its jurisdiction effectively to protect the interests of all Utah ratepayers. Quite simply, in future negotiations, compromises may have to be made because integration of the systems has already occurred. These compromises do not have to be made now when the Commission still has the power to condition how that integration should occur in the first place. (Cross-rebuttal pp. 7-8).

**Q.** What are your conclusions?

**A.** I conclude that the Applicants have made a poor showing that the proposed combination would benefit Wisconsin consumers and the public, as required by state law. In the companion Illinois proceeding ICC Staff witness Lounsberry similarly characterizes the Applicants’ discussion of merger benefits as containing “broad, unsubstantiated generalizations” (p. 20) and also notes the lack of a due diligence review. While net benefits are possible from the consolidation, they
would be appreciably smaller than the gross and would be unevenly distributed between WPSC and WEC customers.

Absent any urgency to approve this acquisition, it could reasonably be rejected for the poor quality of evidence presented and the inadequacy of protections offered, especially protections to municipal and cooperative customers. Should the PSCW nonetheless choose to approve the merger, it should be conditioned on measures that rectify some of the foreseen problems.

Policymakers can mitigate the problems in creative ways that address other fundamental problems, such as the current ownership of ATC.

Q. What conditions do you propose for merger approval?

A. I will confine my proposed conditions to those that address special concerns of my clients. With respect to the rate levelization issues I have described, protections against rate hikes to bulk power customers holding long term contracts with Integrys should be strengthened. I recognize that this measure is in the domain of the FERC but note that the FERC’s assent to appropriate remedies is not guaranteed. Its failure to act would erode the ability of the merger to benefit Wisconsin consumers and the public, and require extra initiative by this Commission to ensure a fair balance. The PSCW does regulate GLU members and has an interest in minimizing the potential negative effects associated with rate levelization. While I am not a lawyer, I believe the PSCW can address this issue in this proceeding. The PSCW should consider imposing a condition that would at least preclude the Applicants from restructuring the combined company in such a manner as to eliminate the independent subsidiary status of the two
electric utilities, and thereby levelize rates, at least for a defined period of time, such as five years, or even longer.

I would note that in response to a PSCW Staff data request, the Applicants have indicated that they would be open to making available additional service under their existing market-based rate (“MBR”) tariffs (Request No. PSCW-12.01, PSC REF#: 224171). This does not adequately address GLU’s concern with respect to rate levelization since those MBR contracts, as indicated above, are cost-based formula rates under which acquisition-related costs and any costs associated with rate levelization will simply pass through to GLU’s wholesale members, and ultimately to their retail customers.

**Q. Do you have any conditions to propose that might address your concerns with respect to ATC?**

**A.** Yes. The single most effective means of ensuring that WEC is not able to exercise majority influence over ATC is to require it, as a condition of the acquisition, to divest between 10 and 12% of its ownership interest in ATC, that is, enough to ensure that the combined interest of the Applicants in ATC is not greater than 50%. The remaining share of Applicant voting rights could still be assigned to other existing owners in votes for most issues, as the Applicants have proposed. To ensure geographic diversity and a stronger voice for parties demanding competitive markets and efficient transmission service provision, the divestiture could be accomplished by making the appropriate portion of WEC’s 26% share available in a voting trust for purchase at a fair market price by Wisconsin municipal utilities and cooperatives, including the current municipal
and cooperative owners of ATC. The sale could be held open for a limited period of time, at the end of which the trust would dissolve and the unpurchased shares would revert back to WEC, so long as the Commission imposes the condition that WEC refrain from voting its shares, except as WEC has represented in this proceeding.

Q. Are there other conditions short of divestiture that can accomplish this goal?

A. Yes. In the event the Commission determines not to impose a divestiture condition, the entire 26% minority voting interest could be held in trust, the trustees of which would be representatives of the municipal and cooperative shareholders of ATC. Also, ATC’s bylaws already permit a voting interest of 3% to nominate Board representatives, and there is an open seat on ATC Management’s Board of Directors. A minimum condition of approval could be to guarantee a seat on the Board for currently unrepresented municipal or cooperative entities.

Q. How would these conditions address your concern?

A. The primary power exercised by the shareholders of ATC Management is voting for the Board of Directors. ATC’s Board has a great deal of control over the management and operation of the company, including project development and approval, approval of ATC’s committees (audit, compensation, finance, and nominating and board affairs) and other important corporate functions. Therefore, allowing municipal and cooperative entities, which are generally more responsive to the needs and interests of ratepayers as opposed to shareholders, a greater opportunity to exert influence over the management and operations of ATC
through Board representation will increase the diversity of interests vital to maintaining ATC's independence as a transmission company.

Q. Does this conclude your testimony?

A. Yes.