**BEFORE THE**

**PUBLIC UTILITIES COMMISSION OF OHIO**

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| In the Matter of the Application of The Dayton Power & Light Company for Approval of Its Electric Security Plan | )  )  ) | Case No. 16-0395-EL-SSO |
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| In the Matter of the Application of The Dayton Power & Light Company for Approval of Revised Tariffs. | )  )  ) | Case No. 16-0396-EL-ATA |
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| In the Matter of the Application of The Dayton Power & Light Company for Approval of Certain Accounting Authority Pursuant to Ohio Rev. Code § 4905.13. | )  )  ) | Case No. 16-0397-EL-AAM |

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| **DIRECT TESTIMONY OF J. EDWARD HESS**  **ON BEHALF OF**  **INTERSTATE GAS SUPPLY, INC.**  **PUBLIC VERSION** |

February 12, 2019

**I. INTRODUCTION**

**Q. Please state your name and title.**

A. My name is J. Edward Hess. I am a self-employed consultant.

**Q. On whose behalf are you testifying?**

A. I am testifying on behalf of Interstate Gas Supply, Inc.

**Q. Please describe your educational background and work history.**

A. I have a Bachelor of Business Administration degree from Ohio University and completed most of Capital University’s Master of Business Administration program. I am a certified public accountant (presently inactive). I was employed by the Public Utilities Commission of Ohio (Commission) in 1975 as a field auditor. I resigned from the Commission in 1977 and joined the public accounting firm of John Gerlach and Company. I rejoined the Commission in July 1980. In March 2009, I retired from the Commission after over 30 years of employment. My last position with the Commission was as the Chief of the Accounting and Electricity Division of the Utilities Department. In that capacity, I was responsible for ensuring statutory compliance with state and federal statutes, rules and procedures governing utility regulation with most of that responsibility focused on the electric sector. I was also responsible for analyzing and testifying to a whole variety of financial data regarding all utilities regulated by the Commission. From October 2009 through May 2015, I was employed by McNees Wallace & Nurick as a technical specialist where I provided practical insight and analytical expertise on regulatory and legislative issues to the business community. I also provided expert testimony on behalf of the firm’s clients in regulatory hearings before the Commission. I have attended and completed numerous continuing education courses relevant to the regulation of public utilities and my accounting profession. I have also participated in regulatory conferences and training seminars and have served as a workshop presenter at the annual energy conference sponsored by the Manufacturers’ Education Council.

**Q. Were you involved with Ohio’s electric restructuring as a member of the PUCO Staff?**

A. Yes. In 1999, I began working with Chairman Glazer on the restructuring of the electric industry. The first Johnson-Mead bill had been proposed, the utilities countered with their own version and everyone involved was working on the second version of Johnson-Mead that eventually became known as Senate Bill 3. The bill passed in July 1999. Before the bill was passed Alan Schreiber became the chairman of the PUCO and I continued my work on the legislation with Chairman Schreiber.

After the legislation passed, I was given the responsibility of managing the Staff’s efforts to implement the bill. That included processing electric transition plans (called “ETP”) and developing rules that were required by the legislation. At the time of the legislation there were 8 electric distribution companies that were required to file transition plans per the legislation. The issues that were addressed in the ETP filings and the rules that were required are too numerous to list here. We completed the required tasks on time and we were ready for the transition on January 1, 2001.

Sometime in late 2002 and early 2003 – shortly after the California Energy Crisis and Enron’s collapse -- there was a general belief that the Ohio industry was not ready for a flash cut to market-based rates on January 1, 2006. We began discussing a longer transition period with all interested parties. I was again given the responsibility of coordinating the Staff efforts. We successfully implemented rate stabilization plans for an additional three or four years with all the utility distribution companies except Monongahela Power Ohio. Monongahela Power was eventually purchased by Columbus Southern after several negotiations and litigations. Eventually, additional legislation, SB 221, was enacted. Among other things, the legislation provided the Commission with additional flexibility to deal with actual circumstances that were different than anticipated when SB 3 was enacted.

As a Staff member, I did help with processing the first round of electric security plans for AEP and First Energy that were put into effect in 2009.

**Q. What was your involvement with Ohio’s electric restructuring as a member of the McNees Wallace and Nurick?**

A. I testified before the Commission in several SSO cases that were filed in the second round of cases. I also submitted testimony in Ohio Power Company’s and Columbus Southern Power Company’s Distribution Rate Case and Fuel cases.

**Q. Do you have any practical insights into DP&L and DPL’s past that may place DP&L’ s current request into the correct context?**

A. I have been involved in regulatory matters with DP&L for over 30 years. Some of the major regulatory matters that I have been involved in with DP&L include overseeing DP&L’s electric transition plan application to transition to a restructured EDU, DP&L’s rate stabilization plan to extend the market development period and create a rate stabilization plan, and later the extension of the rate stabilization plan as a member of the Commission’s Staff. As a member of McNees Wallace and Nurick, I testified in DP&L’s second electric security plan case to ensure that DPL’s unregulated activities did not result in negative financial consequences for the customers of DP&L which the Supreme Court of Ohio determined that DP&L’s recovery of a financial integrity charge to prop up the earnings of its generation business segment was an unlawful transition charge**.** I have also been involved in all of the DP&L base rate cases since the mid-1980s.

**II. BACKGROUND**

**Q. Was a Stipulation filed in this case?**

A. Yes. There was an initial Stipulation filed on January 30, 2017. However, on March 14, 2017 DP&L filed an Amended Stipulation and Recommendation. Throughout my testimony, I refer to the Amended Stipulation as the Stipulation. Among other things, the Stipulation proposes that the Commission approve Distribution Modernization Rider (“DMR”) and the Reconciliation Rider (RR).

**Q. Did the Commission accept the Stipulation and Recommendation?**

A. The Commission modified the Stipulation by rejecting the provision that made the RR a by-passable rider. That was a material change to the settlement.

**Q. What is the RR?**

A. The RR is a stranded cost recovery mechanism that relates to DP&L’s only remaining interest in generation assets, specifically the Ohio Valley Electric Corporation (OVEC). DP&L has a power purchase agreement with OVEC that is cost-based. DP&L would purchase power from OVEC and resell it into the wholesale market. It will flow through the difference between the cost-base rate paid to OVEC and the market-based sales through the non-bypassable RR, which is collected from all distribution customers. Because the RR would permit DP&L to collect revenue from all customers to make up for DP&L’s losses in the wholesale generation market, the RR is a stranded cost recovery mechanism.

**Q. What is the DMR?**

A.The DMR is described as a rider that will enhance both DPL’s and DP&L's financial integrity and provide for a more robust distribution service for customers. It is a non-bypassable charge applicable to all distribution customers**.**

**Q. Are you familiar with the Commission’s criteria for reviewing Stipulations?**

A. Yes, the Commission utilizes a three-prong test. Specifically, the Commission evaluates whether a Stipulation is (1) the product of serious bargaining; (2) in the public interest; and (3) whether the Stipulation will violate any regulatory practice or principle. As I discuss throughout my testimony, the Stipulation is not in the public interest and it violates several regulatory practices and principles.

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

A. The purpose of my testimony is to address the improper DMR, as well as the potential misuse of funds from such rider and recommend accounting for the funds received from the DMR, to the extent that the DMR is approved for any purpose. I testify that the DMR payments that are used to pay DPL for interest obligations, existing debt, and discretionary debt payments is a cross subsidy to a non-regulated entity, which is inconsistent with the State’s policy to avoid anticompetitive subsidies flowing from a noncompetitive retail electric service to a competitive retail electric service or to a product or service other than retail electric service. I also believe that the Commission lacks the authority to require customers to pay the DPL portion of the DMR since the Commission has no regulatory authority or responsibility for DPL and the payment is in direct conflict with DP&L’s and the Commission’s repeated assurance to the DP&L customers that they are protected from any detrimental impact of DP&L’s parent company and affiliated non-utility activities.

I testify that the DMR is simply unnecessary to support the financial stability of DP&L given that DP&L has divested its generating assets and the current rates give DP&L an opportunity to earn a reasonable rate of return on its distribution investments. I also testify that the DMR should be included in the SEET test, to the extent it is approved at all. However, if the Commission believes that it must require customers to provide DP&L with funds through the DMR, I am recommending that the Commission require DP&L to account for any customer provided DMR as customer contributed capital. This accounting would assure the ratepayers that they won’t be paying for these investments/expenditures twice.

**Q. Will you describe DPL and DP&L?**

A. DPL Inc. (DPL) is a regional energy provider that was acquired by the AES Corporation (AES) on November 28, 2011 and is a wholly-owned subsidiary of AES. DPL’s significant subsidiaries include The Dayton Power and Light Company (DP&L), AES Ohio Generation, LLC (AES Ohio Gen), Miami Valley Insurance Company (MVIC), and Miami Valley Lighting, LLC (MVLt). DPL is not regulated by the Commission. DPL is not a public utility subject to the Commission’s jurisdiction. DPL has no right to receive payments directly from retail customers. DPL has no rights to file an application to the Commission for any payments from retail customers. Consequently, its subsidiary has filed the present application for its benefit.

DP&L is a regulated electric distribution utility (“EDU”). It has one shareholder, DPL. In 2017, DP&L transferred its generation assets to an unregulated affiliate, AES Ohio Gen. At the present time, it is simply a “wires” company that owns no generation assets except for its interest in the OVEC.

**Q. Can you give some background of the events that led to DP&L’s request for DMR funds?**

A. Yes, until November 28, 2011, DP&L operated as a wholly owned subsidiary of DPL Inc (“DPL”). DP&L was a vertically integrated electric distribution utility (EDU) that owned generation, transmission and distribution assets but operated its generation, transmission and distribution businesses in separate units. DPL also owned DP&L Energy Resources (DPLER) which sold competitive retail electric service, and DPLE which engaged in the operation of peaking generation facilities and sold power in the whole sale markets. The total combined long-term debt of DPL at the end of 2010 (which includes DP&L’s debt) was $1,026.6 million. DP&L’s long-term debt at the time was $884.0 million. DPL long-term debt, exclusive of DP&L was approximately $142.6 million at the end of 2010.[[1]](#footnote-1) On November 28, 2011, AES purchased DPL’s assets for approximately $3.5 billion. After the merger, DPL’s long-term debt increased to $2,628.9 million by the end of 2011. DP&L’s long-term debt at the end of 2011 was reported at $934.0 million.[[2]](#footnote-2) DPL’s long-term debt exclusive of DP&L was $1,694.9, or an increase of $1,552.3 million from the end of 2010. DPL’s long-term debt was significantly impacted by the acquisition by AES.

**Q. Were there other significant financial impacts to the financial position of DPL that were a direct result of the acquisition?**

A. Yes. AES paid cash of approximately $3,483.6 million dollars for net identifiable assets worth approximately $994.3 million dollars. As a result of the purchase price, DPL was required to book a significant amount of Goodwill[[3]](#footnote-3) of approximately $2,489.3 million[[4]](#footnote-4). During 2012, DPL recognized an impairment to the value of the goodwill and realized a loss of $1,817.2 million significantly impacting 2012 net income and December 31, 2012 retained earnings. The remaining balance of goodwill has been written off as of December 31, 2017.

**Q. What were the Credit Ratings of DPL and DP&L senior unsecured debt before and after the acquisition?**

A. The following table outlines the debt credit ratings and outlook of each company, along with the effective dates of each rating and outlook for DPL and DP&L.[[5]](#footnote-5) Three rating agencies downgraded senior unsecured debt of both DPL and DP&L shortly after the acquisition.



While the merger impacted the credit rating of DPL and DP&L, it clearly had a greater impact on the credit rating of DPL.

**Q. What was the financial impact of the AEP acquisition of DPL on DPL’s financial statements?**

A. The acquisition had a significant financial negative impact on DPL. A significant amount of debt was added to DPL’s balance sheet (approximately $1,552.3 million), a material amount of assets (approximately $2,489.3 million) has been lost, and all the credit ratings were downgraded immediately after the acquisition. The increased debt has become increasingly difficult to service and the lost assets drove negative retained earnings. DPL’s current negative financial position was clearly driven by the acquisition by AES.

**III. THE DMR**

**Q. Will you describe the DMR?**

A. The DMR is described as a rider that will enhance DP&L's financial integrity and provide for a more robust distribution service for customers.[[6]](#footnote-6) The DMR is a non-by passable charge for years 1 through 3 of the term of the ESP. The DMR is proposed to collect $105 million per year. DP&L has the option of extending the duration of the DMR rider for an additional two years. Cash flow from the DMR will be used to (a) pay interest obligations on existing debt at DPL Inc. and DP&L; (b) make discretionary debt prepayments at DPL Inc. and DP&L; and (c) position DP&L to make capital expenditures to modernize and/or maintain DP&L's transmission and distribution infrastructure. DMR funds are to be excluded from Significantly Excessive Earnings Test ("SEET") calculations.

**Q**. **The Stipulation describes the DMR as revenue.[[7]](#footnote-7) Is the DMR revenue?**

A. No. The DMR is customer provided funding to allegedly improve the financial stability of DPL and DP&L and/or to provide funding to assist DP&L to make future capital expenditures to modernize and or maintain its transmission and distribution grid. None of these DMR receipts are revenue, it is customer provided funding. Since it is customer provided funding, to the extent the DMR is approved, the DMR receipts should be accounted for as a liability. I will expand on this later in my testimony.

**IV. DMR USED FOR DPL DEBT PAYMENTS**

**Q. Should the Commission require the DP&L customers** **to provide funds to permit DPL to** **pay for interest obligations, existing debt, and discretionary debt payments.**

A. No. Payments to provide assistance to the unregulated affiliated parent are an anticompetitive subsidy from the regulated affiliate to an unregulated affiliate that provides a competitive electric service and products and service other than retail electric service. Additionally, the Commission does not have oversite authority for the financial well being of DPL as it has explained in many past cases. There is simply no nexus between DPL and a retail electric service provided by DP&L to justify the imposition of a DMR.

**Q. Will you explain why these payments to an affiliated parent are anti-competitive.**

A. With the enactment of Amended Substitute Senate Bill 3 ("SB 3") in 1999, the structure of the vertically integrated industry changed significantly in part to break the link between ownership and control of assets within such an industry structure. With regard to competitive retail electric service such as generation supply and effective January 1, 2001, the EDU was confined to the role of a default supplier to customers not receiving competitive service from a competitive retail electric service ("CRES") provider. This default supplier status currently allows the EDU to obtain market-based or tested compensation for default supply standard service offer SSO through an electric security plan (ESP) or the market rate offer ("MRO") options.

In addition to the default supply role of an EDU, SB 3 imposed numerous requirements on an EDU to make sure that retail customers as well as CRES providers are not subjected to an EDU's discretion in ways that would allow the EDU to favor its owned or controlled assets or affiliated lines of business. These requirements cannot be ignored. When taken into consideration, these requirements act as barriers to the type of proposals that DP&L is advancing in this proceeding. In 2008, Amended Substitute Senate Bill 221 ("SB 221") altered the means by which an EDU could be compensated for its default generation supply service, but SB 221 did not change the core elements of the electric restructuring architecture contained in SB 3 and specifically the requirements that an EDU cannot operate to favor its non- regulated affiliates or use its non-competitive lines of business to provide anticompetitive subsidies to its competitive lines of business.

**Q. Has Ohio adopted laws and regulations governing the relationship between a regulated EDU and its affiliates providing competitive services?**

A. Section 4928.17, Ohio Revised Code, requires a corporate separation plan and defines many of the requirements of that plan. The PUCO adopted rules for these plans originally as a part of the standard filing requirements for electric transition plans [Rule 4901:1-20-16, Ohio Administrative Code ("O.A.C")] and later adopted a more permanent set of rules (Rule 4901: 1-37, O.A.C.).

**Q. Does DPL provide competitive services?**

A. Yes. DPL is a wholly owned subsidiary of The AES Corporation. AES Corporation is a Fortune 500 global power company that provides energy in 15 countries. DPL is an energy holding company whose principal subsidiaries include AES Ohio Gen that co-owns merchant generation facilities. AES Ohio Generation, solely or through jointly-owned facilities, owns coal-fired and peaking generation units representing 2,125 MW located in Ohio and Indiana. AES Ohio Generation sells all of its energy and capacity into the wholesale market.[[8]](#footnote-8)

**Q. Does DMR provide either AES, DPL, or** **AES Ohio Generation a competitive advantage over other generation providers?**

A. Yes. This cross subsidy which is flowing from a noncompetitive retail electric service to a competitive retail electric service or to a product or service other than retail electric service frees up funds that would be necessary to pay the DPL debts that are funded by the DMR payments and allows the affiliated generation suppliers to either enhance their current generation fleet or invest in new forms of generation.

**Q. In addition to the generation owned by AES Ohio Generation, are you aware of any recent acquisitions by either AES, DPL, or AES Ohio Generation that could be directly in competition with other Ohio businesses that participate in the competitive generation markets?**

A. Yes. Shortly after the execution of the January 30, 2017 Stipulation in this case, which included the DMR, on February 24, 2017, AES spent over $400 million to acquire approximately 50% interest in one of the largest solar and wind developers in the United States, FTP Power LLC (“sPower”). In conjunction with Alberta Investment Management Corporation (“AIMCo”), AES announced the acquisition of sPower for $853 million in cash, subject to adjustment, plus the assumption of $724 million in sPower’s non-recourse debt.”[[9]](#footnote-9) The acquisition was “funded with $90 million of subordinated debt to sPower, and the remaining amount of $763 million will be funded with equity from AES and AIMCo in equal proportion.”[[10]](#footnote-10) Thus, unlike the heavily leveraged acquisition of DPL, the acquisition of sPower was funded by primarily cash/equity (89.4% equity and 10.6% debt). sPower portfolio includes 1,274 MW of solar and wind projects in operation or under construction and a development pipeline of more than 10,000 MW located in the United States. On November 6, 2018, eighteen months after acquiring an interest in sPower, AES made an 8K filing with the SEC announcing that “[w]e also agreed to sell 24% of sPower's operating fleet and we will invest the proceeds in sPower's 10 GW development pipeline, yielding higher returns.”[[11]](#footnote-11) With this transaction, AES is now positioned to develop solar and wind projects in Ohio that compete with other Ohio businesses.

**Q. Has sPower invested in any generation projects in the State of Ohio?**

A. sPower recently filed an application before the Ohio Power Siting Board with respect to the Seneca Wind Farm, which is a proposed 212-megawatt project.[[12]](#footnote-12) Seneca Wind LLC is a Delaware limited liability company and a wholly owned subsidiary of sPower Development Company, LLC (sPower).[[13]](#footnote-13)

**Q. You also state that the DMR payments should not be required because the Commission does not have oversite authority for the financial wellbeing of DPL. Will you explain?**

A. Yes. The Commission’s regulatory oversite is limited to public utilities as defined by the Statute. DPL is not a public utility as defined by the statute, it is not regulated by the Commission, and it has no defined distribution service territory.

**Q. Does the Commission have the responsibility or the opportunity to review and approve DPL debt?**

A. No. Again, DPL’s debt is not required to be reviewed by the Commission and I do not believe that the debt that is being paid for was ever approved by the Commission. DP&L indicated as much in response to discovery, stating, “DP&L states that R.C. 4905.40 only applies to ‘public utilities" as that term is defined under R.C. 4905.02; thus, DPL Inc. is not required to acquire Commission approval for long-term debt.”[[14]](#footnote-14)

**Q. Does the Commission have the responsibility to assure that DPL is financially stable?**

A. No. Because the Commission has no regulatory oversight responsibilities for DPL, the Commission cannot assure its financial stability.

**Q. Has the Commission reviewed the relationship of DPL to DP&L in past cases?**

A. Yes. The Commission reviewed the relationship between DPL and DP&L in the below cases and consistently found that the Commission had no oversight responsibilities for DPL and that it would insulate DP&L from the financial risks associated with DPL.

**Case Nos. 99-1687-EL-ETP** – DP&L filed its Corporate Separation Plan. The final version was filed on February 28, 2000 and was eventually supported by DP&L witness Timothy G. Rice. DP&L's proposed corporate separation plan was approved by the Commission as part of the ETP settlement. DP&L assured the Commission that it would abide by the Commission’s corporate separation rules, which include rules governing financial arrangements between affiliates.[[15]](#footnote-15)

**02-2627-EL-COI** – The Commission initiated this proceeding to identify measures available to the Commission to ensure that the regulated operations of Ohio public utilities are not impacted by adverse financial consequences of parent or affiliated companies unregulated operations. The Commission recognized that its jurisdiction was limited in the Ohio Revised Code and did not intend to manage the affairs of holding companies or companies located out of state. The Case was closed in 2009 without a final Commission determination.

**03-1297-EL-AIS** – On July 24, 2003, The Commission denied DP&L’s request to issue up to $279 million of new bonds to refinance DPL notes. The Commission later explained that that denial was intended, among other things, to insulate DP&L from the financial risks associated with its unregulated parent company, DPL.[[16]](#footnote-16)

**04-486-EL-COI** -April 7, 2004, the Commission initiated a Commission Ordered Investigation with an Entry that directed the Staff to investigate DPL’s delay filing its Form 10K with the Securities and Exchange Commission pending completion of a review by the Audit Committee of DPL’s Board of Directors. The Audit Committee was reviewing several areas of concern, including corporate governance, compensation policy, internal controls, and potential tax liabilities addressed in an internal memo from DPL’s controller to the chair of DPL’s Finance and Audit Review Committee. The Commission planned to assess whether any of these matters have or will negatively impact DP&L and, if so, how this might be both rectified and prevented in the future.[[17]](#footnote-17)The Staff reported that DPL’s Board of Directors announced that its Audit Committee had completed its review of the controller’s concerns and that it would immediately begin strengthening disclosures, communications, access to information, internal control and the culture of the corporation in certain areas. The 2003 form 10-K was filed on November 5, 2004. There were numerous resignations from the Board of directors, the resignation of a group vice-president and interim chief financial officer, and the retirement of the president and chief executive officer. In view of those developments, the Commission ordered DP&L to develop and file a comprehensive plan of protection to insulate the regulated utility operations and ratepayers from any untoward impacts of the relationship between DP&L and its parent and/or and nonregulated affiliate companies.

On February 4, 2005, DP&L filed a Protection Plan (Plan). The Plan included descriptions of the Management and Board changes, policy changes, operational changes, Sarbanes-Oxley benefits, financial safeguards that have been installed, and a description of system reliability changes. The Plan was filed to ensure that DP&L and its ratepayers were not harmed by the non-utility activities of its parent and affiliates.

**Case Nos. 08-1094-EL-SSO** - DP&L filed an updated corporate separation plan. The plan was filed as a part of its application and was supported by the testimony of DP&L witness Timothy G. Rice. DP&L agreed, as a part of the stipulation in that case, that its employees and representatives would not have the discretion to act in a manner that was inconsistent with the Commission's corporate separation rules or DP&L's Second Amended Corporate Separation Plan. The stipulation was approved by the Commission.

**11-3002-EL-MER Merger Case -** AES, Dolphin Sub, Inc. (an AES subsidiary) DPL, and DP&L filed an application for the Commission's approval of a merger of Dolphin Sub, Inc with and into DPL Inc. DP&L assured the Commission that DP&L's credit rating would remain at investment grade and that it would seek the Commission's direct authority under Ohio Rev. Code § 4905.42 to pre-approve any future evidence of indebtedness. DP&L also agreed that it would maintain a capital structure that includes an equity ratio of at least 50 percent and that it would not have a negative retained earnings balance. The Commission approved the merger based on three stipulations that were filed.

**Case No. 12-426-EL-SSO** - DP&L proposed to update its corporate separation plan and has requested that the Commission approve the plan (Third Amended Corporate Separation Plan) in an order accepting DP&L's ESP. The changes to the Third Amended Corporate Separation Plan were described as non-substantive and limited to reflect DPL Energy Resources' ("DPLER") acquisition of MC Squared and the acquisition of DPL Inc. by AES Corporation. At the time of this filing, DP&L was still a vertically integrated utility company and requested two riders to protect its total company financial integrity that included the generation function, the transmission function and the distribution function. DP&L stated that the riders were required due to the loss of generation and transmission revenue**.** The Commission approved the Service Stability Rider (SSR) and denied the Switching Tracker (ST). The Ohio Supreme Court eventually overturned the Commission’s authorization of the SSR.

**13-2420-EL-UNC Generation Transfer case -** DP&L filed an amended supplemental application on May 23, 2014 to transfer its generation to an affiliate or to sell the generation assets to a third party. On July 14, 2014, DP&L filed a notice in this case with an attached press release indicating that DP&L had decided to transfer its generation assets to an affiliate by January 1, 2017. The Commission found that the application was reasonable, complied with Ohio Revised Code 4928.17 and Ohio Administrative Code Chapter 4901:1-37, and was in the public interest. The Commission approved the application. On October 1 2017, DP&L transferred its generation assets to an unregulated affiliate, AES Ohio Gen.

In all these cases, DP&L assured the Commission and the Commission assured the ratepayers that they would not be harmed by the non-utility activities of its parent and affiliates.

**Q.** **Are you recommending that the Commission authorize the DMR revenues to pay interest obligations on existing debt at DPL or to make discretionary debt prepayments at DPL?**

A. No. DPL’s financial problems were the direct result of the AES acquisition and I do not believe that the Commission can and/or should require the customers of DP&L to resolve that problem. I also believe that this portion of the payment is a cross subsidy which is flowing from a noncompetitive retail electric service to a competitive retail electric service or to a product or service other than retail electric service which is inconsistent with the policies of the State on Ohio and harmful to generation competition in the State.

**Q. Has DP&L provided an estimate of the financial impact of DPL’s financial problems on DP&L?**

A. No. However, DP&L did provide a workpaper[[18]](#footnote-18) showing the expected “spread” in borrowing costs based upon different credit ratings.  The difference (between A and BBB+) is only 1.350% (for a 20-year note).  Multiplied by $580 million, that spread is only worth $7.83 million in additional borrowing costs per year.  That is considerably lower than an annual $105 million over three years that the current DMR provides.

**V. DMR PAYMENTS TO DP&L**

**Q. Is DP&L’s distribution unit’s financial integrity in jeopardy?**

A. No. After transferring its generating assets, it looks like DP&L is doing just fine.

DP&L recently recommended a stipulation to the Commission in its distribution rate case. By its own admission, the stipulation will enable DP&L to continue to provide safe and reliable service by promoting its financial condition by implementing just and reasonable rates, which will support DP&L's ability to meet and maintain operational needs; facilitate incremental distribution system investments; improve reliability by authorizing a deferral for future recovery of certain annual expenses for vegetation management; begin to implement the lowered federal income tax rate of the Tax Cuts and Jobs Act (TCJA) and establish a framework for returning benefits resulting from the TCJA to customers.[[19]](#footnote-19) The Commission accepted the recommendation and authorized DP&L the opportunity to earn approximately $46.784 million of operating income which represents a 7.27% return on distribution rate base. This operating income was established based upon a hypothetical capital structure, which incorporated a debt to equity ratio of 52/48, even though DP&L’s equity structure was and remains below that level. The 2017 debt/equity ratio is approximately 66/34.[[20]](#footnote-20) Given that equity has a higher authorized rate of return, the rate of return authorized in the distribution rate case is inflated.

**Can DP&L meet its interest obligations based upon its existing distribution and transmission revenues?**

DP&L’s annual debt interest obligations for 2017 were approximately $30 million[[21]](#footnote-21) which are more than paid for by its distribution earnings. That is without considering the additional earnings that DP&L will recover through its distribution riders including the potential for $7 million per year after tax in energy efficiency program shared savings,[[22]](#footnote-22) and its federally authorized transmission rates.

**Q.** **Did DP&L provide any financial information in this case to indicate that DP&L is not under any financial stress?**

A. Yes. Based on DP&L’s estimates of operating income, depreciation expense and interest, DP&L should be able to fund its projected capital expenditures[[23]](#footnote-23). The projected earnings plus the projected recovery of depreciation expense will provide enough funds to pay its interest expense and fund its capital expenditures. I have provided that calculation on my Exhibit JEH 11 which is attached to this testimony and it is summarized below.



Thus, the DMR is not needed to ensure that DP&L can service its debt or fund projected capital expenditures.

**Q. Is there rate relief available for DP&L if their financial situation becomes a problem and they are not able to either satisfy their debt requirements or fund their required capital expenditures?**

A. Yes. An EDU can file a base rate case or a rider case with the Commission seeking relief from cost increases at any time. If the regulatory lag or statutory restrictions (unable to file until a final order has been issued by the commission on any pending prior application or until two hundred seventy-five days after filing such application, whichever is sooner) aren’t timely enough to satisfy the financial problems of the EDU, it can file for emergency rate relief and the Commission may temporarily alter, amend, or, with the consent of the public utility concerned, suspend any existing rates, schedules, or order relating to or affecting any public utility or part of any public utility in this state. The emergency rates take effect at such time and remain in force for such length of time as the commission prescribes. The EDU can also file a request to defer costs (Application to change an accounting method, or AAM) for recovery of those costs during a later period.

**VI. ACCOUNTING**

**Q. If the Commission continues to authorize the DMR to enhance both DPL’s and DP&L's financial integrity and provide for a more robust distribution service for customers, should the Commission require specific accounting for these funds?**

A. Yes. If the Commission continues to believe that the customers should contribute to the financial stability of DPL and DP&L, the Commission should recognize the customers contribution by requiring the funds provided to be accounted for as customer contributed capital. As I mentioned earlier, the Stipulation describes the DMR receipts as revenues. The Commission should not allow DP&L to account for these receipts as revenue when it is received from the customers. Revenues are generally defined as inflows of assets and/or settlements of liabilities from delivering or producing goods, providing services, or other earning activities that constitute a company’s ongoing major or central operations during a period. The DMR does not qualify as revenues. DMR is a funding mechanism and DP&L should account for the ratepayer receipts as a ratepayer contributed capital on the balance sheet, not as revenue. These receipts should be accounted for as a refinancing mechanism which is customer provided, not revenues for services.

**Q. Is accounting for the DMR as revenue consistent with principles of public utility ratemaking?**

A. No, it is completely at odds with the regulatory compact and the regulatory formula. Utility ratemaking is premised on the concept that investors and lenders will be compensated for capital used to invest in utility asses. Equity, debt and customer provided funds are sources of capital. When capital is utilized to fund a utility asset or fund operating and maintenance expenses, the source of the capital (principal) is compensated for by depreciating the asset providing service or including the operation and maintenance expenses in the EDU’s revenue requirements. The interest on the funds is compensated for in the rate of return allowance which is also included in the EDU’s revenue requirements.

**Q. Will you give an example?**

A. Assume an EDU borrows $100 million to replace poles and wires, with 50% funded by equity and 50% funded by debt. The EDU uses these funds to purchase a $100 million of poles and wires. The poles and wires are depreciated over their useful life and the undepreciated balance of the poles and wires is included in the EDU’s rate base. The annual depreciation expense (return of investment) and the annual rate of return on the undepreciated asset (return on investment) are includable items in the EDU’s revenue requirements and are recovered through rates. This formula allows the investors and debtors to fully recover the $100 million of invested/loaned funds that were used to purchase the assets. These two elements taken together provide compensation to lenders and equity investors of the EDU.

**Q. What happens if it is accounted for as revenue?**

A. If it is accounted for as revenue it will be included in income and closed to retained earnings at the end of the year. Retained earnings is considered an equity contribution. Since the Commission has not put any restrictions on how DP&L can use its retained earnings, there is no accounting for it as customer provided funds and all of it will eventually flow through to the stockholders. The ratepayers will receive no benefit or service other the presumed overall financial stability of DPL and/or DP&L.

**Q. How will accounting for the DMR as revenues impact DP&L’s earnings?**

A. Income will increase by $82.346 million if it is accounted for as revenue. With the increased income, DP&L will significantly over earn on its investment to provide electric distribution services. Using the authorized income from DP&L’s last base rate case, I have estimated that the rate of return on rate base with DMR revenues would be approximately 20.07%. This is materially higher than the authorized rate of return of 7.27%[[24]](#footnote-24).



The 20.07% return on rate base would require a 36.93% return on common equity.[[25]](#footnote-25)



**Q. AES has agreed to forgo collection of the Tax Sharing Liabilities payable throughout the DMR term, and DPL will not continue to accrue the Tax Sharing Liabilities in its financial statements. The accrued amount will be converted to an additional equity investment. Is the accounting for this similar to the accounting you are recommending for the DMR?**

A. Yes. AES’s contribution to stabilize the financial position of DPL recognizes their equity investment in DPL which will now be based on a 21% tax rate. I believe that a similar accounting should follow for DP&L customers so that their contribution to DPL’s and DP&L’s financial stability is recognized as their portion of the investment in financial stability.

**Q. Is the portion of the DMR payments to DP&L for interest obligations on existing debt, discretionary debt prepayments, or to position DP&L to make capital expenditures to modernize and/or maintain DP&L’s transmission and distribution infrastructure consistent with sound regulatory policy?**

A. No. Not the way it addressed in the Stipulation or approved by the Commission. As I mention above, the Commission has not required DP&L to properly account for the DSM funds as customer contributed capital. DP&L’s existing debt and interest are currently recovered in rates. DP&L’s capital expenditures to modernize and/or maintain its transmission and distribution infrastructure will be included in a future rate case or rider**.** Without specific accounting requirements to account for these funds as customer contributed capital, the customer will be required to pay for these investments twice, which is not consistent with sound regulatory policy.

**Q. Will you explain?**

A. Let me first address the DMR funds collected for obligations on existing debt and discretionary debt prepayments to DP&L. Debt is fully recovered through the regulatory calculation in a base rate case or through a rider recovery mechanism. The principle portion of that debt is recovered when the utility company converts that principle portion to an asset or uses the funds to operate and maintain the utility plant. If the use is to invest in an asset, the asset is depreciated over its useful life and expensed. As I mention above, the depreciation expense is included in the revenue requirement as the return of the funds invested. If the use of the funds is to operate and maintain the plant, the operation and maintenance costs are expensed, and those costs are also included in the revenue requirement calculation. The interest portion of the debt is included in the utility’s rate of return which is also included in DP&L’s revenue requirement as the return on the unrecovered funds invested. Depreciation expense, operation expense, maintenance expense and the rate of return fully compensate DP&L for the borrowed funds in a base rate case or a rider case.

If the Commission doesn’t require proper accounting for this contribution, the DP&L will recover the debt principle and/or its interest expense from ratepayers twice, first through the current rates where they are being fully compensated for debt and interest expense, and the second through the DMR.

**Q. What about DMR funds that will be used to position DP&L to make capital expenditures to modernize and/or maintain DP&L’s transmission and distribution infrastructure?**

A. Whenever customers are required to prepay for plant investment or fund its ability to position itself to invest in plant, the Commission must require the utility to account for those payments as a contributed capital either as customer advances for construction or as contributions in aid of construction. This is standard accounting for funds that are provided by customers to build plant.  If this contributed capital is a customer advance, DP&L should be required to debit the cash account and credit the customer advance account when the DMR funds are received from ratepayers. The contribution by customers should accumulate on the balance sheet and will used as a rate base offset in a future base rate case. The amortization of the customer advance account should be used to offset the depreciation expense of the plant that the customers have already funded.  The required accounting, the offset to rate base and the amortization of the contributed capital is the mechanism that assures the ratepayer that they are not going to be asked to pay for their contributions twice. If the contributed capital is a contribution in aid of construction, the contribution should be used to offset the plant in service balance.

Without this accounting treatment, the utility could account for these funds as revenue and pass the equity directly on to the shareholders and the ratepayer will be required to pay for its own investment twice. Once through the DMR and the second time when the investment is included in the rate base and depreciated.

**VII. THE ESP VS. MRO TEST**

**Q. What is the ESP vs. MRO Test?**

A. Ohio law requires each EDU “to provide consumers, on a comparable and nondiscriminatory basis within its certified territory, a standard service offer of all competitive retail electric services necessary to maintain essential electric service to consumers, including a firm supply of electric generation service.” With the passage of SB 221, EDU’s were given the choice of establishing the SSO through an electric security plan (ESP) or a market rate offer (MRO). The General Assembly required the outcome of an ESP, including its pricing and all other terms and conditions, to be more favorable than the result that would otherwise apply under the market rate authorized under an MRO. The price comparison test does not apply if the EDU files an MRO, it only applies if the EDU files an ESP

**Q. Why would an ESP have to be more favorable than an MRO?**

A. In order to understand the intent of this provision in the statute, historical context is necessary. As I stated above, an ESP and an MRO are the result of SB 221, which was passed in July of 2008. At the time, the EDUs were all providing service under Commission authorized rate stabilization plans which were put into place to ensure stable and reasonably priced default service prices. The AEP EDUs, Duke and DP&L were still vertically integrated and were providing the standard service with their own generation. The three First Energy EDUs were providing the standard service offer through its affiliate, FES. Customer demand was rising steadily, as were wholesale electric prices. Although there was still a preference for the provision of competitive services by the competitive market, the General Assembly provided a means through which EDUs could continue to provide retail electric generation service to customers in their service territory if that service was priced more favorably than the outcome that would otherwise apply in a fully market-based paradigm. At the time of SB 221, the EDUs with generation relied predominantly on coal-fired generation, with embedded cost of service that were competitive against the market. EDUs that owned coal-fired assets in 2008 could provide SSO services at prices that were below the otherwise applicable market price.

**Q. What pricing and terms may be included within an MRO?**

A. An MRO facilitates market-based SSO pricing for retail electric generation through a competitive bidding process. The first application filed by an EDU that owns generating assets as of July 31, 2008 must establish the SSO price based upon a blend of market pricing and legacy retail generation prices: “the first five years of the market rate offer [must] be competitively bid under division (A) of this section as follows: ten per cent of the load in year one, not more than twenty per cent in year two, thirty per cent in year three, forty per cent in year four, and fifty per cent in year five.” The portion of the SSO price for retail electric generation that is not competitively bid shall be “equal to the electric distribution utility's most recent standard service offer price, adjusted upward or downward as the commission determines reasonable, relative to the jurisdictional portion of any known and measurable changes from the level of any one or more of the following costs as reflected in that most recent standard service offer price.” The EDU’s legacy SSO price for retail electric generation may be adjusted to reflect the following factors: (1) prudently incurred fuel used to provide electricity; (2) prudently incurred purchase power costs; (3) its prudently incurred costs of satisfying the supply and demand portfolio requirements of this state; (4) its costs prudently incurred to comply with environmental laws and regulations.

**Q. Does the MRO statute permit any other adjustments to the SSO price?**

A. Yes, the MRO statute provided a safety valve to ensure that an EDU is not required to provide retail electric generation service below or above its costs. Specifically, the law states “Additionally, the commission may adjust the electric distribution utility's most recent standard service offer price by such just and reasonable amount that the commission determines necessary to address any emergency that threatens the utility's financial integrity or to ensure that the resulting revenue available to the utility for providing the standard service offer is not so inadequate as to result, directly or indirectly, in a taking of property without compensation pursuant to Section 19 of Article I, Ohio Constitution.”

**Q. Under the MRO provision, if Commission found an emergency threatened the EDU’s financial integrity or the resulting revenue available to provide the SSO is so inadequate to result in a taking of property without just compensation, what rate would be adjusted?**

A. The MRO provision is limited to establishing an SSO rate so any adjustments the Commission would deem necessary would be to the to the SSO rate, which is a bypassable charge.

**Q. Would the DMR be permitted in an MRO?**

A. No, it would not be permitted for several reasons. First, the adjustments that the MRO statute provides relate to the portion of the SSO supplied by the EDU’s legacy generation. DP&L is not providing any portion of the SSO price using its owned or operated generating assets; therefore, no adjustment is available. Second, even if an adjustment to the SSO price were available, as I describe above, the DMR is not necessary to permit DP&L to address an emergency that threatens DP&L’s financial integrity. DP&L has conceded that its distribution and transmission businesses are doing just fine. While DPL may have some financial challenges, DPL is not an EDU and it has not filed an ESP or an MRO. Third, there can be no claim that resulting SSO revenues are so inadequate to result in a taking of property, given that the cost of providing the SSO revenue is treated as a purchase power expense for which DP&L is fully compensated.

**Q. Given that the DMR would not be available under a MRO, what impact does that have on the ESP vs. MRO test?**

It would require the DMR to be considered a cost in each year of the ESP. As a result, it would cause the ESP to be less favorable than the MRO outcome by $315 million in the first three years, and the ESP less favorable by $525 million if you assume the DMR is held constant in the last two years of the ESP. These amounts are in addition to the negative values that must be attributed to the RR.

**Q.** **To the extent that the purpose of the DMR is to provide financial support for DPL, could it be authorized in a distribution base rate case?**

A. I don’t believe that financial support for an unregulated affiliate would qualify for recovery in any rate recovery mechanism in the State. As I mentioned before, I do not believe that this Commission has the authority/responsibility for the financial health of any unregulated affiliate, and I don’t believe that it can require the customers of individual EDUs to provide financial support to those unregulated affiliates.

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

A. Yes, it does. However, I reserve the right to further supplement my testimony.

**CERTIFICATE OF SERVICE**

I certify that this Direct Testimony of J. Edward Hess on behalf of Interstate Gas Supply, Inc. was served electronically on the following parties on this 12th day of February 2019.

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/s/ Joseph Oliker\_\_\_\_\_\_\_\_\_

Counsel for IGS Energy

1. JEH-1 (SEC form 10K for 2010, page 97). [↑](#footnote-ref-1)
2. JEH-2 (SEC form 10K for 2011, page 95). [↑](#footnote-ref-2)
3. Goodwill excess of cost over fair value of the identifiable net assets acquired. [↑](#footnote-ref-3)
4. JEH-2 (SEC form 10K for 2011, page 89) [↑](#footnote-ref-4)
5. JEH-1, JEH-2 (SEC forms 10K for 2010, page 63 and 2011, page 63). [↑](#footnote-ref-5)
6. Direct Testimony of R. Jeffrey Malinak In Support of The Amended Stipulation and Recommendation, page 7. [↑](#footnote-ref-6)
7. Amended Stipulation and Recommendation, page 4. [↑](#footnote-ref-7)
8. JEH-3 (AES 2017 Annual Report). [↑](#footnote-ref-8)
9. JEH-4 (AES Form 8-K, page 6 (Feb. 24, 2017)). [↑](#footnote-ref-9)
10. *Id.* [↑](#footnote-ref-10)
11. JEH-5 (AES Form 8-K, page 5 (Nov. 6, 2018)). [↑](#footnote-ref-11)
12. JEH-6 (Case No. 18-488-EL-BGN, *In the Matter of the Application of Seneca Wind, LLC for a Certificate of Environmental Compatibility and Public Need for a Wind-Powered Electric Generating Facility in Seneca and Sandusky Counties*, Application at 1 (Jul. 16, 2018)). [↑](#footnote-ref-12)
13. *Id.* at page 5. [↑](#footnote-ref-13)
14. JEH-7 (DP&L Response to IGS-INT-11-8). [↑](#footnote-ref-14)
15. Rule 4901:1-20-16 04 C, Ohio Administrative Code ("O.A.C")] and later adopted a more permanent set of rules (Rule 4901: 1-37 04 C, O.A.C.). [↑](#footnote-ref-15)
16. *In the Matter of the Commission Investigation of the Financial Condition of Dayton Power and Light* Company, Case No. 04-486-EL-COI, Entry at paragraph (4) (Apr. 7, 2004). [↑](#footnote-ref-16)
17. *Id.* at paragraphs (5)(a) and (6). [↑](#footnote-ref-17)
18. JEH-8 (DP&L’s response to IGS's Sixth Set of Discovery, RPD-6-2). [↑](#footnote-ref-18)
19. JEH-9 (Testimony of Sharon R. Schroder in Support of the Stipulation and Recommendation Page 7 of 16. Case No. 15-1830-EL-AIR). [↑](#footnote-ref-19)
20. JEH-10 (SEC form 10K for 2017, page 131). [↑](#footnote-ref-20)
21. JEH-10 (SEC form 10K for 2017, page 129). [↑](#footnote-ref-21)
22. *In the Matter of the Application of The Dayton Power and Light Company for Approval of Its Energy Efficiency and Peak Demand Reduction Program Portfolio Plan for 2018 through 2020*, Case Nos. 17-1398-EL-POR, *et al.* Opinion and Order at 6, 8 (Dec. 20, 2017). [↑](#footnote-ref-22)
23. JEH-8 (DP&L’s response to IGS's Sixth Set of Discovery, RPD-6-2). [↑](#footnote-ref-23)
24. JEH-12 (Opinion and Order, Case No. 15-1830-EL-AIR, page 46). [↑](#footnote-ref-24)
25. Calculated using the Staff Report Capital Structure (Schedule D-1) and stipulated weighted cost of debt (4.8% O&O page 24), Case No. 15-1830-EL-AIR. [↑](#footnote-ref-25)