Company Exhibit _____

BEFORE THE
PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Application of Ohio Edison Company, The Cleveland Electric Illuminating Company and The Toledo Edison Company for Authority to Provide for a Standard Service Offer Pursuant to R.C. 4928.143 in the Form of an Electric Security Plan	)))))))	Case No. 14-1297-EL-SSO

DIRECT TESTIMONY OF

STEVE STAUB

ON BEHALF OF

OHIO EDISON COMPANY
THE CLEVELAND ELECTRIC ILLUMINATING COMPANY
THE TOLEDO EDISON COMPANY

AUGUST 4, 2014

INTRODUCTION

Q. PLEASE STATE YOUR NAME, TITLE, AND BUSINESS ADDRESS.

A. My name is Steve Staub. I am employed by FirstEnergy Service Company as Vice President and Treasurer. My business address is 76 S. Main St., Akron, OH 44308.

Q. PLEASE DESCRIBE YOUR PROFESSIONAL QUALIFICATIONS, EMPLOYMENT EXPERIENCE, AND EDUCATIONAL BACKGROUND.

A. I earned a Bachelor of Science degree in Accounting and Political Science from the University of Pittsburgh in 1993, a Master of Business Administration from the University of Pittsburgh in 1997, and a Master of Taxation from Robert Morris University in 2007. I worked for Mellon Bank, focusing on capital markets and corporate banking from 1994-1998. I then became a Senior Finance Analyst with Ford Motor Company from 1998-1999. In 1999, I joined Duquesne Light Company as a Senior Financial Consultant where I was promoted to Manager of Corporate Finance in 2002, and then promoted to Assistant Treasurer in 2003. In 2007 I became the Assistant Treasurer for Allegheny Energy Inc., which merged with FirstEnergy Corp. in 2011. I was the Executive Director and Assistant Treasurer in 2012 and was promoted to my current position in 2013. In my current position, I am responsible for Treasury activities including capital markets, cash management, derivatives, investment management, and debt compliance. I am also responsible for Business Planning activities including budgeting, forecasting, and financial planning. My responsibilities extend to each of the companies owned by FirstEnergy Corp., including Ohio Edison Company, The Cleveland Electric Illuminating Company, and The Toledo Edison Company (collectively, the "Companies").

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to explain and support the 11.15% return on equity ("ROE") used to determine the revenue requirements information related to the output from the Davis-Besse Nuclear Power Station ("Davis-Besse") and the W.H. Sammis Plant ("Sammis") (collectively, the "Plants") proposed to be sold to the Companies and to support the adjusted capital structure utilized by Company witness Ruberto.

Q. HOW WILL THE COMPANIES COMPENSATE FIRSTENERGY SOLUTIONS CORP. ("FES") FOR THE OUTPUT UNDER THE PROPOSED TRANSACTION?

A. The Companies will compensate FES for all costs associated with the Plants and Ohio Valley Electric Corporation ("OVEC"), plus a return on capital investments in the Plants. As shown in the testimony of Company witness Lisowski, FES's return on its capital investments in the Plants will include an ROE.

Q. WHAT ROE WOULD BE INCLUDED IN THE PROPOSED TRANSACTION?

A. The ROE agreed to by the Companies and FES is 11.15%.

Q. HOW WAS AN 11.15% ROE DETERMINED TO BE APPROPRIATE AND REASONABLE?

A. The reasonableness of an 11.15% ROE can be demonstrated by referring to relevant Public Utilities Commission of Ohio ("Commission") precedent for a similar contract. Further, current market conditions and the associated risks also show that the use of an 11.15% ROE is reasonable.

AN 11.15% ROE IS REASONABLE

Q. HAS THE COMMISSION RECENTLY ESTABLISHED AN ROE FOR A SIMILAR TRANSACTION?

A. Yes. Recently the Commission considered a similar cost-based pricing mechanism in the AEP Capacity Case.[1] In that proceeding, Ohio Power Company and Columbus Southern Power ("AEP Ohio") sought Commission approval for a cost-based capacity pricing mechanism. This cost-based pricing mechanism bears similarities to the recovery of capital investments here, since the mechanism established in the AEP Capacity Case was primarily intended to compensate AEP Ohio for capital investments in its generation resources. Similar to the proposed transaction in this case, AEP Ohio sought to recover a reasonable ROE.

Q. HOW DID AEP OHIO JUSTIFY ITS PROPOSED ROE?

A. AEP Ohio's proposed ROE was originally based on a template from another proceeding which contained an ROE of 11.1%.[2] AEP Ohio recommended increasing that ROE to 11.15% to be consistent with the ROE proposed in AEP Ohio's most recent distribution case filing.[3]

Q. DID AEP OHIO PROPOSE THAT ITS ROE REMAIN FIXED THROUGHOUT THE TERM OF THE COST-BASED CAPACITY PRICING MECHANISM?

A. Unlike the proposed transaction here where the Companies required an unconditionally fixed ROE, AEP Ohio did not unconditionally guarantee that the ROE would remain

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[1] In the Matter of the Commission Review of the Capacity Charges of Ohio Power Company and Columbus Southern Power, Case No. 10-2929-EL-UNC ("AEP Capacity Case").
[2] *Id.*
[3] *Id.*

fixed for the length of the capacity charge. However, AEP Ohio did propose to fix the ROE for its capacity pricing formula for the term that the rate is applicable, but reserved the right to modify it given any appropriate regulatory filing or filings to modify the ROE.[4]

Q. WHY IS FES'S CONCESSION TO KEEP THE ROE FIXED RELEVANT?

A. By agreeing to fix the ROE at 11.15% over the fifteen-year term of the Economic Stability Program, FES bears all of the risk of a fixed ROE that would otherwise be impacted by rising interest rates over the term. This is a substantial benefit to customers, and demonstrates that using the same 11.15% ROE that was approved for AEP Ohio but fixing it over the term is a conservative approach in this case.

Q. DID THE COMMISSION APPROVE AEP OHIO'S PROPOSED ROE FOR THE CAPACITY CONTRACT?

A. Yes. The Commission approved AEP Ohio's proposed 11.15% ROE without modification.[5]

Q. WHY IS THE AEP CAPACITY CASE ROE APPROPRIATE FOR PURPOSES OF THIS CASE?

A. The AEP Capacity Case involved a contract which bears similarities to the proposed transaction here. In both cases, the generation provider (AEP Ohio or AEP GenCo depending on the period at issue) provides a cost-based service. As discussed in greater detail below, FES has a higher business risk profile than AEP Ohio had when the

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[4] *Id*.

[5] Case No. 10-2929, Opinion and Order, p. 34 ("Further, upon consideration of the arguments with respect to the appropriate return on equity, we find that AEP-Ohio's recommendation of 11.15 percent is reasonable and should be adopted.").

Commission approved the 11.15% ROE for AEP Ohio. However, the transaction contemplated here is comparable to AEP Ohio's in the AEP Capacity Case. Taking all of these factors into consideration, the Companies determined that utilizing a 11.15% ROE, as previously approved by the Commission under similar circumstances, was a more reasonable and conservative approach than using a much higher ROE that reflects FES's specific risk profile as a merchant generation owner.

Q. ARE THERE ANY METHODOLOGIES OTHER THAN THE AEP CAPACITY CASE THAT SUPPORT THE APPROPRIATENESS OF THE 11.15% ROE?

A. Yes. The proposed ROE can also be compared to the ROE most recently approved for the Companies, as modified to account for the risk of fixing it for the 15-year term of the proposed transaction.

Q. WHAT IS THE MOST RECENT ROE APPROVED FOR THE COMPANIES?

A. The most recent approved ROE for the Companies is 10.5%.[6]

Q. IS THE 11.15% ROE GENERALLY CONSISTENT WITH THE ROES APPROVED FOR THE COMPANIES?

A. Yes. Subject to the basis point premium discussed later in my testimony, the ROE is generally consistent with the return authorized for the Companies.

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[6] Case No. 07-551-EL-AIR through 07-554-EL-UNC, Opinion and Order dated January 21, 2009, p. 21.

Q. WHY IS THE MOST RECENTLY APPROVED ROE FOR THE COMPANIES RELEVANT TO THE APPROPRIATE ROE FOR THE PROPOSED TRANSACTION?

A. The Companies' ROE is relevant because it provides a benchmark to measure against and also shows that recent Ohio precedent supports an ROE in this range, and that the 11.15% ROE used in this transaction is reasonable.

Q. IN ADDITION TO THE AEP OHIO CAPACITY CASE AND THE COMPANIES' DISTRIBUTION RATE CASE, WHAT OTHER FACTORS SUPPORT YOUR ASSESSMENT THAT THE ROE IS APPROPRIATE?

A. I also considered how the ROE proposed for this transaction compares to the ROE for distribution utilities and how the long term fixed nature of the proposed transaction would impact the appropriate ROE when starting with those distribution utility ROE values.

Q. HOW DOES THE RISK PROFILE FOR FES COMPARE TO THE RISK PROFILE FOR OHIO ELECTRIC DISTRIBUTION UTILITIES?

A. FES provides energy-related products and services to retail and wholesale customers and owns, through subsidiaries, merchant generation, which is by its nature riskier than an EDU. The higher business risk for FES reflects, among other things, the volatility of market prices for electricity, the uncertain nature of its customer base, and an uncertain regulatory environment from the standpoint of both markets and environmental mandates. FES continues to manage capital spending, O&M costs, maintain its hedging strategy, and maximize its margins—but sustained weakness and volatility in power prices have, and will continue to, hurt FES's cash flow, just as it will other merchant generation companies. Uncertain and uncontrollable market and regulatory risks and current market realities increase the risk of investing in merchant generation, and therefore increase the return required to attract additional investment. Accordingly, FES would have a higher required return on equity than AEP Ohio, which was more fully regulated at the time its 11.15% ROE was authorized. For example, in discussing capital and financing costs for new build generation, Company witness Rose develops an estimated ROE of 13.3% for merchant generation owners, further demonstrating that the 11.15% ROE proposed here, is conservative and reasonable.

Q. SHOULD THE ROE BE LIMITED TO A 10.5% ROE SINCE THAT IS THE ROE MOST RECENTLY APPROVED FOR THE COMPANIES?

A. No. In the AEP Capacity Case, AEP Ohio requested an 11.15% ROE for capacity pricing. AEP Ohio proposed this ROE because it was consistent with the ROE proposed in its concurrent distribution proceeding. The Commission-approved ROE in AEP Ohio's distribution proceeding was lower than the 11.15% requested.[7] Staff opposed the 11.15% ROE in the AEP Capacity Case on the grounds that the lower distribution returns the Commission ultimately approved should be used instead of the 11.15% requested by AEP Ohio. The Commission rejected Staff's position, finding that the distribution ROEs were not appropriate for capacity pricing and authorizing the 11.15% ROE for AEP Ohio.[8]

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[7] Case No. 11-351-EL-AIR, Opinion and Order, p. 11.

[8] Case No. 10-2929, Opinion and Order, p. 34 ("Further, upon consideration of the arguments with respect to the appropriate return on equity, we find that AEP-Ohio's recommendation of 11.15 percent is reasonable and should be adopted. As AEP-Ohio notes. Staffs recommended return on equity was solely based on the negotiated return on equity in the Company's distribution rate case which has no precedential effect pursuant to the express terms of the stipulation adopted by the Commission in that case. Our adoption of a return on equity of 11.15 percent increases Staff's recommendation by $10.09/MW-day.").

Q. WHAT WAS THE DIFFERENCE BETWEEN THE ROE APPROVED FOR AEP OHIO IN ITS DISTRIBUTION RATE CASE AND THAT APPROVED IN THE CAPACITY CASE?

A. In AEP Ohio's distribution case, the Commission approved a stipulation with ROEs from 10.0% to 10.3%. The AEP Capacity Case authorized a generation-related ROE of 11.15%. Therefore, the difference supports an increase in the ROE approved for generation investment that is between 85 and 115 basis points over distribution ROEs.

Q. WHAT IS THE RANGE OF APPROPRIATE ROES IF THE COMPANIES' DISTRIBUTION ROE WAS ADJUSTED IN THE SAME MANNER AS IN THE AEP CAPACITY CASE?

A. Applying the 85 to 115 basis point differential between the AEP Capacity Case and AEP Ohio's most recent distribution case, to the Companies' most recent distribution ROE would yield a range of possible returns on equity of 11.35% to 11.65%.[9] Again, this confirms that an ROE of 11.15% for FES in the proposed transaction is reasonable.

Q. IS THE LENGTH OF THE ANTICIPATED TRANSACTION RELEVANT TO DETERMINING AN APPROPRIATE ROE?

Yes. The fixed nature of the ROE here is valuable in this time of low interest rates, because it provides customers with additional long-term cost certainty. The cost certainty benefit is particularly evident when the long term of the proposed transaction is considered, which would fix the ROE for 15 years. This is a significant benefit to customers because it protects them from the likelihood that rates will rise over time. Consequently, this shifts the risk onto FES.

[9] 10.5% ROE plus 85 to 115 basis points.

Q. IS THERE A WAY TO MEASURE AND VALUE THE INCREASED RISK ASSOCIATED WITH LONG-TERM INVESTMENTS?

A. Yes. The market evaluates the risk of long-term obligations every day. U.S. Treasury Bond ("Treasury Bond") yields (deemed as the risk free rate) are typically used as a benchmark. To price the bond issuance, investors typically demand higher treasury yields to compensate for the greater risks associated with the long-term nature of a 15-year bond versus short-term obligations. One way to develop a reasonable value estimate of the risk involved in fixing a rate of return for a period of time is to measure the spreads between actively traded Treasury Bonds over a comparable time period.

Q. HAVE YOU PERFORMED AN ANALYSIS OF TREASURY BONDS TO EVALUATE THE RISK TO FES IN FIXING THE ROE FOR FIFTEEN YEARS?

A. Yes. I have analyzed data from the last 15 years to determine the average 1-year Treasury Bill interest rate, 2.22%.[10] I have also analyzed that same 15-year period to determine the average 15-year Treasury Bond interest rate, 4.18%.[11] Based on this data, I conclude that the market demands an average 196 basis point increase over the 1-year interest rate to compensate for the longer 15-year term of the investment. This basis point estimate does not account for the additional impact of credit spreads, because, as I mention above, Treasury Bonds are considered to be risk-free investments.

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[10] *See* workpaper SS-1.
[11] *Id*.

Q. WORKING FROM THE COMPANIES' CURRENT DISTRIBUTION CASE ROE, WHAT WOULD THE RANGE OF ROES BE IF THEY WERE ADJUSTED FOR THE RISK TO FES OF FUTURE INTEREST RATE INCREASES?

A. For the proposed transaction, if we start with the Companies' current ROE and adjust it for the average risk of yield increases over the fixed term of 15 years (i.e. 196 basis points), that results in a 12.46% ROE. This analysis provides yet more confirmation that relying on the Commission's AEP Capacity Case precedent for an 11.15% ROE is both appropriate and reasonable. This range does not reflect any risk premium associated with the business profile of FES as compared to the Companies.

<u>THE FES CAPITAL STRUCTURE SHOULD BE ADJUSTED</u>

Q. PLEASE BRIEFLY EXPLAIN FES'S CAPITAL STRUCTURE.

A. Like most large companies, FES funds its operation through a combination of debt and equity. FES's capital structure is approximately 65% equity and 35% debt.

Q. WHY IS THE CAPITAL STRUCTURE RELEVANT TO FES'S RETURN ON ITS CAPITAL INVESTMENTS IN THE PLANTS?

A. The FES capital structure is relevant to the risk associated with an entity. As a general rule, the higher the risk, the higher amount of equity is required. Investors in both debt and equity instruments regularly examine a company's overall capital structure when determining whether to invest.

Q. IS THERE ANY REASON WHY AN ADJUSTED CAPITAL STRUCTURE WOULD BE APPROPRIATE?

A. Yes. Notwithstanding FES's capital structure, which is approximately 65% equity and 35% debt and commensurate with its risk profile, an adjusted capital structure of 50%

equity and 50% debt is comparable to the Companies' 51% equity and 49% capital structure as approved by the Commission in the Companies' last rate case. The same capital structure is also used in the existing Delivery Capital Recovery Rider.[12] Using this capital structure significantly increases the benefits to customers because the compensation will include a higher level of debt than that actually held by FES. Debt commands a lower return than equity, so imputing a higher level of debt than actual lowers the overall cost of capital for the proposed transaction.

<u>CONCLUSION</u>

Q. WHAT ROE IS REASONABLE AND APPROPRIATE FOR THE PROPOSED TRANSACTION?

A. In light of the range of ROEs that were determined using alternative methodologies, using the 11.15% ROE previously approved by the Commission in the AEP Capacity Case is the most reasonable and appropriate way to determine the return on capital investments for the Plants. This ROE is lower than those yielded by the alternative methodologies discussed above, and is in line with the very similar contract previously approved by the Commission for AEP Ohio.

Q. DOES THAT CONCLUDE YOUR TESTIMONY?

A. Yes. I reserve the right to supplement my testimony.

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[12] Case No. 10-388-EL-SSO, Opinion and Order, p. 11