BEFORE THE

PUBLIC UTILITIES COMMISSION OF OHIO

THE DAYTON POWER AND LIGHT COMPANY

CASE NOS. 19-1121-EL-UNC
20-1041-EL-UNC

SIGNIFICANTLY EXCESSIVE EARNINGS TEST

DIRECT TESTIMONY
OF GUSTAVO GARAVAGLIA M.

- □ **MANAGEMENT POLICIES, PRACTICES, AND ORGANIZATION**
- □ **OPERATING INCOME**
- □ **RATE BASE**
- □ **ALLOCATIONS**
- □ **RATE OF RETURN**
- □ **RATES AND TARIFFS**
- ■ **OTHER**

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I. INTRODUCTION

Q. Please state your name, employer and business address.

A. My name is Gustavo Garavaglia M. I am employed by AES US Services, LLC, which provides services to The Dayton Power and Light Company ("DP&L" or the "Company"). My business address is One Monument Circle, Indianapolis, IN 46204.

Q. What is your position and professional relationship with DP&L?

A. I am DP&L's Chief Financial Officer and Chief Financial Officer of AES US Services, LLC.

Q. How long have you been in your present position?

A. I have been CFO of DP&L since January 2019.

Q. What are your responsibilities in your current position?

A. In my current position, I report to the President of AES US Services. I have direct responsibility and oversight for accounting, tax, financial planning & analysis, treasury, and risk management functions of DPL Inc. DP&L and other AES affiliates.

Q. Will you describe briefly your educational and business background?

A. I received a Bachelor's degree in Electrical Engineering from University of Campinas ("Unicamp") in Brazil in 2009 and a Master's degree in Business Administration from FGV Brazil in 2012 and I am a CFA Charterholder.

I joined AES in Brazil in January 2010 as a finance trainee. In November 2011, I moved to Business Development as a Senior Analyst. In June 2012, I took a new role as Strategic Planning Specialist. Starting in May 2013, I did a 6-month assignment with the

Mergers and Acquisitions team at the AES Global Headquarters in Arlington, Virginia and at the end of 2013, I returned to Brazil as Manager for Investment Analysis and Risk Management. In March 2015, I moved to Panama to be the Head of Transactions and Developments for AES in Mexico, Central America and Caribbean and while still in Panama, I expanded my role, and became the Director for Financial Planning & Analysis and Development & Transactions for AES in Mexico, Central America and the Caribbean. In January 2019, I accepted my current position.

Q. What are the purposes of this testimony?

A. The purposes of this testimony are to demonstrate that DP&L passes the Significantly Excessive Earnings Test ("Retrospective SEET") in R.C. 4928.143(F) for 2018 and 2019 under multiple scenarios that both include and exclude the revenues from the Distribution Modernization Rider ("DMR"). Specifically, those scenarios address the following adjustments:

a. proceeds from DP&L's DMR are appropriately excluded from the Retrospective SEET calculation for 2018 and 2019;
b. the Commission should recognize in DP&L's equity base amounts that were written off associated with DP&L's generation assets (DP&L witness Malinak sponsors this adjustment);
c. the Commission should recognize in DP&L's equity base $300 million in capital investments that DP&L's ultimate parent company, The AES Corporation ("AES"), made and committed in DP&L;

d. the Commission should recognize adjustments to the Retrospective SEET calculation associated with the Tax Cuts and Jobs Act and certain property taxes;

e. if the Commission were to include DP&L's DMR proceeds in the Retrospective SEET calculation, then the Commission should subtract from DP&L's earnings the revenue that DP&L would have earned if the Rate Stabilization Charge ("RSC") had been in effect at that time;

f. the 12% Retrospective SEET threshold from DP&L's third Electric Security Plan ("ESP III") Stipulation no longer applies. DP&L witness Malinak explains that the SEET threshold should be between 14.7% and 23.4%, depending on which Scenario is being considered;

g. the Retrospective SEET threshold for 2018 and 2019 should be increased by 100 basis points because DP&L is much more risky than a typical utility;

h. if the Commission were to conclude that DP&L had significantly excess earnings, then the Commission should "[c]onsider[] . . . capital requirements of committed investments" and find that no refund should be issued because a refund would make it very difficult if not impossible for DP&L to make needed capital investments in its system, including its plans to invest in SmartGrid, consistent with the near-unanimous stipulation recently filed with the Commission; and

i. the fact DP&L did not have significantly excessive earnings in 2018 and 2019 is further confirmed by the facts that (a) DP&L had the lowest rates in the state at that time; and (b) DP&L had credit ratings that were among the lowest for regulated utilities in the country at that time.

Q. Can you describe the schedules in this case?

A. Yes, as discussed in more detail in my testimony and the testimony of DP&L witness Malinak, those schedules show the following:

a. Schedules 1 and 6 show the following adjustments for 2018 and 2019 (which are discussed in more detail below): exclusion of DMR proceeds from the Retrospective SEET calculation; the addition of past generation asset impairments to DP&L's equity; the addition of $ 300 million in AES equity infusions to DP&L's equity base; and TCJA and property tax adjustments. DP&L ROE after those adjustments are made was 0.7% in 2018 and 2.0% in 2019.

Those two schedules are DP&L's "base case" for 2018 and 2019 for the Retrospective SEET, as all of the adjustments shown on those schedules should be made. The remaining schedules discussed below demonstrate that DP&L would still pass the Retrospective SEET even if only select adjustments (or combinations thereof) were made.

b. Schedules 2 and 7 show adjustments associated with excluding the DMR from DP&L's revenue. DP&L's ROE after that adjustment was 3.3% in 2018 and 11.7% in 2019.

c. Schedules 3 and 8 show adjustments associated with including the DMR revenues while adding back generation asset write-offs to DP&L's equity base. (DP&L witness Malinak sponsors this adjustment); DP&L's ROE after just that adjustment was 6.8% in 2018 and 8.5% in 2019.

d. Schedules 4 and 9 show adjustments associated with including the DMR in DP&L's revenues, including $300 million equity investments in DP&L by AES, and adjustments for the TCJA and certain property taxes. DP&L's ROE after just those adjustments was 13.2% in 2018 and 13.9% in 2019.

e. Schedules 5 and 10 show adjustments to DP&L's earnings to include DMR proceeds but subtract revenue that DP&L would have received if the RSC had been in place. DP&L's ROE after just that adjustment was 8.1% in 2018 and 13.5% in 2019.

DP&L witness Malinak explains that the ROEs shown in DP&L's schedules are all below the applicable SEET thresholds, so no refund should be issued.

Q. In the SEET filing that DP&L made in 2018 for 2017, did DP&L propose all of the adjustments that you discuss above?

A. No. In that filing, DP&L easily passed the SEET simply by excluding the DMR from its earnings. Therefore, none of the other adjustments described above were made in order to provide a more streamlined regulatory process that reduced the burden upon the Commission and intervening parties. That process resulted in the unopposed stipulation, which excluded the DMR revenues. In light of the Commission's order that the parties file testimony regarding the Supreme Court of Ohio's decision that proceeds from FirstEnergy's DMR should be included in the SEET, DP&L re-examined the SEET adjustments to accommodate the Supreme Court's recent interpretation of the statute.

II. THE COMMISSION SHOULD FIND THAT DP&L PASSES THE SEET

A. DP&L'S DMR is Properly Excluded from the SEET

Q. How is this section of your testimony organized?

A. This section begins by providing background information regarding DP&L's DMR and other related items. This section then explains that the Commission should exclude DP&L's DMR proceeds from the SEET for three separate and independent reasons:

1. The DMR proceeds do not constitute an earned return on equity;
2. The DMR was a non-recurring, special and extraordinary item; and
3. The DMR was a capital charge and it is appropriate that it be excluded.

The adjustments discussed in this section of my testimony are shown on Schedule 2 for 2018 and Schedule 7 for 2019, which show that DP&L earned ROEs of 3.3% and 11.7% respectively during those years. The testimony of DP&L witness Malinak demonstrates that those ROEs are below the applicable thresholds.

1. Background Facts

Q. How was the DMR established?

A. The DMR was established pursuant to a Commission Order that approved a Stipulation and Recommendation in DP&L's ESP III case. In re DP&L's ESP III, March 13, 2017 Amended Stipulation and Recommendation, p. 4 (Case No. 16-0395-EL-SSO) ("ESP III Stipulation").

Q. What was the purpose of the DMR?

A. At that time, and still today, DP&L was in financial distress. The purpose of the DMR was to allow DP&L to improve its financial integrity (including its credit ratings) so that

DP&L had the financial resources necessary to invest in its system and implement SmartGrid. See ESP III Stipulation, p. 3. ("To allow DP&L to provide stable and certain distribution service and to modernize its distribution grid, the Signatory Parties agreed to the following terms.")

Q. Did the Commission approve the DMR?

A. Yes. In its Order, the Commission discussed the fact that DP&L's credit ratings were "below investment grade," that there was "undisputed evidence of the actual adverse consequences" due to DP&L's poor credit ratings, and that a witness for The Office of the Ohio Consumers Counsel had conceded that it was "vitally important" that DP&L have an investment grade credit rating. Opinion and Order, pp. 24-25.

Q. Did the ESP III Stipulation allow DP&L to dividend the DMR proceeds to AES?

A. No. The purpose of the DMR was to improve DP&L's financial integrity so that DP&L could make needed investments in its system and implement SmartGrid. ESP III Stipulation, p. 3. Using the DMR to make dividend payments to AES would have been inconsistent with that purpose.

The Stipulation thus imposed specific restrictions as to what DP&L could do with the DMR proceeds:

> "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."

ESP III Stipulation, p. 5 (emphasis added).

Q. Did the Stipulation contain other restrictions that were designed to ensure that the DMR proceeds were not provided to AES?

A. Yes. Cash is fungible, and the other parties to the Stipulation wanted to ensure that DP&L did not use the DMR to make debt payments, while using money from other sources to make dividend or tax sharing payments to AES. The Stipulation thus prohibited DP&L and DPL Inc. from making any such payments to AES. ESP III Stipulation, pp. 3-4.

Q. Has DP&L's use of the DMR proceeds been audited?

A. Yes. Pursuant to a Commission order, DP&L's DMR proceeds were audited. The auditor concluded that DP&L's DMR proceeds "were used exclusively to make payments of principal and interest at DP&L and DPL outstanding debt and discretionary prepayments of principal in compliance with the Amended Stipulation." In re Review of DP&L's DMR, June 14, 2019, Oxford Advisors Mid-Term Report, pp. 11-14 (Case No. 18-264-EL-RDR).

Q. When is the last time that AES received a dividend or other payment from DP&L?

A. AES has not received any dividend or other payment from DP&L since 2012.

Q. Has AES made significant capital investments in DP&L?

A. Yes. On June 26, 2020, AES contributed $150 million to DP&L to allow DP&L to make needed investments in its infrastructure. In addition, and as more fully described in DP&L's June 17, 2020 8(K) filing, AES has provided a statement of intent to contribute an additional $150 million to DP&L in 2021 to enable Smart Grid investment. AES also converted $137 million in tax liabilities into equity at DPL Inc. as agreed to in the ESP III Amended Stipulation.

Q. Was DP&L's DMR different from FirstEnergy's DMR?

A. Yes. While the two riders had the same name, they operated very differently.

A principal difference is how the DMR funds could be and were used. Specifically, I understand that the Supreme Court plurality held that FirstEnergy's DMR was not lawful because it "awards them money up front with no meaningful conditions attached." In re FirstEnergy, 2019-Ohio-2401, ¶ 19.

First Energy's DMR proceeds were also audited, and the auditor concluded that those proceeds were placed in a pool so that the funds could "benefit[] non-Ohio regulated companies" and be "used to pay dividends." In re Audit of FirstEnergy's DMR, June 14, 2019 Oxford Advisory Mid-Term Report, p. 19. First Energy increased its dividend to its shareholders while it was receiving its DMR. Id. at 36-37.

In contrast, DP&L's DMR funds were used exclusively to make debt payments for DP&L and DPL Inc., and AES received no dividends. The audit of DP&L's DMR confirmed this. In re Review of DP&L's DMR, June 14, 2019, Oxford Advisors Mid-Term Report, pp. 11-14 (Case No. 18-264-EL-RDR).

Q. Are there other pertinent differences between DP&L's DMR and FirstEnergy's DMR?

A. Yes. In the First Energy ESP case, I understand that the plurality stated that "the critical problem is that the companies are not required to make any investments to modernize the distribution grid in exchange for DMR revenues." In re FirstEnergy, 2019-Ohio-2401, ¶ 18 (emphasis in original). DP&L's case is much different because the Commission stated: "Once the modernization plan is approved by and made the order of the Commission, DP&L will be required to implement the modernization plan." Sept. 19, 2018 Third Entry on Rehearing, ¶ 22 (emphasis in original). Unlike FirstEnergy, DP&L was thus "required" to implement grid modernization.

Q. For 2018-2019, how did DP&L's rates for a typical residential customer (1,000 kWh per month) compare to the rates of other Ohio utilities?

A. During that period, DP&L's rates for such a customer were the lowest in the state.

2. The DMR Was Not an Earned Return

Q. Were the DMR proceeds similar to other revenue that is typically earned by utilities?

A. No. Utilities are typically free to use the revenue that they earn for any lawful purpose. Utilities can dividend their revenue to shareholders; utilities can use their revenue to invest in infrastructure or to pay expenses. The DP&L DMR however, had restrictions on its use such that it could not be used for these purposes; instead, it was restricted to be used only to pay and reduce debt obligations. ESP III Stipulation at pp. 3-4. Therefore, the DMR proceeds were not similar to revenue that is typically earned by utilities.

Q. Was the DMR an "earned return on common equity" (R.C. 4928.143(F)?

A. No. As discussed above, DP&L could not dividend or otherwise provide the DMR proceeds to AES or its shareholders. Instead, DP&L was required to use the DMR proceeds to make interest and principal payments at DP&L and DPL Inc. The DMR proceeds thus were not an "earned return" because DP&L's use of those funds was significantly restricted, and those proceeds could not be provided to AES or its shareholders.

Q. Do the restrictions in the ESP III Stipulation on making dividend or tax sharing payments to AES affect whether the DMR was an earned return?

A. Yes. The provisions in ESP III Stipulation, pp. 3-4 that precluded DP&L and DPL Inc. from making dividend or tax sharing payments to AES further confirm that the DMR was not an earned return. Specifically, the purpose of those provisions was to prevent DP&L from using DMR proceeds to pay debt while using other proceeds to make payments to AES. The prohibitions against making payments to AES thus reinforced the prohibition against providing DMR proceeds to AES, further confirming that the DMR proceeds were not an "earned return."

Q. Can you also compare DP&L's DMR to FirstEnergy's DMR regarding whether each was an "earned return"?

A. Yes. As I just mentioned, the Commission should conclude that DP&L's DMR was not an "earned return" because DP&L's use of the DMR proceeds was significantly restricted and the proceeds could not be used to make any payments to AES. In contrast, as also mentioned above, there were no restrictions on FirstEnergy's use of DMR funds, and

FirstEnergy actually increased its dividends while it was collecting the DMR. The two DMRs were thus very different on the question of whether each was an "earned return."

3. The DMR Was a Non-Recurring, Special, and Extraordinary Item

Q. Should non-recurring, special or extraordinary items be excluded from the SEET?

A. Yes. The Commission has held that "for the SEET calculation, the earned return will . . . exclud[e] any non-recurring, special, and extraordinary items." In the Matter of the Investigation of the Development of the Significantly Excessive Earnings Test, June 30, 2010 Finding and Order, p. 18 (Case No. 09-786-EL-ENC).

Q. Should the DMR be excluded from the SEET as a non-recurring, special or extraordinary item?

A. Yes. The DMR was a non-recurring item, as it was scheduled to expire after three years. ESP III Stipulation, p. 4. In fact, the Commission terminated the DMR before that three-year period had expired. In re DP&L's ESP III, Nov. 21, 2019 Supplemental Opinion and Order, ¶ 110 (Case No. 16-395-EL-SSO). The DMR was thus a non-recurring item that should be excluded from the SEET.

4. The DMR Was a Capital Charge that Should be Excluded from DP&L's Earnings

Q. Do you consider the DMR to be a capital charge?

A. Yes. As discussed above, the DMR proceeds were restricted to being used to pay and reduce debt, so that DP&L could borrow under reasonable terms to fund grid modernization. The DMR was thus targeted at altering DP&L's capital structure and was therefore a capital charge.

Q. What conclusions do you draw from that fact?

A. I understand that the SEET statute allows the Commission to make appropriate adjustments related to a utility's capital structure. R.C. 4928.143(F). Since the DMR was a capital charge, it should not be treated as revenue and should be excluded from the SEET.

B. Adjustments Associated With AES Equity and Tax Law Changes

Q. What is shown on Schedules 4 and 9?

A. Those Schedules show that after making adjustments associated with AES' capital contributions to DP&L, the TCJA, and other tax law changes, DP&L's ROEs would be 13.2% in 2018 and 13.9% and in 2019. The testimony of DP&L witness Malinak demonstrates that those amounts are below the applicable SEET thresholds.

1. The Commission Should Adjust DP&L's Equity Balance by $300 Million Associated with AES' Equity Investments

Q. What is the purpose of this section of your testimony?

A. This section of my testimony demonstrates that DP&L plans to make very large investments in its service territory over the next five years, and those investments would not be possible without the $300 million that AES has invested or plans to invest in DP&L. I understand that the Commission is required to "[c]onsider[] . . . the capital requirements of future committed investments in this state" when conducting the SEET (R.C. 4928.143(F)), and the Commission should do so by adding to DP&L's equity balance the $300 million in investments that AES has made or plans to make in DP&L.

Q. Does DP&L have capital requirements for its future committed capital investments in this state?

A. Yes. Pursuant to a Stipulation and Recommendation that was signed in DP&L's grid modernization case (Case No. 18-1875) in conjunction with the Retrospective SEET cases, DP&L plans to invest approximately $249 million over four years to modernize its distribution grid. DP&L and the signatories to that Stipulation agree that those investments will provide significant benefits for customers, including improved reliability. In addition to grid modernization, DP&L is planning to invest $510 million over the next five years in its distribution system. DP&L is also planning to construct approximately $180 million in transmission enhancements as part of PJM's overall RTEP plan over the next five years. Those amounts total $939 million.

DP&L needs to invest in its system because DP&L's infrastructure is aging. For example, 45% of DP&L's substation assets are over 30 years old, while 24% of those assets are over 50 years old. Over 45% of DP&L's distribution poles are more than 40 years old, 35% are over 50 years old, and almost 20% of the distribution poles on the system are over 60 years old. Also, a large portion of DP&L's meters are obsolete electromechanical meters and DP&L's current system includes no advanced metering infrastructure. These are just a few examples of how DP&L is woefully behind the other Ohio utilities that have been making significant capital investments in their system and recovering those investments through riders.

Q. How will DP&L fund those investments?

A. DP&L plans to fund those investments using $300 million in AES equity contributions, using internally-generated funds, and through additional debt financing.

Q. Why is AES investing in DP&L?

A. AES announced its plan to invest $300 million in DP&L because DP&L needed those funds in order to make necessary capital investments so that DP&L could continue to provide safe and reliable service to its customers. DP&L is much riskier than a typical utility (see discussion below), and AES' investments demonstrate a commitment to DP&L and its customers.

Q. Did DP&L discuss the potential AES investments in public filings?

A. Yes. DP&L's 2019 10-K disclosed:

> "We expect our existing sources of liquidity to remain sufficient to meet our anticipated operating needs. Our business is capital intensive, requiring significant resources to fund operating expenses, construction expenditures, scheduled debt maturities and carrying costs, taxes and dividend payments. For 2020 and subsequent years, we expect to satisfy these requirements with cash from operations, funds from debt financing and/or <u>equity capital contributions</u> as our internal liquidity needs and market conditions warrant.
>
> . . . .
>
> DPL is projecting to spend an estimated $621.0 million in capital projects for the period 2020 through 2022, which includes an estimated $613.0 million for DP&L. DP&L's projection includes expected spending under DP&L's Distribution Modernization Plan filed with the PUCO in December 2018 as well as new transmission projects" (Emphasis added.)

SEC Form 10-K for Fiscal Year End Dec. 31, 2019, pp. 40-41 (filed Feb. 2, 2020).

DP&L again discussed the potential equity investment in a recent 8-K:

> "In the first half of 2020, The AES Corporation ("AES") provided a statement of intent to provide capital contributions of $150 million in the aggregate to DPL or DP&L, by June 30, 2020 (the "2020 Contribution") to enable DP&L to improve its infrastructure and modernize its grid while maintaining liquidity. In addition, AES provided a statement of intent to contribute an additional $150 million to DPL or DP&L in 2021 (the "2021 Contribution" and, together with the 2020 Contribution, the "Contributions") to enable smart grid investment. The payment of the Contributions to DPL or DP&L are not guaranteed and are dependent on certain conditions, including, with respect to the 2021 Contribution, recovery of grid modernization investments through the infrastructure investment rider."

SEC Form 8-K, p. 2 (filed June 17, 2020).

Q. Why did you say that DP&L is more risky than a typical utility?

A. Credit ratings are an excellent measure of how risky a utility is, since the ratings are established by independent third parties and are used by lenders to establish interest rates. DP&L's current credit ratings are as follows:

S & P: BB+ (one notch below investment grade), developing outlook

Fitch: BBB- (lowest investment grade rating), negative outlook

Moody's: Baa2 (one notch above the lowest investment grade rating), negative outlook

DP&L is thus either below investment grade (S&P) or barely investment grade (Fitch and Moody's). It is highly unusual for a U.S. utility to have such low credit ratings. For example, of the 29 utilities that Moody's rates, only two have lower credit ratings than DP&L. DP&L's credit ratings demonstrate that it is more risky than a typical utility.

Further, unlike other Ohio utilities, DP&L is not currently collecting a distribution investment rider, a decoupling rider,[1] or an uncollectible rider, which allow for timely recovery of utility investments, minimize risk, and provide more stable cash flow.

Q. Do you have a proposal regarding how the Commission should "[c]onsider[] . . . the capital requirements of future committed investments in this state" when conducting the SEET (R.C. 4928.143(F))?

A. Yes. The Commission should include the $300 million in AES equity investments in DP&L's equity balances for 2018 and 2019.

Q. Why is that proposal reasonable?

A. As an initial matter, that $300 million is a capital requirement necessary to support the investments to which DP&L was committed in 2018-2019 (and remains committed to today). Further, given that the Commission is required to "consider[]" capital requirements associated with "future committed investments" when conducting the SEET, it is reasonable to include the equity investments associated with those capital requirements.

The Commission should thus "consider[] . . . future committed investments in this state" by including AES' equity contribution to DP&L's equity balances in 2018 and 2019 in the SEET.

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[1] At the time of this filing, DP&L has a pending request at the PUCO to defer distribution decoupling costs. However, while approval of a deferral would resolve the income statement impact of lack of a decoupling rider, DP&L's cash flow and liquidity will remain diminished until DP&L can begin recovery of that deferral.

2. <u>Changes in Tax Laws</u>

Q. What is shown in this section of your testimony?

A. This section of my testimony demonstrates that DP&L has certain earnings that were caused by changes in the tax laws, which should be excluded from the SEET in 2019 (these adjustments do not apply to 2018). I understand that the Supreme Court has held that "earnings <u>not caused by</u> the ESP may be excluded from consideration" in the SEET. <u>In re SEET of Ohio Edison</u>, 2020-Ohio-5450, ¶ 24.

Q. In 2019, following the Commission's order in Case 19-572-EL-UNC, DP&L recorded a tax benefit of approximately $18M related to the reversal of excess deferred taxes resulting from the impact of the corporate tax rate change from 35% to 21% enacted by the Tax Cuts and Jobs Act (TCJA). Can you provide the reason for this benefit?

A. Yes. When the TCJA was enacted lowering the corporate tax rate, DP&L was required by the accounting standard governing income taxes, ASC 740, to remeasure its deferred taxes. This remeasurement resulted in a decrease to its net deferred tax liability which was initially estimated and recorded to a regulatory liability pending resolution with the Company's regulators, the PUCO and FERC. DP&L proposed to include in the amount of excess deferred taxes to be reversed for the benefit of its distribution customers those amounts that were related to the deferred taxes included in its distribution rate base. DP&L provided supporting workpapers that demonstrated that those balances were to be reversed for customers benefit and those balances that were unallocated to its distribution customers. Once the Commission approved the stipulation, the regulatory liability for the excess deferred taxes was overstated compared to the original estimate and had to be adjusted to reflect the amounts that had been agreed to by the parties. This resulted in a one-time $18 million tax benefit recorded in 2019.

Q. Should that $18 million amount be excluded from the SEET?

A. Yes, for two reasons. First, the adjustment was a one-time extraordinary event that should be excluded from the SEET. Second, I understand that the only amounts that should be included in the SEET should be earnings related to adjustments to an ESP. Those earnings did not result from an adjustment to an ESP; they resulted from a change in tax laws.

Q. If instead income tax rates were to increase, would you expect a deferred tax deficiency as a result?

A. Yes. In the event of an increase to the corporate tax rate, similar to the TCJA rate decrease, DP&L would be required to estimate and remeasure its deferred net tax liability which would likely result in a deferred tax shortage (an increase to the Company's deferred tax liability). For shortages related to deferred tax balances that are not included in rate base, the Company would record an increase to tax expense and would not expect to seek recovery from its customers; assuming the Commission agrees with DP&L's recommended treatment, DP&L would also expect to exclude the loss from future SEET calculations.

Q. Should DP&L's earnings and equity balance be adjusted to remove the impacts associated with changes in tax laws?

A. Yes. When changes in tax law occur, the increases or decreases on regulated balances are passed back to rate payers. Any increase or decrease related to non-regulated balances would result in a one-time non-recurring charge or benefit associated with the remeasurement of deferred taxes. For the reasons described above, it is appropriate to adjust DP&L's earnings and equity balances to remove the impact of this one-time adjustment as it does not in any way represent an over or under earning.

Q. Can you explain the property tax adjustments shown on Schedules 4 and 9?

A. Yes. Property taxes are estimated and accrued throughout the year and a final assessment of property taxes is typically completed and booked in the following year. The property tax adjustments move the final assessments into the actual year they are incurred.

C. <u>The Difference Between the DMR and the RSC</u>

Q. Can you describe the adjustment shown on Schedules 5 and 10?

A. Yes. As discussed above, the entire DMR should be excluded from the SEET. However, if the Commission were to conclude that the DMR should be included in the SEET, then the Commission should subtract from DP&L's revenues the amount that DP&L would have earned under the RSC if the RSC had been in place at that time. Schedules 5 and 10 show that DP&L would have earned an ROE of 8.1% in 2018 and 13.5% in 2019. The testimony of DP&L witness Malinak shows that these ROEs are below the applicable SEET thresholds.

Q. Why is that adjustment appropriate?

A. I understand that R.C. 4928.143(F) requires the Commission to determine whether any "adjustments" made under the then-governing ESP resulted in significantly excessive earnings. I further understand that when determining the amount of such adjustments, the Supreme Court has stated that the Commission must determine whether significantly excessive earnings resulted from "'any change in rates when compared to the rates in the electric utility's preceding rate plan.'" In re The SEET of Ohio Edison, 2020-Ohio-5450, ¶ 26 (quoting In re Investigation into the Development of the Significantly Excessive Earning Test, Pub. Util. Comm. No. 09-786-EL-UNC, at 15 (June 30, 2010)).

Before the DMR was approved, DP&L was operating under ESP I, which included the RSC. In re DP&L's ESP I, Aug. 26, 2016 Finding and Order, ¶ 23 (Case No. 08-1094-EL-SSO). The elimination of the RSC from ESP I and the implementation of the DMR in ESP III thus constituted a "change in rates when compared to the rates in [DP&L's] preceding rate plan," so the difference between the DMR and the RSC is what should be included in the SEET.

D. The 12% ROE Cap Should Not Apply

Q. The ESP III Stipulation p. 6 states: "Rider DMR revenues shall be excluded from Significantly Excessive Earnings Test ('SEET') calculations. DP&L's SEET threshold will remain at 12%." Should the Commission use that 12% SEET threshold?

A. No, the Commission should not use a 12% threshold for the following reasons.

First, the 12% SEET threshold was part of a bargained-for exchange for the DMR revenues being excluded from the SEET. If the Commission were to conclude that DMR revenues were to be included in the SEET, then the 12% threshold would be inapplicable.

Second, DP&L exercised its statutory right to terminate ESP III, which the Commission approved. In re DP&L's ESP III, December 18, 2019 Finding & Order, ¶ 16 (Case No. 16-395-EL-SSO). The provisions in that Stipulation are no longer enforceable, and DP&L is no longer operating under the terms of that Stipulation. The ESP I Stipulation under which DP&L currently operates does not contain a SEET threshold.

E. The SEET Threshold Should be Increased by 100 Basis Points

Q. What is the purpose of this section of your testimony?

A. This section of my testimony demonstrates that the Commission should increase the SEET threshold calculated by Witness Malinak by 100 basis points for purposes of Scenarios 1 and 2.

Q. Why do you believe that a 100 basis point adder to the SEET threshold proposed by Witness Malinak is appropriate?

A. As described above, DP&L plans to make significant investments in its infrastructure, which are necessary to sustain DP&L's ability to provide safe and reliable service. Further, DP&L is subject to significant risks that most other utilities in this country do not face.

Q. Are credit ratings a good measure of how risky a utility is?

A. Yes. As mentioned above, DP&L's credit ratings are prepared by neutral third parties and are relied upon by lenders and other investors to inform their decision making. They are thus an excellent measure of how risky a business is.

Q. What were DP&L's credit ratings in 2018 and 2019?

A. DP&L's credit ratings at the end of 2017 were in effect for part of 2018. Those ratings were:

a. On October 27, 2017, S&P Global affirmed its BB- issuer rating for DPL Inc. and DP&L, and switched its outlook from negative to stable.

b. On October 30, 2017, Fitch Ratings upgraded DPL Inc.'s issuer rating from B+ (four notches below investment grade) to BB (two notches below investment grade). Fitch Ratings also upgraded DP&L's issuer rating from BB+ (non-investment grade) to BBB- (the lowest investment grade rating). All outlooks were revised to positive from negative. Among the "Key Rating Drivers" discussed by Fitch Ratings was the fact that "DP&L may apply for an additional two-year extension" of the DMR.

c. On October 31, 2017, Moody's affirmed the DPL Inc. senior unsecured credit rating of Ba3 (two notches below investment grade), and Moody's affirmed DP&L's issuer credit rating of Baa3 (the lowest investment grade rating). Moody's changed the outlook for DPL Inc. and DP&L to positive from negative. Moody's explained that its Rating Rationale was based in part on the fact that the DMR was "subject to an extension for an additional two years."

d. On December 20, 2017, S&P raised the issuer ratings for DPL Inc. and DP&L from BB- (three notches below investment grade) to BB (two notches below investment grade), and placed them on CreditWatch Positive.

In 2018, DP&L's credit ratings changed as follows:

a. On March 30, 2018, S&P Global raised DPL Inc.'s and DP&L's issuer credit rating from BB (non-investment grade) to BBB- (the lowest investment grade rating). S&P stated that the upgrade "assumes that the DMR will be extended."

b. On October 9, 2018, Fitch Ratings upgraded DPL Inc.'s credit rating to BBB- (the lowest investment grade rating) and upgraded DP&L's credit rating to BBB (the second lowest investment grade rating). Its ratings said that "DPL Inc. and DP&L's long-term rating stability will depend on the extension of the Distribution Modernization Rider."

c. On December 17, 2018, Moody's issued separate Credit Opinions for DPL Inc. and DP&L. DPL Inc's credit rating was Ba1 (one notch below investment grade) and DP&L's credit rating was Baa2 (two notches above investment grade). Both Credit Opinions stated that Moody's has an "expectation that the PUCO will approve an extension of the Distribution Modernization Rider."

In 2019, DP&L's credit ratings changed as follows:

a. On June 21, 2019, S&P revised its rating outlook to negative. S&P stated that it could lower its rating if the DMR was modified.

b. On June 27, 2019, Moody's affirmed DP&L credit ratings and changed the outlook to stable from positive. Moody's notes that a downgrade would be considered if the DMR was not extended through 2022.

c. On November 26, 2019, following the Commission's order invalidating the DMR, S&P downgraded DP&L's credit rating to BB (two notches below investment grade); outlook remained negative.

d. On December 20, 2019, Moody's revised DP&L's rating outlook to negative from stable.

e. On December 23, 2019, Fitch downgraded DP&L's credit rating to BBB- (lowest investment grade), with a negative outlook.

Q. What conclusions do you draw from those credit ratings?

A. I draw two principal conclusions.

First, it is very uncommon for a utility to have such poor credit ratings. DP&L had among the lowest credit ratings for a utility in the country during 2018 and 2019. Those low credit ratings demonstrate that DP&L was perceived by the financial community to be a very high-risk utility.

Second, those ratings that precede the Commission's order invalidating the DMR assume that the DMR would continue for its full three-year term and that it would be extended for an additional two years. However, the DMR was terminated before its three-year term had ended, and it was never extended resulting in the ratings of DP&L being downgraded by two of the rating agencies as a direct result with the third revising their outlook to negative. If the credit rating agencies knew in 2018 or earlier in 2019 that the DMR would be terminated early, then DP&L's credit ratings would have been significantly lower.

Q. Why is a 100 basis point adder to the SEET threshold necessary?

A. In 2018 and 2019, DP&L was much riskier than almost any other utility in the country. It is thus necessary to increase the SEET threshold to account for that high level of risk.

III. THE COMMISSION SHOULD NOT ORDER A REFUND DUE TO CAPITAL REQUIREMENTS ASSOCIATED WITH DP&L'S COMMITTED INVESTMENTS

Q. If the Commission were to conclude that DP&L had significantly excessive earnings, what effect would a refund order have on the Company's ability to make needed investments?

A. An order that DP&L must provide refunds to customers would eliminate or significantly restrict DP&L's ability to access the funds needed to implement its planned investments for the benefit of customers. As discussed above, DP&L has future committed investments totaling $939 million over the next five years. The capital that DP&L plans to use to make those investments is to come from three sources: internally generated funds, a planned 2021 AES equity contribution of $150 million (in addition to the $150 million already invested in 2020), and through additional debt financing. If the Commission were to order DP&L to issue a refund, then DP&L's ability to access needed capital would be affected as follows:

1. <u>Funds from operations</u>: DP&L would need to use funds from operations to offset any revenue lost due to making refunds to customers. Those funds thus would not be available for capital investments.

2. <u>AES Equity</u>: Any order requiring DP&L to refund money to its customers would make DP&L significantly more risky than it already is, and it would be unlikely that AES would make the $150 million investment in DP&L in 2021 in that situation.

3. <u>Additional Debt</u>: As <u>mentioned</u> above, DP&L's current credit ratings are as follows:

S & P:	BB+ (one notches below investment grade), developing outlook
Fitch:	BBB- (lowest investment grade rating), negative outlook
Moody's:	Baa2 (one notch above investment grade), negative outlook

Any order requiring DP&L to refund money to customers would have a devastating effect on DP&L's earnings and cash flow, which would cause DP&L's credit ratings to fall to well below investment grade as this would be a negative unexpected outcome. In that situation, it would be unlikely that DP&L could borrow sufficient amounts to fund its committed investments. Even if DP&L could raise the required debt amounts, the terms would likely contain restrictive covenants, have a shorter tenor, and come with a materially higher interest rate comparable to what DP&L as an investment grade utility would be able to achieve. The higher cost of this debt would increase DP&L's overall cost of capital and would ultimately have a negative effect on ratepayers.

Q. In the situation that you describe in the prior answer, would DP&L be able to raise the capital needed to make its future committed investments?

A. No. DP&L would not be able to pursue grid modernization at all. In fact, DP&L would struggle to raise the capital needed to simply maintain its distribution and transmission systems.

Q. Does DP&L have relevant experience issuing debt when its credit rating was below investment grade?

A. Yes. The debt that DP&L issued on August 24, 2016, "Term Loan B" was issued in the junk bond market and included conditions that greatly limited the amount of new debt that DP&L could issue; DP&L could not issue more than $100 million in new debt after its generation assets were transferred, which would not be enough to fund the investments that DP&L plans to make. That debt also contained financial covenants that would not have been required if the debt had been issued in the investment grade bond market. Such restrictions would significantly constrain DP&L's ability to operate and would preclude DP&L from pursuing grid modernization, as DP&L will need to issue debt as part of the plan to finance the needed investments.

Those terms can be compared to the terms of DP&L debt that was issued in 2019 to refinance the Term Loan B. On June 6, 2019, DP&L issued $425M of first mortgage bond, "FMB," debt in the investment grade bond markets once it had achieved investment grade credit ratings following the Commission's October 20, 2017 Opinion and Order in ESP III that approved the DMR. The Term Loan B was variable rate debt that had a term of 5 years. The Term Loan B had an interest rate of 4.49% at the time it was paid off in June

2019 following the issuance of the first mortgage bonds. The FMBs have a term of 30 years and a fixed interest rate of 3.95%. The presence of investment grade credit ratings allowed DP&L to reduce the interest rate on its FMB debt by 54 basis points while also extending the tenor by 25 years in comparison to the Term Loan B. This resulted in $2.7 million savings in interest expense per year.

Q. Are there other reasons that it is important that a utility be strong financially?

A. Yes, some recent events had significant impacts to DP&L's system and its customers, which demonstrate the importance of considering the financial health of the utility.

For example, the historic storm that saw fifteen tornadoes rip through the DP&L service territory in May 2019 provides an example of why a financially healthy utility is important to providing essential services to customers. In order to timely restore transmission and distribution services to customers, DP&L had to have sufficient cash to make $36 million in capital and operational expenditures in a very short-time frame to restore the system. Since most of these costs will not be recovered until a future rate case, DP&L needed to have sufficient liquidity to carry these expenses. It is not certain that a non-investment grade utility would have sufficient liquidity to be able to cover costs like this, let alone carry the costs for an extended period before being able to recover them.

Q. Would customers be harmed if DP&L could not make its committed investments?

A. Yes. The Stipulation in these consolidated cases shows that SmartGrid would provide $413.3 million dollars in net benefits to customers on a net present value basis. Stipulation and Recommendation, Ex. 4. Those net benefits would be lost if the

Commission were to order DP&L to refund a material amount of money to customers; thus, preventing DP&L from executing on its SmartGrid plan. Customers would further suffer from deteriorating reliability due to inadequate investment in DP&L's distribution and transmission systems. Deteriorating reliability has particularly adverse effects on small to medium sized businesses that do not have redundant feeds or back-up service; many of those businesses are already suffering financially.

Q. Do you have an additional recommendation regarding how the Commission should "[c]onsider[] . . . capital requirements of future committed investments in this state" (R.C. 4928.143(F))?

A. Yes. In addition to the recommendation that I made above regarding the AES equity investments, the Commission should consider the fact that any finding that DP&L should issue a refund to customers would make it impossible for DP&L to raise the capital that DP&L would need to invest in its distribution and transmission systems, including grid modernization. The Commission should thus conclude that any such finding would do more harm than good, and that such an order should not be issued.

IV. OTHER ADJUSTMENTS

Q. Can you explain the adjustment for "Loss on Disposition of Retired Assets" that is shown on all of the Schedules?

A. Yes. The Loss on Disposition of Retired Assets adjustment was made for two reasons. First, it is a one-time nonrecurring charge. Second, it is related to retired generation assets and including this loss in 2018 would reduce DP&L's ROE inappropriately if left in. The adjustment is made to add back this loss to both Adjusted Earnings and Equity.

Q. Can you explain the adjustment for "Accrued Penalty in Account 426.3" that is shown on all of the Schedules?

A. Yes. Accrued Penalties have been added back such that any amounts associated with penalties are not benefiting DP&L by reducing the earned return.

Q. Has DP&L included adjustments for "Loss on Disposition of Retired Assets" and "Accrued Penalty in Account 426.3" in past Retrospective SEET cases that have been approved by the Commission?

A. Yes, those adjustments were included in past DP&L SEET cases that have been approved by the Commission, most recently in Case No. 18-873-EL-UNC.

V. <u>CONCLUSION</u>

Q. Can you please provide a summary of your testimony?

A. DP&L passes the Retrospective SEET for 2018 and 2019 irrespective of whether the DMR is included or excluded in DP&L's earnings. The agreement in the Stipulation & Recommendation that DP&L passes the Retrospective SEET for those years was a material component of a comprehensive Stipulation that includes DP&L's SmartGrid plan and provides significant benefits to a path forward for DP&L and its customers.

Q. Does this conclude your direct testimony?

A. Yes, it does.

CERTIFICATE OF SERVICE

I certify that a copy of the foregoing Direct Testimony of Gustavo Garavaglia M.. has been served via electronic mail upon the following counsel of record, this 23rd day of December, 2020:

Steven L. Beeler
Robert A. Eubanks
Thomas G. Lindgren
OFFICE OF THE OHIO ATTORNEY GENERAL
30 E. Broad Street, 16th Floor
Columbus, Ohio 43215
steven.beeler@ohioattorneygeneral.gov
robert.eubanks@ohioattorneygeneral.gov
thomas.lindgren@ohioattorneygeneral.gov

Counsel for Staff of the
Public Utilities Commission of Ohio

Matthew R. Pritchard
Rebekah J. Glover
McNees Wallace & Nurick LLC
21 E. State Street, 17th Floor
Columbus, Ohio 43215
mpritchard@mcneeslaw.com
rglover@mcneeslaw.com

Counsel for Industrial Energy Users-Ohio

Christopher Healey
William J. Michael
Amy Botschner O'Brien
Angela O'Brien
OFFICE OF THE OHIO CONSUMERS' COUNSEL
65 E. State Street, 7th Floor
Columbus, Ohio 43215
christopher.healey@occ.ohio.gov
william.michael@occ.ohio.gov
amy.botschner.obrien@occ.ohio.gov
angela.obrien@occ.ohio.gov

Michael D. Dortch
Justin M. Dortch
KRAVITZ, BROWN & DORTCH, LLC
64 E. State Street, Suite 200
Columbus, Ohio 43215
mdortch@kravitzllc.com
jdortch@kravitzllc.com

Counsel for Office of the
Ohio Consumers' Counsel

Steven D. Lesser
N. Trevor Alexander
Mark T. Keaney
Kari D. Hehmeyer
BENESCH, FRIEDLANDER, COPLAN
& ARONOFF LLP
41 South High Street, Suite 2600
Columbus, OH 43215-6164
slesser@beneschlaw.com
talexander@ beneschlaw.com
mkeaney@beneschlaw.com
khehmeyer@ beneschlaw.com

Counsel for the City of Dayton and Honda of America Mfg., Inc.

Michael L. Kurtz
Kurt J. Boehm
Jody Kyler Cohn
BOEHM, KURTZ & LOWRY
36 East Seventh Street, Suite 1510
Cincinnati, Ohio 45202
mkurtz@BKLlawfirm.com
kboehm@BKLlawfirm.com
jkylercohn@BKLlawfirm.com

Counsel for Ohio Energy Group

Kimberly W. Bojko
CARPENTER LIPPS & LELAND LLP
280 North High Street, Suite 1300
Columbus, Ohio 43215
Bojko@carpenterlipps.com

Counsel for Ohio Manufacturers' Association Energy Group

David C. Rinebolt
OHIO PARTNERS FOR AFFORDABLE ENERGY
P.O. Box 1793
Findlay, Ohio 45839

Counsel for Ohio Partners for Affordable Energy

Devin D. Parram
Dane Stinson
Jhay T. Spottswood
BRICKER & ECKLER LLP
100 South Third Street
Columbus, Ohio 43215-4291
dparram@bricker.com
dstinson@bricker.com
jspottswood@bricker.com

Counsel for The Ohio Hospital Association

Angela Paul Whitfield
CARPENTER LIPPS & LELAND LLP
280 North High Street, Suite 1300
Columbus, Ohio 43215
paul@carpenterlipps.com

Counsel for The Kroger Co.

Stephanie M. Chmiel
Kevin D. Oles
THOMPSON HINE LLP
41 S. High St., Suite 1700
Columbus, Ohio 43215
Stephanie.Chmiel@ThompsonHine.com
Kevin.Oles@ThompsonHine.com

Counsel for University of Dayton

Christine M.T. Pirik
Madeline Fleisher
DICKINSON WRIGHT PLLC
150 E. Gay Street, Suite 2400
Columbus, Ohio 43215
cpirik@dickinsonwright.com
mfleisher@dickinsonwright.com

Counsel for Mission:data Coalition

Madeline Fleisher
DICKINSON WRIGHT PLLC
150 E. Gay Street, Suite 2400
Columbus, Ohio 43215
mfleisher@dickinsonwright.com

Counsel for Smart Thermostat Coalition

Joseph Halso
SIERRA CLUB
ENVIRONMENTAL LAW PROGRAM
1536 Wynkoop Sttreet, Suite 200
Denver, Colorado 80202
joe.halso@sierraclub.org

Richard C. Sahli
RICHARD SAHLI LAW OFFICE, LLC
981 Pinewood Lane
Columbus, Ohio 43230
rsahli@columbus.rr.com

Counsel for Sierra Club

Miranda Leppla
Trent Dougherty
Chris Tavenor
1145 Chesapeake Avenue, Suite I
Columbus, Ohio 43212
mleppla@theoec.org
tdougherty@theoec.org
ctavenor@theoec.org

Counsel for Ohio Environmental Council

Robert Dove
Kegler Brown Hill + Ritter Co., L.P.A.
65 E. State Street, Suite 1800
Columbus, Ohio 43215
rdove@keglerbrown.com

Counsel for Natural Resources Defense Council

Mark A. Whitt
Lucas A. Fykes
WHITT STURTEVANT LLP
88 E. Broad Street, Suite 1590
Columbus, Ohio 43215
whitt@whitt-sturtevant.com
fykes@whitt-sturtevant.com

Counsel for Direct Energy, LP

Michael J. Settineri
Gretchen L. Petrucci
VORYS, SATER, SEYMOUR AND PEASE LLP
52 E. Gay Street
Columbus, Ohio 43215
mjsettineri@vorys.com
glpetrucci@vorys.com

Drew Romig
Armada Power, LLC
230 West Street, Suite 150
Columbus, Ohio 43215
dromig@armadapower.com

Counsel for Armada Power, LLC

Caroline Cox
ENVIRONMENTAL LAW & POLICY CENTER
21 W. Broad St., Suite 800
Columbus, Ohio 43215
ccox@elpc.org

Nikhil Vijaykar
ENVIRONMENTAL LAW & POLICY CENTER
35 E. Wacker Dr. Suite 1600
Chicago, Illinois 60601
nvijaykar@elpc.org

Counsel for Environmental Law & Policy Center

Dylan F. Borchers
Kara H. Herrnstein
Jhay T. Spottswood
BRICKER & ECKLER LLP
100 South Third Street
Columbus, Ohio 43215-4291
dborchers@bricker.com
kherrnstein@bricker.com
jspottswood@bricker.com

Counsel for Chargepoint, Inc.

/s/ Jeffrey S. Sharkey
Jeffrey S. Sharkey

1470122.1