

STATE OF MICHIGAN
BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

In the matter of the application of)
THE DETROIT EDISON COMPANY)
to increase rates, amend its rate)
schedules governing the distribution and)
supply of electric energy, implement)
Power Supply Cost Recovery plans,)
factors and reconciliations in its rate)
schedules for jurisdictional sales of)
electricity and for miscellaneous)
accounting authority and regulatory)
asset recovery.)

MPSC Case No. U-13808

QUALIFICATIONS
AND
DIRECT TESTIMONY
OF
DANIEL G. BRUDZYNSKI

THE DETROIT EDISON COMPANY
QUALIFICATIONS OF DANIEL G. BRUDZYNSKI

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1 **Q. Please state your full name and business address.**

2 A. My name is Daniel G. Brudzynski. My business address is The Detroit
3 Edison Company, 2000 Second Avenue, Detroit, Michigan 48226.

4

5 **Q. Please state your educational background.**

6 A. I graduated from Wayne State University in 1982 with a Bachelor of Science
7 degree in Business Administration with concentration in finance and
8 accounting. I earned my Masters of Business Administration from the
9 University of Detroit in 1987.

10

11 **Q. Please describe your work experience.**

12 A. I joined The Detroit Edison Company ("Company", "Detroit Edison" or
13 "DECo") in 1997 as assistant controller. In this capacity, I was responsible
14 for all corporate related functions within the finance and accounting areas.
15 These included the areas of corporate accounting, budgeting, forecasting,
16 business planning process, corporate governance, board of directors
17 reporting and communication.

18

19 Prior to joining Detroit Edison I held several positions of increasing
20 responsibility in the finance area at Chrysler Corporation (DCC) from 1984
21 to 1997. Most recently I was manager of the redesign of the forecast and
22 implementation of new processes and systems, encompassing the areas of

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1 profit, cash, inventory, balance sheet and business planning. Before that
2 assignment, I held a variety of financial positions in the areas of
3 manufacturing, product development, engineering and corporate offices.

4

5 Prior to working at Chrysler, I worked in the commercial lending division of
6 First of America Bank as a commercial credit analyst, where I constructed
7 lending proposals, and presented loan packages before executive
8 committees for approval.

9

10 **Q. What is your current position?**

11 A. In February 2001, I was elected Vice President and Controller of Detroit
12 Edison. I am responsible for an organization of approximately 175
13 professionals encompassing all areas of accounting and finance.

14

15 **Q. Are you a member of any professional organizations?**

16 A. I am a member of the Financial Executives Institute, Detroit Chapter, and I
17 serve on the board of directors of Focus Hope.

18

THE DETROIT EDISON COMPANY
DIRECT TESTIMONY OF DANIEL G. BRUDZYNSKI

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1 **Q. What is the purpose of your testimony?**

2 A. My testimony will present an overview of Detroit Edison's total operation and
3 maintenance ("O&M") expenses for the 2002 historical test year, and the
4 projected annual O&M expense for 2003 through 2008. I will support, as
5 reasonable and necessary, pension expense, employee benefits and health
6 care costs, and the expected O&M and capital expenditures of the corporate
7 support staff functions. In addition, I will discuss some of the key drivers
8 influencing the economics of these costs.

9

10 To provide a comparative look at how O&M and capital expenditures have
11 changed over recent history, I will discuss the evolution of actual
12 expenditures from 1999 to 2002. Finally, my testimony will demonstrate that
13 recovery of the merger control premium in light of achieved merger synergy
14 cost reductions is reasonable and necessary based on the identifiable
15 customer benefits that have resulted from the MCN Energy merger ("MCN").

16

17

18 **Q. Mr. Brudzynski, are you sponsoring any exhibits?**

19 A. Yes. I am sponsoring the following Exhibits:

20 A-1, Schedule A-4 Corporate Support Group Costs – Adjustment
21 Summary Year 2002

22

23 A-16, Schedule F3 Capital Expenditures
24 2002 Actual and 2003 - 2008 Forecast

25

Line No.		
1	A-16, Schedule F5-6	Synergies Achieved By Organization- Operating and Maintenance Expenditures including Payroll Taxes
2		
3		
4		
5	A-16, Schedule F5-7	Derivation of Weighted Synergies Allocation
6	A-16, Schedule F5-8	Derivation of Control Premium
7	A-16, Schedule F5-9	Control Premium Revenue Requirement
8	A-16, Schedule F5-10	DECo Cost Analysis – MPSC Summary of O&M 1992 – 2002
9		
10		
11	A-16, Schedule F5-11	DECo Cost Build Up Analysis
12		
13	A-16, Schedule F5-12	DECo – External Related Factors Pension and Benefits O&M and Total Costs
14		
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16	A-16, Schedule F5-13	DECo – Generation Strengthening
17		
18	A-16, Schedule F5-14	DECo Continuous Improvement
19		
20	A-16, Schedule F5-15	Operation and Maintenance Expense 2002 Actual and 2003-2008 Forecast
21		
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23	A-16, Schedule F5-16	Operation and Maintenance Expense Corporate Support and Other
24		
25		
26	A-16, Schedule F5-17	Corporate Overhead Costs By Support Group 2004 Forecast
27		
28		
29	A-16, Schedule F5-18	Massachusetts Formula – 2004 Forecast (based on the 2003 budget)
30		
31		
32	A-16, Schedule F5-19	Operating & Maintenance Expense Employee Benefit Summary
33		
34		
35	A-16, Schedule F5-20	Operating & Maintenance Expense Pension Expense
36		
37		
38	A-16, Schedule F5-21	Pension Plan Summary
39		
40	A-16, Schedule F5-22	ABO – Asset and Liability Reconciliation 2002
41		
42	A-16, Schedule F5-23	Operating & Maintenance Expense Other Post Employment Benefits (OPEB)
43		

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1 **Q. Were these exhibits prepared by you or under your direction?**

2 A. Yes, they were.

3

4 **DETROIT EDISON O&M**

5

6 **Q. What are Detroit Edison's historical and forecasted O&M expenses by**
7 **year for 2002 through 2008?**

8 A. Exhibit A-16, Schedule F5-15 shows total O&M costs, exclusive of the costs
9 of fuel and purchased power, for the 2002 historical test year and the
10 forecasted O&M expense by year for 2003 through 2008. The O&M costs
11 related to Production, Transmission, Distribution and the Low Income
12 Energy Fund are being sponsored by Messrs. Dow, Baig, Colonnello,
13 Lapplander, and VanHaerants. In my testimony, I sponsor projections for
14 Employee Pension and Benefits, the projections for Corporate Support
15 Group Expenses, the forecast of Other Expenses and Accruals, and the
16 recoverable portion of the Control Premium, all of which are summarized on
17 Exhibit A-16, Schedule F5-15.

18

19 **EMPLOYEE PENSION AND BENEFITS COSTS**

20

21 **Q. What is the purpose of your testimony regarding employee pension**
22 **and benefits costs?**

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1 A. I will provide an overview and support these costs. I will also highlight key
2 drivers of Detroit Edison's projected pension obligations, other post-
3 employment benefits ("OPEB"), active employee health care and other labor
4 related benefits, for years 2003 through 2008. The costs for these items are
5 reflected in Exhibit A-16, Schedule F5-19.

6

7 **Q. What are the components of pension costs related to retiree benefits?**

8 A. Under the Statement of Financial Accounting Standards 87, *Employer's*
9 *Accounting for Pensions* ("SFAS 87"), there are four components of pension
10 costs.

11

12 Service costs: This represents the pension benefits earned by active
13 employees during the current period on a present value basis. It is based
14 on current and projected salaries, expected employee turnover and
15 expected benefits to be paid based on actuarial assumptions of life
16 expectancy.

17

18 Expected return on assets: This is an estimate of the expected investment
19 return on assets invested in the pension trusts for the current period. While
20 actual year-to-year investment returns can vary significantly in the short run,
21 the expected return is determined based on long-term financial market
22 expectations in order to avoid large swings in pension costs based on short-

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1 term investment performance. This component in the projection is based on
2 an estimated return of 9% annually for 2003 and beyond.

3

4 Interest costs: The interest cost recognized in the current period is the
5 increase in the Projected Benefit Obligation (“PBO”) due to the passage of
6 time. The PBO is the actuarial present value of benefits attributable to the
7 pension benefit formula discounted back to current dollars at the 6.75%
8 discount rate. Measuring the PBO as a present value at the beginning of
9 the period requires the accrual of an interest cost for the current period at a
10 rate equal to the discount rate. The estimated 6.75% discount rate used in
11 the projections is based on a number of external benchmarks, such as the
12 cost of high quality debt, as well as data from our independent actuarial firm,
13 Hewitt Associates. The discount rate assumption selected is then reviewed
14 by our external auditors, Deloitte and Touche.

15

16 Amortizations: In addition to these current period costs, pension costs also
17 include the effect of the delayed recognition of prior costs. This includes the
18 amortization of prior service costs and unrecognized gains and losses.
19 Prior service costs arise from pension plan amendment changes that will
20 provide the employee economic benefits in the future. When a plan
21 provision is changed that will impact future benefit payments for existing
22 employees, the incremental change in the PBO liability is amortized equally
23 over the average remaining years of service of the employees impacted. In

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1 addition, gains and losses are changes in the amount of either the PBO or
2 plan assets resulting from experience different from that assumed in the
3 actuarial assumptions. Most notably, since discount rates and return on
4 asset assumptions are based on estimates, there are differences in the
5 levels of estimated and actual returns on assets invested, as well as
6 changes in the PBO arising from changes in discount rates when these
7 gains or losses exceed the certain materiality thresholds. Unrecognized
8 gains and losses are amortized based on a period equal to the average
9 remaining service life of employees covered by the plan.

10

11 **Q. Please describe the adjustments you are sponsoring related to pension**
12 **costs.**

13 A. I am sponsoring an adjustment to increase pension cost as reflected on
14 Exhibit A-16, Schedule F5-20 from the \$31 million applicable in 2002, to the
15 \$112 million projected cost in 2004. This increase in pension costs is
16 significantly impacted by the low discount rates and the reduction in actual
17 and estimated asset returns. While Detroit Edison and its customers have
18 enjoyed the benefits of strong asset returns and relatively low liabilities over
19 the last 20 years, the impact of recent changes in interest rates and the
20 financial markets requires that these higher costs now be recognized.

21

22 **Q. How are these cost components projected to change between 2002**
23 **and 2004?**

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1 A. The impact of lower interest rates and lower investment returns are key
2 drivers in increased pension cost of \$80 million in the 2004 forecast year,
3 above 2002 levels. Exhibit A-16, Schedule F5-20, details these
4 components for 2002 through 2004.

5 ▪ Service costs earned in 2004 are expected to be higher due to the
6 impact of lower discount rate assumptions (6.75% in 2004 vs. 7.25% in
7 2002). This lower discount rate attributes to higher value of benefits
8 earned in 2004 dollars.

9 ▪ Interest costs also increased due to the increase in PBO, again as a
10 result of lower discount rates.

11 ▪ Expected returns on plan assets are lower in 2004 than in 2002
12 because of both a reduction in the expected return on assets to 9%,
13 and lower overall market-related value of plan assets due to the recent
14 financial market weakness. Since the market related value of plan
15 assets is smoothed over a three-year period, the reduction in asset
16 balances due to recent investment losses is not fully reflected until
17 2004.

18

19 **Q. Please describe the changes in amortized costs between 2002 and**
20 **2004.**

21 A. The amortization of the transition obligation is eliminated in 2003 due to the
22 completion of the 15-year amortization period that began in 1987 upon
23 adoption of SFAS 87. The prior service cost amortization is the same as in

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1 2002. The amortization of gains and losses increase from \$2 million in 2002
2 to \$45 million in 2004, reflecting the unrecognized losses from both the
3 actual investment returns compared to the expected returns and the
4 increase in the PBO resulting from the reduction in discount rates. As of
5 December 31, 2002 Detroit Edison has almost \$775 million in accumulated
6 unrecognized losses. The amortizations in 2003 and 2004 are the
7 beginning of the recognition of those losses in the SFAS 87 cost.

8

9 **Q. Does the performance of the assets in the trust and the increased**
10 **pension liability have any impact on the Company's pension funding**
11 **requirements?**

12 A. Yes, due to requirements of the Employee Retirement Income Security Act
13 ("ERISA"), Detroit Edison had an estimated pension funding obligation by no
14 later than 2004 of over \$200 million. As a result of this requirement, Detroit
15 Edison contributed \$222 million into the pension plan in January 2003 and is
16 projecting contributions in 2004 of \$162 million due to Pension Benefit
17 Guarantee Corporation ("PBGC") funding requirements. These
18 contributions have the positive effect of providing a reduction in the pension
19 costs due to a higher asset balance for determining the expected return on
20 assets in the pension trust. In the absence of this funding, the pension
21 expense in the forecast year would have been over \$25 million higher than
22 in my projection described above.

23

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1 **Q. Why did the Company record the minimum pension liability?**

2 A. The minimum pension liability was recognized pursuant to the requirements
3 of SFAS 87 and Statement of Financial Accounting Standards 130,
4 *Reporting Comprehensive Income* (“SFAS 130”).

5

6 **Q. Please describe the amounts recorded relating to the minimum
7 pension liability.**

8 A. The Company recognized an additional liability for its pension plan of \$532
9 million, which represented the excess of the Accumulated Benefit Obligation
10 (“ABO”), over the actual assets in the pension trust. In addition, SFAS 87
11 also required the Company to write-off the prepaid pension asset of \$150
12 million. Offsetting these amounts was an intangible asset of \$50 million,
13 which represented unamortized prior service costs and transition
14 obligations. These amounts totaled \$632 million. After providing for
15 deferred income taxes of \$221 million, the net charge to Other
16 Comprehensive Income (“OCI”) was \$411 million. This charge to OCI was
17 a reduction to the Company’s Common Equity balance.

18

19 **Q. Please describe the Regulatory Asset on Exhibit A-16, Schedule F5-21
20 related to Minimum Pension Liability.**

21 A. As of December 31, 2002, the Company recognized a Regulatory Asset
22 related to the Minimum Pension Liability of \$532 million. Similarly, Common

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1 Equity and Deferred Income Taxes were increased by \$411 million and
2 \$221 million, respectively.

3

4 **Q. Why is it appropriate to recognize a Regulatory Asset for impact of the**
5 **minimum pension liability?**

6 A. An offsetting Regulatory Asset was recognized to prevent the minimum
7 pension liability accounting from distorting both the rate base and the
8 measure of capital resources invested in support of the Company's rate
9 base. The accrual of this minimum pension liability did not change the level
10 of capital required to support the Company's utility operations or the sources
11 of capital. Rather, it was a non-cash accrual to recognize a potential future
12 liability.

13

14 **Q. What was the basis for recognizing the Regulatory Asset?**

15 A. In the MPSC Annual Report filed by Detroit Edison for 2002, the regulatory
16 asset was recognized based on our belief that the practices and precedent
17 of the MPSC relative to pension costs provided adequate assurance that the
18 costs reflected in this liability would be recognized in future rates. In the
19 corroboration of that belief, the MPSC Staff provided a letter expressing its
20 opinion of how pension costs have been historically treated for rate-setting
21 purposes. The standard for recognizing this regulatory asset pursuant to
22 the Statement of Financial Accounting Standards 71, regarding *Accounting*
23 *for the Effects of Certain Types of Regulation* (SFAS 71) required a

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1 conclusion that the MPSC had adopted practices and precedents that
2 allowed pension costs as measured under SFAS 87 and the cost of pension
3 plan curtailments under SFAS 88 regarding *Accounting for Settlements and*
4 *Curtailments of Defined Benefit Pension Plans* (“SFAS 88”) in utility rates.

5

6 **Q. What Michigan Public Service Commission (“Commission”) practices**
7 **and precedents did you rely on in concluding that the accrual for the**
8 **Regulatory Asset was appropriate?**

9 A. The Commission’s historical practice regarding pension cost has been to
10 recognize both the expense and working capital impacts consistent with
11 SFAS 87. Prior to the adoption of SFAS 87, utility rates included pension
12 expense as determined by the cash funding of pension plans. In the
13 Commission’s Order in Case No. U-10102, which was DECo’s first general
14 rate case subsequent to the implementation of SFAS 87, DECo’s revenue
15 requirement reflected pension costs based on SFAS 87. The Commission
16 has recognized pension costs as determined under SFAS 87 in the revenue
17 requirements of other utilities subject to the Commission’s rate setting
18 jurisdiction when the company requested such treatment.

19

20 Similarly, the Commission’s policy regarding the costs of pension
21 curtailments, including early retirement plans, has been to allow the current
22 period cost deferral with the subsequent amortization of such costs in future
23 rates, when such deferral was requested by the utility. Michigan

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1 Consolidated Gas Company (“MichCon”) received accounting and
2 subsequent ratemaking authority for the deferral and amortization in future
3 rates of the costs of an early retirement plan in 1979 (Case Nos. U-5976
4 and U-5955). Additionally, the MPSC approved deferred accounting
5 requests of Southeastern Michigan Gas Company and Michigan Gas
6 Utilities in 1985 and 1986 (Case Nos. U-8088 and U-8405 respectively).
7 Moreover, in a 1989 Order in a Consumers Power (“Consumers”) gas rate
8 case, the Commission captured the gain arising from a partial settlement of
9 its pension plan obligation through the purchase of an annuity. While \$28
10 million of the total \$39 million gain was used to offset current period costs of
11 an early retirement program, \$10 million of the gain was reflected as a
12 revenue requirement reduction through a five-year amortization. This gain
13 was determined according to SFAS 88. Of special interest is the following
14 excerpt from that Order:

15

16 “The Commission finds that Consumers’ exception is not well-taken.
17 Consumers’ ratepayers funded the purchase of the pension assets. It is
18 undisputed that if Consumers had not settled its pension obligation through
19 the purchase of an annuity, the gain in the market value of the pension
20 assets would have accrued to the ratepayers pursuant to SFAS 87. Only by
21 amortizing the gain over a period of years may Consumers’ ratepayers
22 realize any benefit from a transaction entirely funded with their money.”
23 (Case No. U-8678, et al, December 7, 1989, p. 71)

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1 In light of these practices and precedents regarding both pension costs as
2 measured under SFAS 87 and the cost of pension plan curtailments under
3 SFAS 88, it was determined that the accrual of the regulatory asset was
4 appropriate. Deloitte and Touche, Detroit Edison's independent auditing
5 firm, concurred with our conclusion.

6

7 **Q. Why did the Company's ABO exceed the assets as of December 31,**
8 **2002?**

9 A. An analysis of the Company's pension is provided on Exhibit A-16,
10 Schedule F5-22. The assets in the trust were \$8 million higher than the
11 ABO as of December 31, 2001. But, in 2002, the Company was impacted
12 by the continuation of the poor performance in the equity markets and had
13 losses on its assets of almost 10%, or \$182 million. This was exacerbated
14 by the continued slide in high quality debt costs used to discount the future
15 benefit obligations into current dollars. The discount rate was reduced to
16 6.75% from the 7.25% a year earlier. This had the effect of increasing the
17 ABO by \$115 million. In addition, the ABO was increased by the normal
18 current period service costs and the interest cost on the ABO. These items
19 had the impact of reducing the assets in excess of ABO by \$540 million.
20 While SFAS 87 generally allows for the smoothing of year-to-year changes
21 in asset performance and liabilities through delayed recognition of gains and
22 losses, once the ABO exceeds the assets, the minimum liability must be
23 recognized.

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1 **Q. Will recognition of the Regulatory Asset increase the Company's**
2 **revenue requirement in this case?**

3 A. No, it will not. Since the Regulatory Asset is merely an offset to both the
4 minimum pension liability and the reduction to common equity, the
5 Company's revenue requirement is not impacted by the recognition of this
6 asset.

7

8 **Q. Please describe the adjustments you are sponsoring related to Other**
9 **Post Employment Benefits ("OPEB").**

10 A. I am sponsoring an adjustment to increase OPEB from the \$58 million
11 applicable in 2002 to the \$109 million projected cost in 2004. See Exhibit A-
12 16, Schedule F5-23.

13

14 **Q. What is the authoritative accounting basis for the measurement of**
15 **OPEB costs?**

16 A. OPEB is a cost recognized pursuant to Statement of Financial Accounting
17 Standards No. 106, *Employers' Accounting for Postretirement Benefits*
18 *Other Than Pensions* ("SFAS 106").

19

20 **Q. What are the components of OPEB?**

21 A. OPEB has the same basic cost components as I described for pension
22 costs. They are:

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1 Service cost: This is the portion of the expected post retirement benefit
2 obligation attributable to employee service during the period on a present
3 value basis. Since the ultimate benefit received by employees after their
4 retirement is dependent upon years of service and age upon retirement, this
5 cost reflects actuarial assumptions of employee turnover, age at retirement
6 and expected longevity. This cost is also dependent on the estimated costs
7 of providing these benefits subsequent to retirement and thus are impacted
8 by both current medical cost levels and expected medical cost escalations.

9

10 Interest cost: This is the cost arising from the current period interest on the
11 discounted Accumulated Post-Retirement Benefit Obligation (“APBO”). Like
12 pensions, the accumulated liability was discounted to today’s dollars based
13 on the 6.75% discount rate.

14

15 Expected return on assets: This is an offset to the costs of the OPEB based
16 on the expected long-term return on assets invested in qualified trusts. This
17 return is currently estimated to be 9% annually.

18

19 Amortizations: This cost component includes the amortizations related to
20 prior service costs, transition obligation and unrecognized gains and losses.
21 Prior service costs are amortized over the estimated remaining service lives
22 of employees at the time of the last plan change. The transition obligation is
23 amortized over 19 years, based upon the Commission’s determination in

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1 Case No. U-10102 for Detroit Edison. Gains and losses are amortized over
2 the current estimated remaining service lives of active employees. As of
3 December 31, 2002, Detroit Edison had unrecognized losses of almost
4 \$475 million stemming from differences between the estimated and actual
5 returns on assets, increases in the APBO arising from the reduction in
6 discount rates as well as revised escalations in medical costs.

7

8 **Q. How has the Commission treated OPEB in recent rate cases?**

9 A. The Commission authorized the use of OPEB for accounting purposes in its
10 generic accounting order in Case Nos. U-10040/10040A. The Commission
11 included in Detroit Edison's cost of service in Case No. U-10102 an
12 expense level based on the quantification of OPEB pursuant to SFAS 106.
13 The Commission has consistently recognized OPEB costs under SFAS 106
14 for other utilities as well.

15

16 **Q. Has the Commission consistently used actuarial determinations of**
17 **projected OPEB costs in determining the cost of service of other**
18 **utilities?**

19 A. No, it has not. For example in the gas rate case of Consumers Energy,
20 Case No. U-13000, order issued November 7, 2002, the Commission used
21 a historical period OPEB and escalated that cost for expected inflation
22 related increases. The Commission concluded that it was reasonable to
23 assume that OPEB costs were related to labor cost escalations.

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1 **Q. Is that a reasonable assumption for this instance in Detroit Edison's**
2 **case?**

3 A. No, it is not. OPEB costs are based on a complex interaction of medical
4 cost expectations, interest rates and long-term return on assets, which have
5 little correlation to increases in labor costs. Moreover, the impact of
6 actuarial gains and losses that arise from differences between estimated
7 and actual returns on assets and changes in liabilities due to changes in
8 discount rates have no direct correlation to general inflation.

9

10 **Q. Is there a more suitable approach for projecting OPEB costs?**

11 A. Yes, there is. The most reliable and supportable method of determining
12 future OPEB costs is to use the cost projections based on a comprehensive
13 actuarial analysis prepared in accordance with SFAS 106. The projections I
14 describe below were developed by Hewitt Associates, an internationally
15 recognized actuarial expert that incorporates the best estimates available of
16 the future costs of OPEB recognizing the interaction of expected future
17 medical costs, long term return on assets and current discount rates. This
18 projection is reviewed and concurred by our external auditors, Deloitte &
19 Touche, and represents the most reliable estimate of future OPEB costs.
20 Therefore, it should be recognized in determining the revenue requirement
21 in this case.

22

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1 **Q. What medical cost escalation assumptions are reflected in projected**
2 **OPEB costs?**

3 A. Medical costs for retirees under 65 years old reflected an assumed 10%.
4 escalation in 2003 and with annual increases trending down to 5% by 2009.
5 Cost trends for retirees 65 years old and over are assumed to escalate by
6 9% in 2003, with the annual increase trending down to 5% by 2009. Costs
7 are assumed to escalate by 5% annually thereafter for all ages.

8

9 **Q. What is the basis for these cost trends?**

10 A. During most of the 1990's, annual health care cost increases experienced
11 by the Company were relatively modest. However, beginning in 2000, trend
12 rates jumped substantially, reflecting higher prescription drug prices,
13 increased service utilization, and to a degree, higher costs due to the
14 increasing use of technology for increasing life expectancy. The cost trends
15 used in the determination of the OPEB cost reflect this recent experience,
16 but with the potentially optimistic presumption that double digit annual
17 escalations in medical costs are not sustainable over the long-term. Thus,
18 the annual escalation is assumed to trend down to a 5% annual escalation
19 by 2009.

20

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1 **Q. How do the cost trends assumed in the OPEB cost projection compare**
2 **to other companies?**

3 A. Since the issues impacting health care costs are endemic to virtually all
4 corporate providers, the health care escalation assumptions are consistent
5 with other companies. In a recent survey of 70 companies by Hewitt
6 Associates, the average initial cost trend rate was about 10%, with more
7 than half of the respondents using a rate between 9% and 11%. The
8 ultimate long-term cost trend averaged over 5% with the vast majority
9 assuming a rate between 5% and 5.5%. Thus, the assumptions used in
10 Detroit Edison's OPEB cost projection are comparable with other
11 companies.

12

13 **Q. Please describe the underlying causes of the change in OPEB costs**
14 **between 2002 and 2004.**

15 The cost components for OPEB are reflected on Exhibit A-16, Schedule F5-
16 23 for 2002 through 2004. These include:

17 • Service costs are estimated to increase from \$25 million in 2002, to \$41
18 million in 2004 based on the current period discounted actuarial present
19 value of accumulated post-retirement benefit obligations, including the
20 projected medical cost escalations discounted to current dollars at
21 6.75%. This increase reflects the impact of higher medical cost
22 escalations and a lower discount rate. This increase also reflects the
23 impact of a reduction in the years of service for employees to earn the

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- 1 accumulated post-retirement benefit obligations, as described later in my
2 testimony. While the change in eligibility reduced the total liability, the
3 reduced years of service had the impact of increasing current service
4 costs.
- 5 • The recent change in eligibility requirements decreased the total liability
6 by \$40 million. This reduction in the liability is recognized as an offset to
7 the amortization of the transition liability over 14 years.
 - 8 • The interest cost is expected to increase from \$59 million to \$75 million
9 in 2004 due the increase in the accumulated post-retirement benefit
10 obligation.
 - 11 • The expected return on assets is reduced from a \$44 million credit to a
12 \$38 million credit. This reflects a reduction in the expected return on
13 assets from 9.5% in 2002 to 9.0% in 2004, and the recognition of the
14 lower market value of the assets invested in the qualified trusts.
 - 15 • The reduction in the amortization of the transition obligation from \$19
16 million to approximately \$9 million recognizes the impact of the changes
17 in the APBO described elsewhere in my testimony. These changes had
18 the effect of lowering the APBO by \$143 million (which includes the \$40
19 million above). This reduction in APBO is recognized as a reduction to
20 the Transition Obligation and is being amortized over 14 years, the
21 remaining service lives of the employees impacted by the change in
22 benefits. Thus, while the initial Transition Obligation of \$191 million as of
23 December 31, 2002, is being amortized over 19 years, this amortization

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1 has been reduced by the impact of the reduced benefits. The remaining
2 amortization period is 10 years.

3 • Finally, the increase in the amortization of losses from \$2 million to \$23
4 million reflects the current period impact of the unrecognized asset
5 losses and increase in accumulated post-retirement benefit obligations
6 arising from the difference in actual and estimated returns on assets and
7 the impact of the lower discount rate. This unrecognized loss is being
8 amortized over 12 years.

9

10 **Q. Please describe the reduction in OPEB related to the securitization of**
11 **the transition obligation.**

12 A. As shown on Exhibit A-16, Schedule F5-19, the total OPEB amount
13 determined by Hewitt Associates was adjusted to exclude \$7 million of
14 transition obligation amortization costs that were securitized in 2001. The
15 transition obligation associated with Detroit Edison's generation operation of
16 \$84 million was included in the securitization of regulatory assets. As the
17 securitization of this transition obligation required its immediate recognition in
18 2001, it eliminated the need for any future amortization. This reduction
19 produces the net OPEB cost of \$109 million applicable to 2004.

20

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1 **Q. Describe the employee benefits other than pension and OPEB**
2 **provided by Detroit Edison and the projected cost increases for these**
3 **benefits between 2002 and 2004.**

4 A. The other major components of Detroit Edison's benefit package include the
5 choice between several health care plans, life insurance, long term disability
6 coverage, and a 401(k) Savings and Investment Plan. The projections of
7 these benefits are summarized on lines 5 through 8 on Exhibit A-16,
8 Schedule F-19. These costs are projected to increase from \$100 million in
9 2002 to \$115 million in 2004. The largest component is the cost of medical
10 and related benefits for active employees. Specifically, for 2003, the
11 Company has forecasted a 13% rate of escalation for medical services,
12 18% for prescription drug coverage, and 5% for dental, (collectively referred
13 to as "Active Health Care"). Based on these trend rates, our forecast is for
14 Active Health Care costs to escalate at a 13% rate utilizing 2002 as the
15 base, and continuing at that rate going forward. These projected increases
16 compare to actual cost increases experienced by the Company of 15% and
17 14% in 2001 and 2002 respectively. While the Company has initiated a
18 series of actions to reduce the trend in costs, these actions are assumed to
19 bring the future cost trends to the 13% annual escalation level. The cost of
20 Life Insurance is projected to increase from just under \$6 million in 2002 to
21 over \$6 million in 2004 based on the increased insurance coverage
22 resulting from higher labor costs. Similarly, Savings Plan costs are
23 projected to increase from just under \$20 million in 2002 to over \$21 million

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1 in 2004 based on the projected increase in labor costs. Other benefit costs
2 are projected to decrease in 2003 due to one-time costs incurred in 2002.
3 In subsequent years the increases are based primarily on projected labor
4 cost escalations.

5

6 **Q. What has Detroit Edison been doing to control its cost of benefits for**
7 **active employees and retirees?**

8 A. While controlling benefit costs has been a matter of great concern over the
9 years, the most recent increase in costs has led the Company to take
10 dramatic action. Specifically, in 2001, the Company initiated an aggressive
11 campaign to manage its benefits costs for both active employees and
12 retirees. Substantial increases in cost sharing and significant plan design
13 changes for active employees decreased the Company cost of benefits by
14 \$2.5 million. Program and administrative costs were reduced \$2.7 million by
15 aggressively renegotiating provider and carrier contracts. In addition, the
16 Company implemented a series of changes at the beginning of 2003 that
17 reduced the Company's cost of retiree benefits and eliminated Company
18 sponsorship of post-retirement medical coverage for new non-represented
19 employees. The changes introduced in 2003 are projected to provide an
20 annual savings of \$5 million. These changes included, where applicable,
21 increases in the non-represented retiree responsibility for health care costs
22 from 3% in 2003 to 8% in 2004. In addition, the eligibility requirements for
23 current employees to receive post-employment health care benefits were

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1 increased from 15 years of service acquired after age 40 to 10 years of
2 service acquired after age 45.

3

4 **Q. What actions does Detroit Edison expect to take in the future to**
5 **minimize benefit spending?**

6 A. Going forward into 2004, the Company is continuing its aggressive efforts to
7 minimize benefits cost while still providing a competitive benefits array for
8 attraction and retention of its workforce. However, a large group of retirees,
9 due to contractual agreements previously negotiated with the Company's
10 unions, are exempt from most health care cost sharing increases. Actions
11 planned to be implemented in 2004 include additional plan design changes
12 to further reduce the Company's cost of benefits. Changes include
13 significantly increasing active employee contributions by at least 25% over
14 the average 2003 levels and further increasing employee co-pays and
15 deductibles required by participants of the plans. In addition, the Company
16 plans to institute an aggressive disease management program and offer
17 healthy lifestyle incentives. This will include programs such as smoking
18 cessation, weight loss and other similar healthy life style programs. These
19 are all being designed to positively impact the long-term health care trend
20 rates experienced by the Company.

21

22 **Q. Please describe the credit to benefit costs related to capitalization and**
23 **transferred costs.**

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1 A. This credit to benefit costs represents the portion capitalized as part of
2 overheads related to Detroit Edison employees working on capital projects,
3 and amounts transferred out in the form of benefit loading on DECo labor
4 working on behalf of non-DECo affiliates.

5

6 **CORPORATE SUPPORT GROUP COSTS**

7

8 **Q. What is the Corporate Support Group (“CSG”)?**

9 A. The CSG was established following the MCN Energy acquisition as part of our
10 “shared services” business process approach, whereby corporate staff
11 functions previously residing in separate corporate entities (Detroit Edison,
12 MichCon, and/or MCN Energy) were centralized and consolidated into various
13 support organizations. This consolidation resulted in efficiencies, cost savings
14 and enhanced governance and internal controls. Each organization within the
15 CSG provides services enterprise wide.

16

17 **Q. What organizations are included in the Corporate Support Group?**

18 A. The organizations within the CSG provide a variety of Administrative and
19 General (“A&G”) type services to the Company. These include:

- 20 • Audit Services
- 21 • Accounting and Finance
- 22 • Tax
- 23 • Treasury

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- 1 • Corporate and Governmental Affairs
- 2 • Communications
- 3 • Corporate Offices and Services
- 4 • Human Resources
- 5 • Information Technology
- 6 • Legal
- 7 • Regulatory Affairs
- 8 • Strategic Planning

9

10 **Q. Are there “shared service” type groups other than the CSG?**

11 A. Yes, the customer service and marketing functions also operate under a
12 shared service model, but their span of support is only to the regulated electric
13 and gas (Detroit Edison and MichCon) distribution operations versus the
14 enterprise-wide orientation of the CSG.

15

16 **Q. You mentioned that the CSG was combined following the MCN
17 acquisition. Please elaborate on the rationale behind the acquisition.**

18 A. On May 31, 2001, DTE Energy completed the acquisition of MCN. Upon
19 completion of the acquisition, which was viewed internally as a merger, DTE
20 became a fully integrated electric and natural gas company with a strong
21 regional energy infrastructure and competitive operations spanning the
22 energy value chain. The new company has immediately realized operating
23 synergies through capture of economies of scale and scope, the

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1 consolidation of its corporate headquarters and staff support, and the
2 leveraging of contiguous and overlapping service territories. The
3 transaction also served to preserve MichCon as a Michigan based utility
4 company, since at the time of the merger MichCon was part of the
5 financially distressed MCN.

6

7 As I will discuss in more detail, realization of operating synergies or as I
8 refer to them, “merger synergies” does not and could not occur without a
9 cost. The cost in this instance is that portion of the merger acquisition that
10 DTE was required to pay to take control of MCN which resulted in the
11 capture of the value of merger synergies for utility customers and
12 shareholders. I believe it is prudent and reasonable to recover merger
13 related costs where there is a demonstrated benefit to customers. As I will
14 discuss, it is evident that the cost savings that flow to customers as a result
15 of merger synergy cost reductions are significantly greater than the portion
16 of the acquisition premium that Detroit Edison is seeking to recover in rates.

17

18 **Q. How did DTE and MCN manage the merger of the two companies in its**
19 **efforts to capture merger synergies?**

20 A. In order to integrate the two companies, DTE/MCN implemented a merger
21 transition process that was designed to maximize value to customers,
22 enhance employee opportunities, and improve customer satisfaction.
23 Through the combination of the two companies’ operations, the merged

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1 enterprise has been able to realize efficiencies in terms of workforce and
2 process, while establishing the conditions necessary throughout the
3 organization for the new company to succeed.

4

5 **Q. Were any organizations within Detroit Edison excluded from the**
6 **merger transition process?**

7 A. Yes. The Fossil Generation and Nuclear Generation groups were excluded
8 from the merger transition process because they were portions of the
9 Company that did not overlap with any MCN businesses, and therefore
10 were not impacted by the merger. However, where there were efficiencies
11 that could be achieved through the consolidation of various support
12 functions that had been previously dispersed into the business units e.g.,
13 HR, finance, IT etc., these administrative support functions were centralized
14 into their respective corporate support organizations, and the related cost
15 synergies were incorporated into the consolidated organization.

16

17 **Q. Please describe the term “business unit”.**

18 A. For purposes of my testimony, business units within Detroit Edison
19 encompass the operating-related line organizations. These include Energy
20 Distribution, with its main operations of electric distribution and transmission
21 and Energy Resources, with its main operations of fuel supply, fossil plant
22 operations and the Fermi nuclear facility.

23

Line
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1 **Q. Why were staff functions centralized?**

2 A. The centralization of the corporate staff functions was key to achieving
3 operating efficiencies and merger synergies. These staff groups provide
4 services to all business units. Similar to others in our industry and within
5 business more broadly, we adopted a “shared service” approach whereby
6 efficiencies in the form of long-term reductions in costs could be gained by
7 streamlining and standardization of processes and strengthening internal
8 controls. Improvements in overall governance within corporate functions
9 could also be gained from the “shared service” approach.

10

11 Customers will in turn benefit from leaner, more efficient organizations and
12 processes that can better withstand external influences that can result in
13 increased costs.

14

15 **Q. Couldn't this centralization have occurred without the merger?**

16 A. Yes, but the overwhelming majority of value created by centralizing staffs
17 was in the efficiencies gained by combining the two separate, yet
18 overlapping electric and gas staff functions.

19

20 **Q. How do synergies fit in the greater context of continuous improvement**
21 **activities?**

22 A. Much of the value created from the MCN acquisition was in the form of cost
23 reductions realized through combining overlapping functions and internal

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1 services. During the process of merger integration, the overall efforts in
2 driving to even higher levels of productivity and efficiency within merger
3 affected areas, served as a catalyst across Detroit Edison that also had a
4 positive impact upon non-merger groups. To better facilitate internal
5 management reporting, these efforts were tracked and reported collectively
6 as merger synergies. Many cultural shifts that had their roots in merger
7 integration and continue on today, such as our ongoing efforts in rolling out
8 the DTE Operating System, a framework of tools, methodologies and
9 processes focused on continuous improvement of corporate processes and
10 on attainment of operational excellence. Therefore, for purposes of my
11 testimony, merger synergies are cost reductions and efficiencies gained
12 within merger-affected organizations, which do not include cost savings due
13 to continuous improvement initiatives.

14

15 **Q. What O&M merger synergies have been achieved?**

16 A. In 2002, DTE Energy achieved over \$128 million in O&M synergies. These
17 O&M synergies are summarized in Exhibit A-16, Schedule F5-6.
18 Approximately \$84 million of the O&M synergies can be attributed to Detroit
19 Edison based on the nature and source of the savings that were created.
20 This attribution represents, 66% of the total DTE cost synergies that were
21 achieved in 2002 as detailed on Exhibit A-16, Schedule F5-7. By 2004, the
22 O&M synergies for Detroit Edison are forecasted to be over \$114 million

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1 based on a combination of incremental synergies and the continuing impact
2 of economics and inflation.

3

4 **Q. How was the 66% allocation factor determined?**

5 A. The derivation of the 66% allocation is reflected on Exhibit A-16, Schedule
6 F5-7. The starting point for the allocation factor was the original ten-year
7 projected cost savings of \$963 million shown in column (d). While some of
8 the cost savings were projected to be directly related to the individual
9 business units, as shown in column (b), the majority of cost savings were
10 expected to be derived from the Corporate Support Groups, as shown in
11 column (c), and thus not directly related to the operating units. The
12 proportions of the cost savings directly related to the operating units are
13 shown in column (e). Column (f) summarizes the allocation of each of the
14 CSG's cost savings to the operating units based on the pre-merger
15 allocation of each of the CSG's costs. The allocation factors in columns (e)
16 and (f) were weighted based on the relative magnitude of direct costs to
17 Corporate Support costs in columns (b) and (c). The resulting weighted
18 average is shown in column (g). Based on this analysis, 66% of the cost
19 synergies can be attributed to Detroit Edison, while MichCon and the other
20 operating units of DTE will realize 28% and 6%, respectively.

21

22 **Q. What were the merger related initiatives that resulted in \$84 million in**
23 **2002 merger synergy cost savings?**

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- 1 A. The \$84 million in 2002 merger synergy cost savings were accomplished
2 through a variety of initiatives. The primary merger synergy was realized
3 when, as a result of extensive pre-merger work by the management team,
4 the Early Retirement Option (“ERO”) and Voluntary Resignation Offer
5 (“VRO”) programs were implemented. Through this package of retirement
6 supplements and severance payments, 1,186 employees in merger-affected
7 organizations opted to leave the combined companies. In selected areas,
8 some replacement of positions vacated was required to continue to provide
9 needed services, yielding a net employee reduction of 811. The portion of
10 this reduction that was attributed to Detroit Edison merger synergies
11 resulted in \$43.8 million in labor and benefit cost savings in 2002. This
12 amount is forecasted to increase to \$58.4 million by 2004, due to labor
13 economics, and increased cost of pensions and benefits. The remaining
14 \$40.4 million in 2002 merger synergy savings occurred as a result of
15 significant reductions in non-labor costs attributable to reduced needs due
16 to the ERO/VRO reductions and through the elimination of duplicative
17 services and processes of the combined organizations. From DTE’s
18 perspective, the ERO/VRO process was necessary to “right size” the
19 corporate workforce and position Detroit Edison as a leaner, cost efficient
20 electric utility, which is operating in a more competitive marketplace.
21
- 22 **Q. Were there cost reductions in other areas of Detroit Edison during the**
23 **merger implementation time frame?**

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1 A. Yes, there were other O&M savings achieved in the business units related
2 to pre-existing initiatives, and/or continuous improvement projects. To the
3 extent necessary, these savings are discussed within the testimonies of
4 Messrs. Dow, Baig, Colonnello and Lapplander.

5

6 **Q. As it relates to merger-affected groups, please describe the O&M**
7 **synergy savings to Detroit Edison for Information Technology**
8 **Services.**

9 A. Information Technology Services ("ITS") was able to achieve overall O&M
10 synergy savings of \$25 million in 2002, and forecasted to be \$37 million in
11 2004.

12 These savings were achieved in the following areas:

13 • Base labor reductions due to the ERO/VRO process, including the
14 elimination of overlapping leadership positions and increased span of
15 control netted \$5.4 million in savings in 2002, which is forecasted to
16 grow to \$7.3 million in 2004.

17 • Other savings of \$19.6 million in 2002, which are forecasted to grow to
18 \$29.7 million in 2004, were achieved by combining the two ITS
19 organizations in the areas of:

20 — Contract labor reductions in the areas of maintenance, desktop
21 and LAN support and research and development

22 — Reduced infrastructure support related to the broader CSG
23 workforce reduction (PCs, laptops, telecom)

Line
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1 — Renegotiations of contracts and the elimination of infrastructure
2 duplication

3 — Managing ITS related costs through consolidation of workforce
4 and support assets is a key ingredient in mitigating utility O&M
5 costs that are under constant upward pressure from inflation
6 and technology changes.

7

8 **Q. Please discuss the Affiliated Computer Services, Inc. (“ACS”) contract**
9 **termination and its impact on Detroit Edison?**

10 A. This ITS synergy savings was related to the termination of the contract MCN
11 Energy had with ACS for mainframe operations support of its customer
12 billing system. DTE determined after extensive study during merger
13 integration that integrating MCN’s billing system with Detroit Edison’s would
14 improve customer billing and collection processes, improve customer
15 information and access to billing records resulting in more accurate billings
16 and more friendly customer interface. While we experienced some initial
17 difficulties when combining the two billing systems, these problems have
18 been identified and addressed. With these issues behind us, the merger
19 synergies and delivery of the resulting customer benefits is back on track.
20 Based on the efficiency gained by combining the two billing systems, and
21 the resulting excess computing capacity it created, the Company terminated
22 its external support agreement provided by ACS. During 2002, the year in
23 which the contract was terminated, \$12.6 million in savings to DTE Energy

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1 were achieved, excluding a negotiated cost to buy-out to the contract of
2 \$14.6 million. Beginning in 2003, the first full year after the termination of
3 the ACS contract, annual savings to DTE Energy are approximately \$20
4 million. The synergies applicable to Detroit Edison were \$8.6 million in
5 2002, and forecasted to be \$13.2 million in 2004.

6

7 **Q. Please describe the Detroit Edison O&M synergy savings relative to**
8 **Corporate Services.**

9 A. Corporate Services, which contains our supply chain, facilities, vehicle fleet
10 and transactional shared service organizations, achieved \$8.1 million of
11 overall synergies savings in 2002, and is forecasted to be \$12.9 million in
12 2004, due to the ERO/VRO workforce reduction.

13

14 **Q. Please describe the Detroit Edison O&M synergy savings relative to**
15 **Corporate Communications.**

16 A. Corporate Communications had overall synergy savings of approximately
17 \$2.5 million in 2002, which is forecasted to grow to \$3.0 million in 2004.
18 The labor related synergies, achieved by eliminating overlapping functions
19 as a result of the ERO/VRO programs, was approximately \$1.3 million in
20 2002, and is forecasted to be \$1.6 million in 2004. Additional non-labor
21 synergies of approximately \$1.2 million were achieved in 2002, and are
22 forecasted to be \$1.3 million in 2004. The non-labor synergies were
23 realized by combining employee publications, websites and bill enclosures

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1 for quarterly customer news letters, and other inserts (i.e. “Rights and
2 Responsibilities”, and “Winter Protection”.)

3

4 **Q. Please describe the O&M synergy savings in Detroit Edison’s**
5 **Controller’s Organization.**

6 A. The Controller’s organization had \$4.5 million of overall synergy savings in
7 2002, and is forecasted to be \$5.6 million in 2004. This was primarily a
8 result of the ERO/VRO workforce reduction that eliminated overlapping
9 accounting activities and processes. Non-labor savings of \$1.2 million in
10 2002, and forecasted to be \$1.3 million in 2004, were achieved by in-
11 sourcing the project evaluation and cost management functions as a result
12 of the skills and competencies of the new combined organization.

13

14 **Q. Please describe the O&M synergy savings to Detroit Edison for Human**
15 **Resources.**

16 A. Human Resources achieved \$9.8 million of overall synergy savings in 2002.
17 The synergy savings in Human Resources is forecasted to be \$12.3 million
18 in 2004. This was primarily a result of ERO/VRO workforce reductions,
19 which targeted overlapping functions and processes in the areas of training,
20 labor relations, employee relations, recruiting, staffing, organizational
21 development, and benefits administration. Non-labor savings in the area of
22 organization development yielded \$3.5 million of savings in 2002. Non-

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1 labor synergy savings are forecasted to be \$3.7 million in 2004 due to
2 reductions in the need to have external resources perform this work.

3

4 **Q. Please describe the O&M synergy savings to Detroit Edison for**
5 **Finance and Treasury.**

6 A. Finance and Treasury achieved \$4.0 million of overall synergy savings in
7 2002. This savings is forecasted to be \$5.5 million in 2004. These savings
8 were primarily a result of ERO/VRO workforce reductions, which targeted
9 overlapping functions and processes in the areas of tax, cash management,
10 trust investments and payment processing. Non-labor savings of \$1.9
11 million in 2002, and forecasted to be \$3.1 million in 2004 were achieved
12 through the integration of tax systems and the reduction of outside
13 resources utilized by the treasury organizations.

14

15 **Q. Please describe the O&M synergy savings to Detroit Edison for Legal.**

16 A. The Legal group achieved \$1.9 million of overall synergy savings in 2002
17 and is forecasted to be \$2.3 million in 2004 as a result of a workforce
18 reduction of overlapping functions enabled by the ERO/VRO programs and
19 reduced use of outside counsel as a result of combining the merged
20 organizations.

21

22 **Q. Please describe the O&M synergy savings to Detroit Edison for**
23 **Corporate and Government Affairs.**

Line
No.

1 A. Corporate and Government Affairs had overall O&M synergy savings of
2 approximately \$2.8 million in 2002 and forecasted to be \$3.4 million in 2004,
3 as a result of ERO/VRO workforce reductions and a decreased dependence
4 on shared external governmental affair resources, by optimizing our efforts
5 on environmental initiatives and the elimination of duplicate programs.

6

7 **Q. Please describe the O&M synergy savings to Detroit Edison for**
8 **Strategic Planning and Development.**

9 A. Strategic Planning and Development had overall synergy savings of
10 approximately \$2.5 million in 2002, which is forecasted to grow to \$3.3
11 million in 2004 related to workforce reductions and the reduced dependence
12 on outside resources.

13

14 **Q. Please describe the O&M synergy savings to Detroit Edison for**
15 **Corporate Offices.**

16 A. Corporate Offices had overall synergy savings of approximately \$1.9 million
17 in 2002 and forecasted to be \$2.5 million in 2004 related to the reduction in
18 the number of corporate officers and their associated administrative support.

19

20 **Q. How will customers benefit from the cost savings that have resulted**
21 **from merger synergies?**

22 A. As I have explained, cost synergies gained in combining the two
23 organizations have, and continue to provide O&M cost savings by reducing

Line
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1 the workforce through ERO/VRO programs, with the attendant non-labor
2 loadings associated to these reductions, and other cost reductions resulting
3 from the acquisition of MCN have added tangible value to customers in the
4 form of permanent reductions in cost. Therefore, I believe it is prudent and
5 reasonable to recover the cost of the acquisition premium that made the
6 merger possible.

7

8 **Q. What is the appropriate method of determining the costs of the**
9 **acquisition premium?**

10 A. The final price paid by DTE for MCN was an aggregate consideration of
11 \$2.370 billion. The premium paid above MCN's book value was \$1.478
12 billion. While this difference is generally referred to as goodwill or
13 acquisition premium, this is not the amount that I propose be recognized in
14 this proceeding. Rather, my proposal is to recognize only that portion of the
15 acquisition premium that can be identified as related to the ability to
16 exercise day-to-day control over the operations of MCN, and its principal
17 subsidiary, MichCon, and therefore, realize the synergy savings the
18 acquisition offered. The appropriate way to determine the premium paid to
19 "take control," or control premium, is to compute the difference in the
20 purchase price of MCN and the market value of MCN immediately prior to
21 the announcement of the merger agreement.

22

23 **Q. How did you calculate the control premium?**

Line
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1 A. As detailed in Exhibit A-16, Schedule F5-8, lines 2 through 22 reflect the
2 derivation of the aggregate value of the total purchase consideration of the
3 combination of cash and DTE common stock, based on the closing price of
4 DTE's common stock on the New York Stock Exchange on May 31, 2001,
5 for the purchase of MCN. This recognizes that 55% of the total
6 consideration was paid in cash at a price of \$24 per MCN share of common
7 stock and that 45% was paid through the issuance of 0.715 shares of DTE
8 common stock for each MCN share. Line 24 reflects the closing price of
9 MCN's common stock on the New York Stock Exchange on October 4,
10 1999, the day before the merger was announced. Line 26 reflects this price
11 multiplied by the number of MCN shares outstanding which represents the
12 market value of MCN of \$1.595 billion (Line 26) before the merger was
13 announced. The difference between the market value and the price paid
14 was \$0.774 billion (Line 28). This amount is the price above MCN's market
15 value that can be attributed to the value paid by DTE for the ability to control
16 MCN and its assets. Indeed, this is the cost of having the ability to integrate
17 the two principle operating companies, Detroit Edison and MichCon, and
18 thus create the merger synergies that flow from common operation and
19 management.

20

21 **Q. Why did DTE pay this control premium?**

22 A. This premium was supported by the expectation that significant cost
23 synergies were to be derived from the common operation and management

Line
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1 of Detroit Edison and MichCon. At the time of the announcement of the
2 merger, these cost synergies were estimated to well exceed \$1 billion over
3 the first ten years. As I have already discussed, these cost synergies were
4 to be created through workforce reductions, and through reductions in
5 common support costs, such as accounting, information systems and other
6 administrative areas, as well as through the combination of customer related
7 services where Detroit Edison and MichCon had overlapping service
8 territories. These cost reductions could only have been achieved through
9 the merger. Since estimated savings, on average, of over \$150 million a
10 year can be assumed to be perpetual, based on the new steady-state
11 operations, it is clear that the \$774 million control premium was less than
12 the expected value to be derived from the combination.

13

14 **Q. Please describe the inclusion of the annual cost for Detroit Edison's**
15 **portion of the control premium you propose to recover in rates.**

16 A. The components of the control premium are summarized on Exhibit A-16,
17 Schedule F5-9. It is estimated that 66%, or \$511 million, of the control
18 premium is applicable to Detroit Edison based on the attributed merger
19 synergies. Since this represents the benefits to customers realized as cost
20 reductions, it is therefore reasonable to allocate the control premium based
21 on the same percentage. Recognizing the annual amortization, as
22 described below, the average balance of the unamortized control premium
23 is reflected on Line 10. Applying Detroit Edison's pre-tax cost of capital

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1 developed by Mr. VanHaerents to this balance produces a 2004 annual cost
2 of \$53.9 million. Using a 40-year life, this amount is increased by the
3 annual amortization of the control premium of \$12.8 million. Since this cost
4 is not deductible for either Federal Income Tax or for the Michigan Single
5 Business Tax, this amount is grossed-up by the revenue multiplier to
6 produce an annual revenue requirement of \$20.1 million. Line 24 reflects
7 the sum of the return on and of capital results in a total revenue requirement
8 of \$74.0 million in 2004.

9

10 **Q. Why have you used the pre-tax overall cost of capital of Detroit Edison**
11 **in this analysis?**

12 A. Since the cost synergies realized by Detroit Edison are going to be passed
13 on to customers through lower rates, the control premium cost was based
14 on the cost of capital applicable to utility operations. It is reasonable to
15 presume that this premium is being financed proportionate to all other uses
16 of capital and thus the overall rate of return is appropriate.

17

18 **Q. What is the basis for the 40-year amortization?**

19 A. The cost synergies made possible by the successful merger integration will
20 provide permanent benefits to Detroit Edison and its customers. Thus, I've
21 adopted the longest amortization period generally recognized for long-lived
22 assets.

23

Line
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- 1 **Q. How will Detroit Edison account for the control premium costs?**
- 2 A. In the month that the MPSC authorizes recovery of this cost in Detroit
- 3 Edison's rates, Detroit Edison will initiate the amortization of the principal
- 4 balances as well as the carrying cost based on the overall cost of capital
- 5 adopted in this proceeding.
- 6
- 7 **Q. Please describe the carrying costs billed from DTE to Detroit Edison**
- 8 **since the merger was completed.**
- 9 A. DTE bills all regulated and non-regulated affiliates the interest cost
- 10 associated with the total acquisition cost of MCN. Since Generally
- 11 Accepted Accounting Principles ("GAAP") do not provide for the recognition
- 12 of billing the cost of equity, the billing of interest costs on the entire
- 13 purchase cost was used as a substitute for the overall carrying cost,
- 14 including the cost of equity, applied to the Control Premium. This interest
- 15 billing will be revised following the conclusion of these rate proceedings to
- 16 be consistent with the use of the overall cost of capital, including the cost of
- 17 equity, applied to the Control Premium. While the recognition of the equity
- 18 cost is not allowed under GAAP, it is appropriate to recognize the costs
- 19 under SFAS 71 when specifically approved by the rate-setting agency.
- 20
- 21 **Q. Please describe the changes in the Control Premium costs between**
- 22 **2002 and 2004.**

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1 A. The Control Premium cost in 2004 reflects the revenue requirement related
2 to the amortization and carrying cost from the Control Premium arising from
3 the merger with MCN. While this cost is derived in the projected test
4 periods based on the overall cost of capital applied to a portion of the
5 acquisition premium, the cost recognized in 2002 is merely the cost of debt
6 applied to the entire acquisition premium with no annual amortization of the
7 balance.

8

9 **Q. Did the Commission approve the merger?**

10 A. Since the Commission is not required by law to approve utility mergers, it
11 did not do so. However, due to concerns raised by the Federal Trade
12 Commission ("FTC"), pertaining to the impact on competition in the on-site
13 power generation market, MichCon executed a long-term capacity sale to
14 Exelon, a Chicago based energy company. In addition, DECo proposed
15 tariff revisions designed to make on-site generation more attractive to
16 customers and developers. In its February 14, 2001 order approving these
17 requests, the Commission recognized the customer benefits to be derived
18 from the merger.

19

20 **Q. How is value created by the MCN merger reflected in O&M reductions**
21 **for Detroit Edison?**

22 A. As a means of validating that savings accreted to Detroit Edison in the form
23 of cost reductions, a comparison of O&M expense by major component has

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1 been done using the historical test year of 2002 and the prior period of
2 1999. The comparison year 1999 was chosen because it reflected the last
3 full year of operation before the merger transition process began and
4 represents a good example of steady state Detroit Edison operations.

5

6 **Q. What was the basis for this comparison?**

7 A. As detailed in Exhibit A-16, Schedule F5-10, MPSC Form P-521, 2002 O&M
8 levels were used as the starting point from which the following adjustments
9 were made in order to properly compare 1999 to 2002 operating cost levels:

- 10 • Fuel and Purchased Power expenses were excluded since they were not
11 impacted by the merger.
- 12 • The low income energy fund, a component of the securitization process,
13 was excluded from 2002.
- 14 • The International Transmission Company (“ITC”) was excluded to reflect
15 its spin-off from Detroit Edison.

16

17 After making these adjustments, there remains \$984 million in 1999
18 controllable O&M expenses, compared to 2002 controllable O&M of \$1,099
19 million, or an increase of \$115 million.

20

21 **Q. Does the \$115 million increase in Detroit Edison’s controllable O&M**
22 **from 1999 to 2002 include the effects of the merger synergies?**

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1 A. Yes, without the \$84 million in cost reductions from the capture of merger
2 synergies, 2002 O&M would have been significantly higher.

3

4 **Q. In light of the cost synergies that were realized by Detroit Edison post-**
5 **MCN merger, what factors have caused O&M expense to increase over**
6 **this time period?**

7 A. There were a variety of factors affecting O&M over this time period, beyond
8 the \$84 million of overall merger synergy savings. As detailed in Exhibit A-
9 16, Schedule F5-11, these factors were:

10 • External-oriented factors such as storms, employee benefit cost
11 increases and homeland security needs which impacted Detroit Edison's
12 O&M expenses by \$68 million.

13 • A re-investment and strengthening strategy for our aging generation fleet
14 added another \$58 million in O&M expense.

15 • The impact of national, state and local economies and inflation on our
16 base labor (3% annually) and material costs (1.5% annually) added an
17 incremental \$85 million.

18 • Increased customer service related costs added another \$4 million.

19

20 Partially offsetting these increases were:

21 • Year 2000 ITS compliance work in 1999 that was discontinued after the
22 millennium rollover reduced O&M by \$42 million.

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1 • Continuous improvement activities within operations to gain incremental
2 operating efficiencies also reduced O&M by \$38 million.

3

4 This yielded a “pre-merger impact” level of controllable O&M in 2002 of
5 \$1,120 million. When the impact of the merger synergy cost savings of \$84
6 million, \$4 million in cost-to-achieve, and \$59 million of merger interest
7 applicable to Detroit Edison are added, the result is a net increase of \$115
8 million in Detroit Edison controllable O&M over this timeframe.

9

10 **Q. Can you please explain in further detail, the external factors that**
11 **contributed to the increases reflected in 2002 O&M?**

12 A. Yes. As detailed in Exhibit A-16, Schedule F5-12, significant costs that
13 were primarily driven by external factors include:

14 • As I have discussed, increased pension and benefit costs have risen \$41
15 million over the 3-year time period reflecting increases in health care
16 costs, prescription drugs and increased HMO premiums and higher
17 pension costs. As outlined on page 2 of this exhibit, this impact includes
18 the reported expense increase in benefit costs, plus the net affect of
19 avoided costs due to the ERO/VRO employees (cost increases that
20 would have occurred “if not for” the workforce reductions), to arrive at a
21 “pre-merger impact” level of O&M expense. It should also be noted in
22 this summary that benefit costs overall (those expensed, securitized, and

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- 1 capitalized) increased \$53 million over this timeframe, reflecting a 16%
- 2 annual rate.
- 3 • Incremental storm restoration costs increased in 2002 over 1999 levels
- 4 by \$13 million, due to 2 large catastrophic storms in the first quarter of
- 5 2002.
- 6 • Increased insurance policy premiums of \$8 million due to a general
- 7 tightening of the property and general liability insurance market due to
- 8 higher claims and the diminution of investment returns by the insurance
- 9 carriers. In addition, since 1999, the Company has both increased its
- 10 nominal coverage as well as initiated coverage for business interruptions
- 11 at its power plants.
- 12 • Increased security costs of \$3 million, also due to heightened homeland
- 13 security measures to protect our facilities, assets and customers against
- 14 increased threats.
- 15 • Increased external auditor fees and other process changes of \$3 million,
- 16 as a result of new SEC regulatory requirements around accounting and
- 17 corporate governance practices.
- 18 • The details supporting the factors that contributed to increases in Detroit
- 19 Edison's 2002 O&M that are not related to employee benefits or CSG
- 20 are discussed and supported by the testimony of Messrs. Dow, Baig,
- 21 Colonnello, Lapplander and VanHaerants.
- 22

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1 **Q. What are some of the examples of the incremental spending Detroit**
2 **Edison made in generation strengthening over the past three years?**

3 A. In order to maintain acceptable levels of reliability for our customers, and to
4 address operating issues with an aging generation fleet, a focused plan
5 within Power Generation over this time period was implemented and
6 continues over the near term. This “re-investment” included more frequent
7 and comprehensive periodic outages, increased maintenance, increased
8 scope of our nuclear refueling outages, and increased staffing to address
9 anticipated attrition and related new operator training. As you can see on
10 Exhibit A-16, Schedule F5-13, this incremental O&M spending in 2002 over
11 1999, amounted to \$58 million.

12

13 **Q. Has Detroit Edison realized any savings in addition to those created**
14 **from merger synergies?**

15 A. Yes, in addition to merger synergies, Detroit Edison continues to actively
16 pursue all reasonable opportunities to improve the efficiency of its
17 operations, reduce costs, and strengthen its processes so that the utility
18 services provided to customers are cost efficient and reliable. These other
19 cost reduction opportunities fall in the category of continuous improvement
20 activities. A majority of the non-merger related continuous improvement
21 activities over this time frame originated within Distribution Operations as
22 our generation business unit focused primarily on re-investment initiatives.
23 As detailed on Exhibit A-16, Schedule F5-14, these examples included

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1 productivity gains within line clearance, storm restoration, and substation
2 maintenance in addition to leveraging the workforce reductions as part of
3 the ERO/VRO programs. Continuous improvement activities are covered in
4 more detail within Mr. Dow's testimony.

5

6 **Q. Please describe the projected O&M forecast for Corporate Support**
7 **(CSG).**

8 A. Exhibit A-16, Schedule F5-16 provides the detailed expense projections for
9 each of the CSG organizations. These O&M expenses are projected to
10 increase from \$211 million in 2002 to \$222 million in 2004. This exhibit also
11 shows that these expenses are projected to escalate to \$245 million by
12 2008. Included in the projected \$11 million increase in CSG between 2002
13 and 2004 are the following:

14 ■ Further CSG synergy savings of over \$11 million in 2003 and 2004. These
15 savings consist of \$9 million within Information Technology related to the
16 elimination of the ACS contract costs and further reductions in contract
17 employees. Additionally, the sale of the Guardian Building is projected to
18 reduce Corporate Service costs by \$2 million by 2004.

19 ■ Insurance costs are projected to increase \$12 million in this period. This
20 cost is related to Detroit Edison's insurance coverage for property losses
21 and liability claims against the Company. Due to the continuing impact of
22 large scale claims against these insurers, ranging from heightened
23 homeland security concerns to recent corporate scandals (i.e., Enron,

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1 WorldCom, and Global Crossing), the cost of insuring against these risks
2 has risen dramatically. In addition, the ongoing poor performance in the
3 financial markets has eliminated the ability of insurers to hold down
4 premiums through the benefits of the market gains realized in the Bull
5 Market of the last decade.

6 ■ Price level changes are expected to increase the non-labor related costs by
7 \$8 million during the two-year period. This is based on inflation related price
8 increases assuming an annual escalation of 3.0%. While employee salaries
9 are projected to increase 3% annually, productivity enhancements within the
10 Corporate Support Groups made possible through the deployment of the
11 DTE Operating System are assumed to completely offset these salary
12 increases.

13

14 **Q. Please describe the projected O&M forecast for the Other Expenses**
15 **and Accruals.**

16 A. This cost is projected to decrease from \$24 million in 2002 to almost \$14
17 million by 2004, as detailed on Exhibit A-16, Schedule F5-16. The principal
18 factors impacting this reduction are:

19 ■ Injuries and Damages costs which are projected to decrease by \$14 million
20 during this period due to Detroit Edison incurring an unusually high level of
21 claim related expenses in 2002. The projection presumes a level of claims
22 more representative of prior year's experience.

23

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1 ▪ Other costs for 2002 were impacted by a prior period adjustment in the
2 employee incentive plan accrual that reduced the 2002 costs by \$7 million.
3 Partially offsetting this cost was a \$4 million non-recurring increase to the
4 employee vacation accrual required to properly reflect the Company's actual
5 liability as of the end of 2002. Since these cost offsets are not included in
6 the projections, the net result is to increase 2004 costs by \$3 million.

7

8 The projected cost also reflects changes in the year-end labor accruals
9 related to the number of workdays not paid as of December 31 of each year.

10

11 **Q. How is Detroit Edison's allocable share of Corporate Support Group**
12 **costs determined?**

13 A. The centralization of the CSG provides demonstrated value to customers
14 through the efficiencies and cost savings this corporate model enables. In
15 order to attribute a reasonable and appropriate share of the CSG costs to
16 Detroit Edison, we utilize a combination of methods that includes direct
17 assignment and verifiable cost drivers that reflect the unit of work performed
18 by staff functions for the utility.

19

20 **Q. Please describe the details of CSG cost billings.**

21 A. Certain CSG related costs can be directly recorded within Detroit Edison, such
22 as uncollectible expense, while others are billed to Detroit Edison through the
23 use of cost drivers based on resource consumption. More specifically, each

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1 department within a corporate support organization identifies products and
2 services it provides by legal entity and/or business unit to determine resource
3 consumption. This is then analyzed to determine the most appropriate
4 measure, which represents a unit of work, to be used in determining the billing
5 of products or services being provided to Detroit Edison by the administrative
6 function. This measurement mechanism is called a cost driver. The cost
7 driver, in cost accounting terms, is the unit of work/output that is used to
8 determine a formula for billing the products or services to Detroit Edison and
9 other DTE entities. As departments incur costs during the year, they are billed
10 to Detroit Edison pursuant to the appropriate cost driver. (Exhibit A-16,
11 Schedule F5-17 details these by organization.)

12

13 **Q. Could you provide examples of how this process works?**

14 A. Cost drivers represent units of work that best reflect the content of the work
15 performed. For example, our payroll department within Corporate Services
16 processes paychecks. Given the transactional nature of this work, the
17 volumetric cost driver of “paychecks processed” provides the best indication
18 of work performed by this group for a specific legal entity. This department
19 provides services for Detroit Edison and other entities, hence costs billed
20 are based on the volume of paychecks processed for Detroit Edison during
21 the year. Other examples within the CSG include invoices paid, number of
22 PC desktops serviced, and applications maintained.

23

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- 1 **Q. How often are the cost drivers and level of support reviewed?**
- 2 A. Cost drivers are evaluated and established during the 4th quarter of the year
3 at a detailed workflow level based on resource consumption. These cost
4 driver standards and levels of support are reviewed twice (mid-year and
5 year-end close), during the following year to reflect actual experience. True-
6 up adjustments, based on actual resource consumption, are made to reflect
7 the proper billing of administrative costs. The projected billings in 2004 for
8 the CSG are based on 2003's current experience.
- 9
- 10 **Q. What are your billing assumptions for Corporate Support to Detroit
11 Edison in the forecast years of 2004-2008?**
- 12 A. The cost driver billing assumptions for corporate support costs during the
13 forecast time period are held constant at 2004 forecast year levels,
14 reflecting the assumption that service levels will remain consistent with
15 current patterns.
- 16
- 17 **Q. Why wouldn't CSG departments directly charge all costs to corporate
18 entities or business units rather than bill costs as described above?**
- 19 A. The Company adopted the shared service delivery model for the corporate
20 administrative groups to achieve greater efficiency in operations, higher
21 quality of services, and lower operating cost as evidenced by the significant
22 synergy savings. We considered the 100% direct charge concept and
23 discarded this alternative since the costs to implement and administer

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1 outweigh the benefits given the significant additional transactions created on
2 a monthly basis across multiple general ledger platforms. Other non-direct
3 charge options were reviewed and we selected our cost driver model
4 because it is accurate, efficient, cost effective and representative of costing
5 standards utilized in a variety of applications across many industries.
6 Whatever slight differences that may exist between cost driver billings and
7 what direct charge billings would be, are small and overshadowed by the
8 significant cost necessary to gain the perceived accuracy of direct charges.

9

10 **Q. How have you billed costs for which no direct cost driver was**
11 **discernable?**

12 A. While the vast majority of costs, about 93%, have been billed to Detroit
13 Edison and its affiliated companies based on the direct drivers I have
14 described, a limited number of administrative activities are shared across
15 the enterprise that do not possess cost driver attributes (a unit of work
16 directly attributed to a legal entity), or that are on behalf of the parent, DTE
17 Energy, that indirectly benefits Detroit Edison. It is in these cases that we
18 use the commonly accepted cost allocation methodology traditionally
19 referred to as the Massachusetts Formula ("Mass Formula"). The Mass
20 Formula is designed to measure relative size and complexity as a means of
21 assessing the degree of support services each individual company, within
22 the context of the broader enterprise.

23

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1 **Q. Why is the Mass Formula an appropriate cost driver?**

2 A. The Mass Formula utilizes a blend of metrics (based on relative size and
3 resource utilization) to quantify an entity's impact on the enterprise as a
4 means of providing a consistent and equitable allocation of common or
5 "shared" costs. In that regard, the Mass Formula had traditionally consisted
6 of three equally weighted components:

- 7 • Gross plant
- 8 • Gross revenue
- 9 • Labor costs

10

11 As originally configured for purposes of allocating State taxable income for
12 multi-state companies in Massachusetts, these three components were
13 deemed to be relevant indicators of the relative magnitude of a corporate
14 entity. Subsequently, these same determinants have been routinely used
15 by rate setting agencies for allocating common costs that are not
16 susceptible to direct assignment.

17

18 **Q. Has the Commission used the Mass Formula in billing common costs?**

19 A. Yes, it has. In a number of rate cases over the last 20 years, the
20 Commission set rates based on the use of the Mass Formula, or some
21 derivative thereof. In some instances the revenue component has been
22 revised to reflect gross margin as measured by revenue less the cost of
23 goods sold. This modification was designed to avoid year-to-year

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1 distortions based solely on the variability of commodity prices. Similarly, the
2 Mass Formula has been routinely adjusted to recognize net plant rather
3 than gross plant. Most recently, the components have been adjusted to
4 include investments in Joint Ventures that are not recognized as plant
5 investments. All of these modifications have been adopted in pursuit of a
6 reasonable method for assessing the benefit received arising from the
7 occurrence of common costs.

8

9 **Q. Why is it important to bill these common costs?**

10 A. The critical need is to recognize that most of the common costs allocated by
11 the Mass Formula are costs that would be borne completely by the utility in
12 the absence of a holding company or affiliates. Thus, it is imperative to
13 balance the tangible cost efficiencies and benefits gained for customers
14 through centralizing these common activities along with recognizing a
15 reasonable share of these common costs should be borne by the utility.
16 The Mass Formula is a reasonable and widely accepted means of striking
17 that balance in developing the basis for common cost allocations.

18

19 **Q. What components have you reflected in your derivation of the Mass**
20 **Formula?**

21 A. I have developed a Mass Formula cost allocation using three components.
22 1) Gross margin: Revenue less the cost of goods sold. Thus, electric sales
23 at Detroit Edison are reduced by the power supply costs. Similarly,

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1 MichCon revenues are reduced by its cost of purchased gas sold. Non-
2 utility revenues have been reduced by the cost of commodity purchases
3 reflected in their cost of goods sold. This mirrors the approach
4 previously adopted by the Commission.

5 2) Net Plant and Joint Venture investments: This component has been
6 adjusted, consistent with traditional Commission practice, to be based on
7 net plant rather than gross plant. Detroit Edison's net plant balance has
8 been adjusted to include the net book value of the Fermi II assets
9 securitized in 2001. While the impairment and subsequent securitization
10 reduced Detroit Edison's net plant, it is appropriate to recognize the
11 capital invested in Fermi II for the purpose of allocating common costs.
12 This also includes Joint Venture investments not recognized in the
13 consolidated net plant balances.

14 3) Labor costs: All direct payroll costs for all companies.

15

16 Details of the Mass Formula calculation used in 2004 are detailed in
17 Exhibit A-16, Schedule F5-18.

18

19 **Q. What common costs have you billed based on the Mass Formula?**

20 A. Common costs billed based on the Mass Formula include; investor
21 relations activities, shareholder services, corporate secretary work and
22 Board of Directors' expenses. In each case these are costs that either

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1 could not be directly assigned, or that did not have a definable resource
2 consumption-based cost driver.

3

4 **Q. Please explain in general the content of the 2002 Form P-521 revisions**
5 **as shown in Exhibit A-1, Schedule A4.**

6 A. Exhibit A-1, Schedule A4 details the following adjustments, and
7 reclassifications to the 2002 Form I:

8 • \$14.5 million on Line 2 reclassified to A&G expense from Power,
9 Transmission and Distribution to reflect the proper account classification.

10 This has no impact to net income.

11 • Reductions of \$3.6 million of operating expenses and \$1.3 million of other
12 income/deductions for the following:

13 — A \$5.6 million adjustment decreased the amount billed to Detroit
14 Edison pursuant to the year end cost driver adjustment.

15 — Mass Formula revisions included securitized assets and gross
16 margin adjustments decreased the amounts billed to Detroit Edison
17 by \$0.3 million.

18 — Benefit overhead adjustments to direct labor performed by MichCon
19 employees on behalf of Detroit Edison increased O&M by \$1.0
20 million.

21 **CAPITAL EXPENDITURES**

22

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1 **Q. What is the purpose of your testimony regarding projections for capital**
2 **spending?**

3 A. I will provide an overview of Detroit Edison's projected capital spending for
4 2003 through 2008. In addition, I am sponsoring the projections related to
5 Corporate Support (CSG) and construction overheads.

6

7 **Q. What have the trends been in capital spending over the past few years**
8 **at Detroit Edison?**

9 A. Exhibit A-16, Schedule F3, page 2, provides a comparison of the 1999 and
10 2002 time periods. Overall capital spending is up \$167 million in 2002 over
11 comparable 1999 levels. A key driver of this change has been the
12 investments related to environmental compliance. A more "normalized" look
13 at capital expenditures over this timeframe, after adjusting for
14 environmental, nuclear fuel and peaking generation, shows a much lower
15 level of base business spending, reflecting our ongoing efforts around
16 productivity and continuous improvement. However, it is becoming more
17 difficult to balance the capital needs of the base business given that Edison
18 must continue environmental compliance, deal with expanding service
19 territory infrastructure and an aging generation fleet, and manage these
20 costs in an electric market where rates are reduced and revenues lost to
21 choice are increasing.

22 **Q. Please describe the projected capital spending for Detroit Edison.**

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1 A. Exhibit A-16, Schedule F3, page 1 shows total capital spending for the
2 historical test year 2002 and the projected capital spending for forecast years
3 through 2008. While the capital spending of Production and Distribution are
4 being sponsored by Messrs. Baig, Colonnello and Dow, this schedule
5 provides a summary of Detroit Edison capital spending.

6

7 **Q. Please describe the projected capital spending forecast for Corporate**
8 **Support (CSG) and construction overheads.**

9 A. Projected capital spending for Corporate Support as detailed on Exhibit A-16
10 Schedule F3, page 1, outlines increased capital investment needs that are
11 largely driven by technology improvements, asset preservation, and facility
12 improvements. These are covered in more detail later in my testimony.
13 Construction overheads, which include employee benefits as part of
14 capitalized labor, AFUDC and taxes are expected to rise from 2002 levels
15 primarily as a result of increased pension and health care costs.

16

17 **Q. Please discuss the ITS capital projects forecasted in 2004 as reflected**
18 **on Exhibit A-16, Schedule F3, Line 15.**

19 A. The ITS 2004 capital forecast for Detroit Edison is projected to be \$31
20 million, and consists of three major areas; new project initiatives, existing
21 system enhancements and infrastructure maintenance (hardware, telecom,
22 software).

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1 New projects are initiatives that support efficiency and productivity efforts
2 within the business units. New project spending is forecasted at \$9.2 million
3 for 2004. The major projects include the Voice Response Unit (VRU) natural
4 language production rollout to support the Customer Service initiatives (\$2.6
5 million), Fossil Generation document management (\$0.9 million), electronic
6 bill presentment and payment plans (\$1.1 million), and assorted other
7 projects (\$4.6 million). The bill presentment and VRU projects represent
8 important components in Detroit Edison's plans to provide more seamless,
9 customer friendly interfaces

10

11 Enhancement projects are improvements to existing systems and
12 applications intended as a means of gaining productivity or improving
13 functionality of applications already in service. Enhancements to existing
14 systems are forecasted at \$7.1 million. These projects will support
15 Distribution Operations (\$1.8 million), Customer Service (\$1.7 million),
16 Energy Resources (\$1.8 million) and Corporate Support Groups (\$1.7
17 million). The productivity gained from these projects will help Detroit Edison
18 to mitigate future cost increases from external factors that might otherwise
19 put upward pressure on customers' rates.

20

21 Infrastructure projects are those projects that address the ongoing
22 infrastructure needs of Detroit Edison in the area of mainframe operations,
23 LAN management, disaster recovery, telecommunications and client/server

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1 support. For 2004, infrastructure projects are forecasted at \$13.8 million.
2 These projects include client/server needs (desktops, laptops, servers,
3 printers, etc) (\$4.2 million), conversion of mainframe legacy applications
4 (\$1.7 million), Document Management System (\$1.0 million), and assorted
5 other smaller dollar initiatives. These initiatives help Detroit Edison maintain
6 its status as a cost efficient productive local electric utility and provide the
7 flexibility to deal with changing economic and technological environments.
8 Customers benefit from improvements in customer interfaces more efficient
9 billing and greater assurance that reliability of their electric service will
10 continue.

11

12 **Q. Please discuss the Corporate Services capital projects forecasted in**
13 **2004 as reflected on Exhibit A-16, Schedule F3, Line 16.**

14 A. Corporate Services capital projects for 2004 are forecasted at \$53.0 million.
15 The major projects include the following:

16 • Asset preservation projects of \$13.0 million, which consist of
17 maintaining existing facilities roofing, paving, elevators, HVAC,
18 furniture and carpeting.

19 • Headquarters facility improvements of \$16.5 million, as part of a
20 multiyear project to renovate and upgrade the Edison Center
21 complex, including structural and security improvements, HVAC,
22 elevators, grounds and parking.

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1 • Warren Service Center facility improvements of \$5.0 million, as part
2 of ongoing renovation and replacement.

3 • An assortment of other organizational projects that include
4 warehousing improvements, power plant facility needs, service
5 center improvements, and ongoing fleet vehicle replacements.

6 These capital projects reflect the continuing costs of maintaining a healthy
7 electric utility with the appropriate assets necessary to continue the
8 provision of reliable cost efficient utility services.

9

10 **Q. Does this conclude your overall testimony?**

11 A. Yes it does.

12