

STATE OF MICHIGAN
BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

In the matter of the Commission's own motion)
ordering **THE DETROIT EDISON COMPANY**)
to show cause why its retail rates for the sale)
and distribution of electric energy should not)
be decreased.)

Case No. U-14838

QUALIFICATIONS
AND
DIRECT TESTIMONY
OF
PAUL A. STADNIKIA

THE DETROIT EDISON COMPANY
QUALIFICATIONS OF PAUL A. STADNIKIA

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

2 A. My name is Paul A. Stadnikia. My business address is DTE Energy
3 Company, 2000 Second Avenue, Detroit, Michigan 48226.

4

5 **Q. By whom are you employed and in what capacity?**

6 A. I am Assistant Treasurer and Director of Corporate Finance and Trust
7 Investments for DTE Energy and its subsidiaries including The Detroit
8 Edison Company ("Detroit Edison" or "Company").

9

10 **Q. What are your responsibilities as Assistant Treasurer and Director of**
11 **Corporate Finance and Trust Investments for Detroit Edison?**

12 A. I am responsible for assisting the Treasurer in managing both the capital
13 needs of the Company and the Company's pension and trust assets. These
14 responsibilities include managing corporate liquidity and financing activity,
15 including the raising of both equity capital and capital markets debt for DTE
16 Energy Company, Detroit Edison and Michigan Consolidated Gas
17 Company. I assist with maintaining relationships with the commercial and
18 investment banking community and interacting with the rating agencies.

19 I am responsible for managing the Company's defined benefit and defined
20 contribution pension assets, as well as nuclear decommissioning and other
21 trust assets. This includes recommending and implementing investment
22 policies, investment manager selection and monitoring, and FASB 87/106
23 reporting in conjunction with the Company's actuary of record.

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1 **Q. Please describe your educational background.**

2 A. I graduated from Central Michigan University in 1981 with a Bachelor of
3 Science degree in Business Administration, majoring in Accounting. In
4 addition to my academic training I have also attended various seminars,
5 including Ibbotson Associates' Cost of Capital and Equity Risk Premium
6 conferences, and The National Society of Rate of Return Analysts' 28th
7 Financial Forum.

8

9 **Q. Would you please describe your professional experience?**

10 A. I began my employment with Consumers Energy Company in July of 1981
11 as a Graduate Accountant in the Corporate Budgeting Department. At that
12 time the Company was known as Consumers Power Company. My
13 responsibilities increased over time from assisting with, to the supervision
14 of, the planning, analyzing and developing of an overall picture of
15 Consumers' short term financial position. This was achieved by the
16 development of the corporate operating budget and monthly earnings
17 forecasts, which provided senior management with financial information
18 required for decision-making and support for financial requirements. In this
19 capacity, I was responsible for the preparation of our Vice President and
20 Controller's and/or Chief Financial Officer's monthly Board of Director
21 presentations regarding actual variations to the operating budget and
22 forecasts.

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1 In 1990, I was promoted to the position of Principal Analyst in the Financial
2 Planning section of the Financial Planning Department. In this position I
3 was responsible for performing all aspects of financial modeling and
4 analysis as it related to the overall performance of Consumers Energy
5 Company, its electric and gas business units and individual projects
6 involving financial issues as assigned. The duties of this position included
7 performing financial analyses, preparing long term financial forecasts for
8 senior management review, providing financial analysis support for
9 regulatory proceedings, and maintaining planning models along with various
10 financial spreadsheets. Also included was the responsibility for preparation
11 of the Executive Vice President and Chief Financial Officer's presentations
12 to CMS Energy's Board of Directors, rating agencies, investment bankers,
13 and financial institutions.

14

15 Consistent with changes in company job titles and a reorganization of our
16 department, in 1995 my position was changed to Senior Financial Analyst in
17 the Corporate Planning Department.

18

19 In April 1997 I accepted the position of Financial Projects Director. My
20 primary responsibility was to provide finance support and analysis. In
21 August 1998 I was promoted to Senior Director of Finance.

22

23 **Q. What were your responsibilities as Senior Director of Finance?**

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1 A. My responsibilities were broad and included raising CMS Energy
2 Corporation equity capital, raising capital markets debt for CMS Energy,
3 Consumers Energy and CMS Panhandle, raising project debt for various
4 CMS Energy companies and evaluating merger and acquisition candidates.
5 My responsibilities also included developing relationships with investment
6 bankers.

7

8 I was promoted to Assistant Treasurer of Consumers Energy and CMS
9 Energy in 1999. In December 2002 I was appointed Treasurer of
10 Consumers Energy.

11

12 **Q. What were your responsibilities as Treasurer for Consumers Energy**
13 **and as Assistant Treasurer for CMS Energy?**

14 A. As Treasurer of Consumers Energy I was responsible for, among other
15 things, managing corporate liquidity and financing, treasury operations and
16 maintaining relationships with the commercial and investment banking
17 community. This included responsibility for raising capital market debt for
18 Consumers Energy. As Assistant Treasurer for CMS Energy, I was
19 responsible for treasury operations and assisting in raising CMS Energy
20 Corporation equity capital as well as raising capital market debt for CMS
21 Energy and its subsidiary companies.

22

23 In October of 2003 I accepted the position of Executive Director of Financial
24 Planning.

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2 **Q. What were your responsibilities in this position?**

3 A. As Executive Director of Financial Planning my responsibilities were
4 consolidating CMS Energy's five year financial plans used for
5 management's strategic decision making and direction, rating agency
6 presentations, investment community presentations, commercial lending
7 and Corporate Finance decisions.

8

9 **Q. What is your present position?**

10 A. As mentioned previously, I am currently Assistant Treasurer and Director of
11 Corporate Finance and Trust Investments for DTE Energy and its
12 subsidiaries, including The Detroit Edison Company. I accepted the position
13 of Assistant Treasurer and Director of Corporate Finance on November 1,
14 2004. The additional responsibilities involving Trust Investments were
15 added in March of 2006.

16

17 **Q. Have you previously testified before this Commission?**

18 A. Yes. I presented testimony on return on equity issues in Case No. U-11560,
19 capital structure and cost of capital in Case No. U-13730, and testimony in
20 Case No. U-13220-R. In addition, I have testified before the Federal Energy
21 Regulatory Commission in Docket No. RP96-290-000 on capital structure,
22 cost of capital and return on equity issues.

THE DETROIT EDISON COMPANY
DIRECT TESTIMONY OF PAUL A. STADNIKIA

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

2 A. The purpose of my testimony is to present my recommendations regarding
3 the capital structure and cost of capital which should be used in computing
4 the overall rate of return for ratemaking purposes to set just and reasonable
5 rates for Detroit Edison.

6

7 **Q. How is your testimony organized?**

8 A. My testimony is organized as follows:

9 I. Summary of Recommendations

10 II. Development of Capital Structure

11 III. Development of Cost Rates

12 IV. Summary and Conclusions

13

14 **Q. Which Exhibits are you supporting?**

15 A. I am supporting the following Exhibits:

Exhibit DE-4	Schedule D2	Cost of Long Term Debt – as of 12/31/2005
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Exhibit DE-4	Schedule D3	Cost of Preferred and Preference Stock – as of 12/31/2005
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Exhibit DE-4	Schedule D4	Cost of Common Shareholders Equity – as of 12/31/2005
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Exhibit DE-4	Schedule D5	Cost of Short Term Debt – as of 12/31/2005
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Exhibit DE-12	Schedule D2	Cost of Long Term Debt – for 2006 through 2011
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Exhibit DE-12	Schedule D3	Cost of Preferred and Preference Stock – for 2006 through 2011
Exhibit DE-12	Schedule D5	Cost of Short Term Debt – for 2006 through 2011

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

3 A. Yes.

4

5 **I. SUMMARY OF RECOMMENDATIONS**

6 **Q. What capital structure are you recommending to be utilized in the**
7 **overall rate of return calculation for The Detroit Edison Company?**

8 A. I am recommending a permanent capital structure that has approximately
9 the same amount of long term debt and common equity. Since the
10 Company does not have any preferred stock, the debt and equity
11 components of the permanent capital structure I recommend would be
12 approximately 50% each. Throughout my testimony I discuss Detroit
13 Edison's business challenges and risks and hence, the need for a stronger
14 capital structure. Permanent capital is long term perpetual capital.
15 Common equity, preferred stock and long term debt are sources of
16 permanent capital. The capital structure that I am recommending is shown
17 on Exhibit DE-12, Schedule D1-2, as supported by Mr. Horgan. Later in my
18 testimony I will explain some of the known and measurable changes in the
19 development of this capital structure.

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1 **Q. What is your recommendation for Detroit Edison's cost of long term**
2 **debt, preferred stock, and short term debt for 2007?**

3 A. I am recommending 5.91% for the cost of Detroit Edison's long term debt
4 and 5.40% for the cost of Detroit Edison's short term debt. The Company
5 does not have preferred stock and therefore has no cost rate. Within Exhibit
6 DE-12, Schedule D2 supports the cost rate for long term debt, Schedule D3
7 supports the cost rate for preferred stock and Schedule D5 supports the
8 cost rate for short term debt.

9

10 **II. DEVELOPMENT OF CAPITAL STRUCTURE**

11 **Q. What do you mean by capital structure?**

12 A. Capital structure means different things to different people. Typically a
13 company's capital structure at least includes the amount of equity and debt
14 necessary to support the operations of its business. Michigan's electric
15 regulatory capital structure includes long term debt, short term debt,
16 preferred equity, common equity, deferred taxes, deferred Job Development
17 Investment Tax Credit and deferred Investment Tax Credit. Michigan's gas
18 regulatory capital structure is comprised of the same, plus customer
19 deposits and other interest bearing debits and credits. The Federal Energy
20 Regulatory Commission's capital structure uses only debt, preferred stock
21 and common equity. Finance professionals' calculation of a company's
22 capital structure is comprised of long term debt, preferred equity and
23 common equity. Depending on the use of the calculation, sometimes short
24 term debt is included. For further clarification, short term debt is often

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1 excluded if it is utilized primarily to support working capital needs in the
2 normal course of business. Finance professionals will sometimes include
3 capital leases and off-balance sheet obligations, such as operating leases in
4 their determination of debt. Rating agencies also make adjustments to a
5 company's capital structure for their analysis, including capital leases and
6 off-balance sheet obligations, such as operating leases and long term power
7 purchase agreements.

8

9 **Q. What capital structure are you recommending to be used for Detroit**
10 **Edison in this Case?**

11 A. The capital structure that I am recommending is the electric regulatory
12 capital structure as shown on Exhibit DE-12, Schedule D1-2. This capital
13 structure includes long term debt, short term debt, preferred equity, common
14 equity, deferred taxes, deferred Job Development Investment Tax Credit
15 and deferred Investment Tax Credit. Within this capital structure I am
16 recommending a permanent capital structure that has approximately the
17 same amount of long term debt and common equity. Since the Company
18 does not have preferred stock the long term debt and equity components
19 each account for approximately 50% of the permanent capital structure.

20

21 **Q. Why is it important to use a fair and reasonable capital structure in**
22 **setting a company's rates?**

23 A. It has long been recognized that the determination of a fair and equitable
24 return on equity is important to attract both equity and debt capital to the

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1 company to support investment. It is important that the overall return
2 established in this Case for Detroit Edison be sufficient to not only attract
3 equity investment, but to assure confidence in the financial soundness of
4 Detroit Edison and to allow it to raise money at competitive costs and
5 reasonable terms and conditions.

6

7 **Q. How does debt affect capital structure?**

8 A. The amount of debt in a capital structure is referred to as leverage. Use of
9 a highly leveraged capital structure can reduce the amount of equity capital
10 but substantially increase the Company's risk profile. An increased risk
11 profile increases both the required return of the equity investor and the cost
12 of debt. Likewise, it is important that the Company have a financially
13 healthy balance sheet in order to attract incremental capital at reasonable
14 terms and costs for future investment. The Commission should consider
15 both, the appropriate costs for the components of the capital structure and
16 the appropriate weight or percent of the components of the capital structure.

17

18 **Q. What are some of the factors considered in determining the**
19 **appropriate capital structure?**

20 A. Some of the factors considered in determining the appropriate capital
21 structure are:

- 22 • The basic risk inherent in the company's line of business—greater
23 business risk requires a more conservative (i.e. a higher percentage
24 of equity) capital structure,

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- 1 • The level of capital required, both now and in the future, to implement
- 2 the company's business plan, and
- 3 • The certainty of the company's business, capital expenditures and
- 4 cash flow forecasts—lower certainty suggests the need for more
- 5 flexibility (i.e. a higher percentage of equity) in the capital structure.
- 6 For example, as I discuss later in my testimony, Electric Choice
- 7 creates the potential for significant volatility in Detroit Edison's cash
- 8 flows and thus demands a stronger capital structure.

9

10 **Q. How does a company's capital structure impact its ability to attract**
11 **capital?**

12 A. Having a weak or highly leveraged capital structure may lead to higher
13 required returns on equity and cost of debt. It also can impact the
14 company's ability to obtain capital. For example, a company with a highly
15 leveraged capital structure may lose its investment grade rating from the
16 rating agencies. Non-investment grade companies have a limited investor
17 base who are less predictable on pricing and availability. The current trend
18 for rating agencies and creditors is requiring stronger capital structures to
19 achieve investment grade ratings. Furthermore, rating agencies are
20 allowing little or no time for a company to correct and improve its capital
21 structure before lowering its credit rating. Accordingly, companies must
22 proactively anticipate the credit markets and rating agencies by correcting
23 and improving their capital structure.

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1 **Q. Why is access to capital important?**

2 A. If a company, such as Detroit Edison, is unable to raise adequate capital,
3 the company operates in an inefficient manner. For example, expenditures
4 for reliability and maintenance may be delayed due to a lack of financial
5 resources even if the impact is increased operating costs. Also, a company
6 may forego capital projects with long term benefits to customers. Access to
7 capital is essential for the long term stability of Detroit Edison.

8

9 **Q. How does a company's capital structure impact borrowing cost?**

10 A. A stronger balance sheet supports an investment grade rating on long term
11 debt. The investment grade rating provides greater access to credit
12 markets and a lower cost of debt. Thus, companies with stronger capital
13 structures generally have lower borrowing costs than companies with
14 weaker capital structures.

15

16 **Q. Does a company's capital structure have any direct commercial or**
17 **business implications?**

18 A. Yes. Detroit Edison buys and sells significant amounts of power in the
19 electricity markets. Companies with an adequate capital structure and a
20 strong credit rating have the option to purchase and sell required power in
21 the most cost effective way. Companies with inadequate capital structures
22 may be required to post cash or other collateral, adding to customer costs.

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1 **Q. How does capital structure affect the financial risk of the company?**

2 A. In the case of corporate dissolutions, shareholder investments are
3 subordinate to those of bondholders. Thus, the greater the debt level the
4 greater the risk to the shareholder. Accordingly, shareholders must be
5 compensated for taking this higher risk. Some equity investors may find
6 that risk, over a certain level of debt, to be intolerable, even if they are
7 offered a significant return. Company witness Dr. Morin has testified in
8 support of an 11.25% return on common equity based upon a 50/50 capital
9 structure and an Electric Choice Tracking mechanism. If the Commission
10 finds that Detroit Edison's capital structure should be something other than
11 what is recommended or declines to implement the Electric Choice Tracking
12 mechanism, then the return on common equity authorized should be greater
13 than 11.25% to compensate the equity investor for the additional risk.

14

15 **Q. Will higher debt levels in a capital structure affect the cost of debt?**

16 A. Yes. The cost of debt rises as more debt is added to the capital structure.
17 The overall cost of capital to a company increases as debt ratios increase.

18

19 **Q. What is business risk?**

20 A. Business risk involves the uncertainties facing a particular corporation and
21 the likelihood of insolvency. Also, business risk includes the volatility and
22 uncertainty of expected future cash flows. For Detroit Edison, that
23 uncertainty includes the risk of funding and recovering the cost associated
24 with regulatory spending including, but not limited to, environmental and

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1 capacity needs expenditures. Other challenges include such issues and
2 risks as, competition related to Electric Choice, the service territory in which
3 the company operates, and the increase in commodity prices. An increase
4 in commodity prices impacts the cost of fuel the Company must purchase to
5 supply electricity to its customers and the cost of materials the Company
6 must purchase in order to provide safe and reliable service to its customers.

7

8 **Q. How do companies mitigate business risk?**

9 A. A company with higher business risk must reduce its financial risk. That is,
10 the company must improve its capital structure by reducing debt and
11 increasing equity. The greater the volatility and uncertainty of cash flows,
12 the greater the pressure on the company to improve its overall capital
13 structure, even to the detriment of its expenditure programs, which could
14 impact, among other things, customer satisfaction through lower reliability.

15

16 **Q. How does the current financial and business environment affect**
17 **business and financial risk?**

18 A. Companies do not operate in a vacuum. External events affect their
19 perceived risk. When business risk increases, the capital structure must be
20 adjusted and strengthened to offset this risk. This is done by reducing
21 leverage and increasing equity relative to overall capital. In general, the
22 utility industry as a whole is at greater risk than in the past due to increased
23 competition, customer choice initiatives, environmental issues, higher
24 commodity prices and increasing operating costs.

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Consistent with my belief and experience concerning the relative riskiness

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of the utility industry, Standard & Poor's ("S&P") concludes: :

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"During the year, Standard & Poor's Ratings Services recorded 46 downgrades of holding companies and operating subsidiaries"

5

6

It further states:

7

"Downgrades in 2005 were attributable to overall deterioration in bondholder protection measures, unsupportive rate decisions, heightened adversarial regulatory and political developments, burdensome construction programs, unrecovered investments, a focus on shareholder value, and more aggressive growth strategies. Upgrades were traced to reduced exposure to riskier unregulated activities, healthier balance sheets, increasing free cash flow, enhanced liquidity, expectations of sustained profitability, supportive rate decisions, stronger business profiles, and credit supportive actions by management." (S&P "Pace of U.S. Utility Actions Picked up in 2005; Downgrades Dominate" dated February 1, 2006)

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Similarly, FitchRatings' ("Fitch") opines:

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"For gas and electric utilities, high energy prices, combined with rising capital spending and higher nonfuel operating expenses, will make individual utilities dependent on multiple rate increase and/or energy-adjustment tariffs to recover their higher costs, thus creating more political and regulatory risk. Also, consumers are likely to reduce their consumption in response to materially higher gas and electricity prices, which could trigger a cycle where utilities have to request additional tariff increases in order to recover their fixed costs. Utilities that fail to recover their full costs from consumers will experience lower cash flows and profits, increased debt leverage and weaker credit metrics." (Fitch "U.S. Power and Gas 2006 Outlook" dated December 15, 2005)

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Q. How would you characterize the current business environment in which Detroit Edison operates?

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A. I characterize the business environment of Detroit Edison as riskier compared to the environment encountered in past years and riskier in

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1 relation to other electric utilities. S&P assesses a firm's business risk profile
2 on a scale of '1 to 10" (where '1' represents excellent and '10' vulnerable).
3 Detroit Edison's business risk profile is 6. In S&P's February 1, 2006 article,
4 68% of U.S. utilities have a business risk profile of 1-5, leaving Detroit
5 Edison in the riskiest one-third of all utilities.

6

7 **Q. In what way is Detroit Edison's business environment riskier?**

8 A. The current business environment continues to challenge Detroit Edison. In
9 my opinion, the regulatory environment is not viewed very positively by the
10 rating agencies. The continued uncertainty around the Electric Choice
11 Program and its impact on the Company continues to be a concern. Mr.
12 Buckler discusses the details, risks and impacts of the Electric Choice
13 program which is a continuing concern expressed by the rating agencies.
14 The Metropolitan Detroit and Southeastern Michigan economy and the
15 impact that the auto industry continues to have on Detroit Edison is another
16 concern. The changing environmental laws, regulations, and potential
17 associated liabilities are added risks. Because of these risks, cash flows
18 are less certain, making it difficult to plan for system improvements and
19 capacity additions. The volatility in commodity prices and rising cost of fuel
20 used to generate electricity also increase Detroit Edison's perceived
21 business risk. Future capital required to either build or purchase new
22 capacity increases risk. This translates into the need for a stronger balance
23 sheet and added common equity for Detroit Edison.

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1 **Q. In your opinion, why is the Michigan regulatory environment not**
2 **viewed positively.**

3 A. S&P has been very public with their views regarding the regulatory
4 environment in Michigan. For example, soon after the Commission's Detroit
5 Edison rate order in Case No. U-13808 in late 2004, S&P downgraded the
6 Company's corporate credit rating from BBB+ to BBB.

7

8 S&P concluded:

9 *"The rating action reflects expectations for credit metrics consistent with*
10 *the 'BBB' corporate credit rating despite the impact of the recent*
11 *Michigan Public Service Commission (MPSC) rate order for Detroit*
12 *Edison. Detroit Edison's competitive position and cash flow have eroded*
13 *throughout 2004 with the introduction of deregulation in Michigan, but*
14 *the recent MPSC decision attempts to rectify the landscape."*

15 The report continues:

16 *"However, in aggregate these actions are not sufficient to significantly*
17 *bolster the utility's business profile and arrest the weak consolidated*
18 *credit metrics before year-end 2006 at the earliest"* (S&P "Research
19 Update: DTE Energy and Units Downgraded; Outlook Stable" dated
20 December 1, 2004)

21

22 Fitch reported:

23 *"Fitch previously viewed the state regulatory environment as particularly*
24 *favorable to the financial health of regulated electric and gas utilities in*
25 *2004 and 2005 reports. While still generally favorable, currently, Fitch*
26 *sees increased event risk related to state regulatory and political*
27 *reactions to rising energy prices. Companies subject to disproportionate*
28 *increase in costs and in greatest need of tariff increases are most at risk.*
29 *Sooner or later, resistance to full recovery of utilities' rising costs could*
30 *result in unfavorable rate decisions, which would erode profit margins*
31 *and weaken utility cash flow."* (Fitch "U.S. Power and Gas 2006
32 Outlook" dated December 15, 2005)
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1 **Q. Has Standard & Poor's raised any concerns regarding this recent**
2 **"show-cause" rate case?**

3 A. Yes. In response to the Commission's order establishing this Case, S&P
4 reported on March 24, 2006:

5 *"In our opinion, a rate decrease could erode the company's financial*
6 *profile to a level not consistent with current ratings. Furthermore, a*
7 *driving factor for DTE's stable outlook is advancing a constructive*
8 *regulatory agenda."* (S&P "Bulletin: DTE Energy Unit's Potential Rate
9 Decrease Does Not Immediately Affect Rating" dated March 24, 2006)

10

11 From my experience in the industry and with the rating agencies, this is a
12 clear message from S&P that Detroit Edison's current credit rating may be
13 in jeopardy. This rate case and consequent order on customer rate
14 structure could immediately affect the Company's credit rating.

15

16 **Q. Does S&P have concerns about Detroit Edison's pricing and rate**
17 **structure?**

18 A. Yes, in the most recent S&P report on Detroit Edison S&P states:

19 *"Detroit Edison has struggled with its rate structure as lucrative*
20 *commercial and industrial customers have opted for alternate providers.*
21 *Such customers significantly subsidize the cost of providing residential*
22 *service. In addition, regulatory proceedings for rate increases at the*
23 *electric and gas units have lagged, exacerbating DTE Energy's financial*
24 *weakness. Detroit Edison's balance sheet has also carried the burden*
25 *of environmental compliance costs and stranded costs, which the*
26 *company will now recover over a protracted period."* (S&P "Bulletin:
27 DTE Energy Unit's Potential Rate Decrease Does Not Immediately
28 Affect Rating" dated March 24, 2006)

29

30 Detroit Edison's customer attrition and the demographics of its slow-growth
31 operating territory pose major challenges which S&P recognizes. S&P

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1 downgraded Detroit Edison on the heels of the last rate case. Despite
2 improvements in the Company's financial position subsequent to U-13808, I
3 believe S&P has sent a very clear message that they are again concerned
4 about the outcome of this case. I am very concerned that S&P may
5 downgrade Detroit Edison again should negative results emerge from the
6 Commission's order in this case.

7

8 **Q. Are you concerned about Detroit Edison's credit ratings from Fitch?**

9 A. Yes, I am concerned that Fitch's perception of Detroit Edison's risk profile is
10 deteriorating. In a recent Fitch recent report, two concerns in particular for
11 Detroit Edison are:

- 12 • *Inability to recover increased utility expenses in future rate*
13 *proceedings, reducing the utilities' operating cash flow, and*
- 14 • *Decline in industrial/commercial customer base.*
15 (Fitch "U.S. Power and Gas 2006 Outlook for Key Credits" dated
16 January 11, 2006)

17

18 Fitch is concerned about Detroit Edison's operating cash flow and the
19 impacts of Electric Choice.

20

21 **Q. What factors does Moody's Investors Service say could cause a rating**
22 **decrease for Detroit Edison?**

23 A. Moody's Investors Service ("Moody's") has similar concerns as those
24 expressed by S&P and Fitch. Moody's lists two things in a recent report that
25 could change Detroit Edison's rating downward. They are:

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- 1 • *Continued increases in operating costs that would not be sufficiently*
- 2 *covered by recent rate increases, thereby weakening its credit*
- 3 *metrics, and*
- 4 • *The continuation of customer migration under Michigan's Customer*
- 5 *Choice program which could lead to lower operating margins.*
- 6 *(Moody's "Credit Opinion: Detroit Edison Company" dated April 25,*
- 7 *2005)*
- 8

9 **Q. What things can Detroit Edison do to increase its credit quality?**

10 A. The main thing Detroit Edison can do to improve its balance sheet is to

11 reduce leverage and improve its credit metrics.

12

13 **Q. How does Detroit Edison plan on increasing its credit quality?**

14 A. Detroit Edison is attempting to improve its balance sheet by obtaining long

15 term debt and common equity ratios of approximately the same amount

16 from a permanent capital structure basis. This current plan provides for the

17 Company to be at an approximate 50% long term debt to capital ratio and a

18 50% common equity to capital ratio near the end of 2007. The first step was

19 an equity infusion to Detroit Edison of \$150 million in the second quarter of

20 2006. The Company then plans on another \$100 million equity infusion in

21 the fourth quarter of 2006 and another \$250 million of equity in 2007. Equity

22 infusions are planned to continue into 2008 and beyond to keep the long

23 term debt and common equity components of the capital structure balanced.

24

25 **Q. Is a 50% level of common equity the optimal level for Detroit Edison?**

26 A. No. A 50% level might sustain Detroit Edison at its current rating and may

27 be necessary to avoid a further downgrade from S&P. Dr. Morin states in

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1 his testimony that the optimal capital structure is one which maintains an "A"
2 credit rating. Because capital structures affect credit ratings, this also
3 implies the optimal capital structure requires more equity than what is
4 currently the case at Detroit Edison.

5

6 **Q. Will the Company always try to keep this balanced capital structure?**

7 A. After this case is decided, as the rating agencies' perceptions become
8 known and understood, and as the Company's business environment is
9 reassessed, the Company might need to increase the level of Common
10 Equity in its capital structure. As mentioned earlier, the optimal capital
11 structure is to achieve an "A" credit rating which takes more common equity
12 than what is currently recommended.

13

14 **III. DEVELOPMENT OF COST RATES**

15 **Q. What is the purpose of Exhibit DE-4, Schedule D2?**

16 A. Exhibit DE-4, Schedule D2 calculates Detroit Edison's long term debt cost
17 as of December 31, 2005. The cost was calculated on a net proceeds basis
18 which accounts for issuance discounts, premiums and financing expenses
19 for each bond. The cost rate does not include the unamortized loss on
20 reacquired debt. As shown, the average long term debt cost at December
21 2005 is 5.79%.

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23 **Q. What does Exhibit DE-4, Schedule D3 show?**

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1 A. Exhibit DE-4, Schedule D3 shows that Detroit Edison does not have
2 preferred or preference stock outstanding.

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4 **Q. What does Exhibit DE-4, Schedule D4 show?**

5 A. Exhibit DE-4, Schedule D4 shows Detroit Edison's present authorized cost
6 of common shareholders equity of 11.00%.

7

8 **Q. What does Exhibit DE-4, Schedule D5 show?**

9 A. Exhibit DE-4, Schedule D5 reports the cost of short term debt at December
10 2005 as 4.70%.

11

12 **Q. What is the purpose of Exhibit DE-12, Schedule D2?**

13 A. The purpose of Exhibit DE-12, Schedule D2 is to calculate Detroit Edison's
14 weighted average long term debt costs for the years 2006 through 2011.
15 Starting with the actual 12/31/05 long term debt outstanding, any known and
16 measurable changes for each year were made to arrive at the year end
17 balance. Known and measurable changes include any issuances,
18 retirements or refinancings and are as follows:

(\$000)	2006	2007	2008	2009	2010	2011
Retirements	21,113	24,316	25,213	26,181	527,225	20,505
Issuances	250,000	170,000	250,000	160,000	150,000	100,000
Refinancings	-	-	32,375	-	500,000	25,910

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20 The rates for new debt issuances were based on forward long term
21 borrowing rates of BBB utilities. These forward rates were obtained from

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Bloomberg, a leading provider of financial data, news and analytics, as of April 24, 2006. Including these planned long term debt issuances, retirements, and refinancings, the weighted average long term debt cost is as follows:

2006	2007	2008	2009	2010	2011
5.87%	5.91%	5.96%	5.99%	6.13%	6.16%

Q. Does Detroit Edison have or expect to issue Preferred and/or Preference Stock?

A. No, not at this time nor are there any planned for the future. This is stated on Exhibit DE-12, Schedule D3.

Q. How did you determine the cost of short term debt on Exhibit DE-12, Schedule D5?

A. The cost of short term debt for 2006 through 2011 is based on forward short term borrowing rates obtained from Bloomberg, as of April 24, 2006. These costs are for a BBB rated utility. The short term debt cost rates are as follows:

2006	2007	2008	2009	2010	2011
5.20%	5.40%	5.50%	5.70%	5.90%	5.95%

V. SUMMARY AND CONCLUSIONS

Q. Can you summarize your recommendation and conclusions?

A. Detroit Edison's weighted cost of capital should be based on a capital structure consisting of a minimum of 50% common equity as a percentage

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1 of total permanent capital. Detroit Edison is at risk of a credit downgrade
2 and the Company continues to have significant business challenges. S&P
3 is closely watching the outcome of this case. The Company believes that it
4 must take action to strengthen its credit quality and did so by increasing its
5 common equity by \$150 million in May 2006. Plans call for the Company to
6 increase its common equity by another \$100 million in the fourth quarter of
7 2006 and another \$250 million in 2007. Additional common equity may be
8 infused in 2008 and beyond to attain a balanced permanent capital
9 structure.

10

11 Detroit Edison should continue to strengthen its capital structure to a
12 minimum of 50% equity. Such action will be advantageous to both the
13 Company and its customers and is a reasonable and prudent course.

14

15 **Q. Does this complete your testimony?**

16 A. Yes, it does.

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