OCC EXHIBIT NO. ______

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

REHEARING REBUTTAL TESTIMONY
OF
MATTHEW I. KAHAL

On Behalf of the
The Office of the Ohio Consumers' Counsel
10 West Broad Street, Suite 1800
Columbus, Ohio 43215-3485

JULY 15, 2016

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Attachments

I. OVERVIEW

Q1. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A1. My name is Matthew I. Kahal. I am employed as an independent consultant retained by the Office of the Ohio Consumers' Counsel ("OCC") to address certain issues in this docket. My business address is 1108 Pheasant Crossing, Charlottesville, VA 22901.

Q2. HAVE YOU PREVIOUSLY SUBMITTED TESTIMONY IN THIS CASE?

A2. Yes. On December 22, 2014, the OCC and NOPEC submitted direct testimony that I prepared that addresses the statutory test for the Electric Security Plan ("ESP") versus the Market Rate Offer ("MRO") alternative. That testimony includes a statement of my qualifications and listing of past testimony. On March 2, 2015, the OCC and NOPEC submitted supplemental testimony that I prepared that evaluated the first stipulation ("First Stipulation") submitted in this docket on December 22, 2014. On December 30, 2015, the OCC and NOPEC submitted my testimony concerning the Third Stipulation, which testimony was labeled Second Supplemental Direct Testimony. On June 22, 2016, I submitted Rehearing Direct Testimony on behalf of the OCC addressing the merits of the proposed Modified Retail Rate Stability Rider ("Rider RRS").

At this time, I am submitting Rehearing Rebuttal Testimony which is prepared on behalf of the OCC.

Q3. WHAT IS THE PURPOSE OF YOUR REHEARING REBUTTAL TESTIMONY?

A3. On May 2, 2016, the three FE Ohio Utilities (Ohio Edison Company, Cleveland Electric Illuminating Company, and the Toledo Edison Company) submitted in this docket an Application for Rehearing contesting several rulings in this Commission's March 31, 2016 Opinion and Order ("The March 31 Order"). Beginning at page 14 of that filing, the FE Utilities submitted a proposed revised version of the Rider RRS. In response, the Staff filed testimony opposing the Modified Rider RRS proposal, and instead proposed an alternative ratemaking initiative. This new Staff proposal is explained primarily in the Rehearing Testimonies of Staff Witnesses Joseph P. Buckley and Hisham M. Choueiki. My Rehearing Rebuttal Testimony critiques this new Staff proposal and explains why that proposal should be rejected as not in the public interest.

Q4. WHAT IS THE STAFF RECOMMENDATION?

A4. As explained by Witness Buckley, Staff is recommending a "Distribution Modernization" Rider as part of ESP IV that addresses and is intended to protect the credit ratings of parent FirstEnergy Corp. ("FE" or "FE Corp"). As he notes, FE is rated Baa(3) by Moody's Investor Service ("Moody's") and BBB- by Standard & Poor's ("S&P"), the lowest investment grade ratings. He believes such improvement (and the avoidance of a downgrade to below investment grade) is in the interest of FE Ohio Utilities' customers. To address this problem, he recommends collecting $131 million per year from customers through this rider for a period of at least three years (about $400 million total).[1] In addition, Mr. Buckley recommends that the Utilities can request an extension of the Staff's proposed plan for an additional two years for a total of five years (about $650 million total assuming the annual collection of $131 million is not modified).[2]

These additional collections from customers were calculated by Witness Buckley as the FE Corp's Ohio Utilities' allocated share (22 percent) of the total amount of cash flow needed for FE Corp to achieve a cash flow from operations to debt ("CFO/Debt") ratio of 14.5 percent.[3] For Staff's proposal to provide the desired outcome (provide credit support for FE Corp) Staff must assume that all other subsidiaries of FE Corp will provide a proportionately similar cash flow increase. Because as previously stated, Mr. Buckley's calculation of $131 million of additional revenue is based on his determination that the FE's Ohio Utilities account for 22 percent of FE consolidated cash, and he implicitly assumes that

[1] Buckley Rehearing Testimony at 3.

[2] Buckley Rehearing Testimony at 7.

[3] Buckley Rehearing Testimony at 3-4.

recent historical experience is representative of what is likely to occur in the future.[4]

Q5. DOES STAFF DEMONSTRATE THAT THE $400 MILLION TO $650 MILLION COLLECTED FROM CUSTOMERS WILL PROVIDE CUSTOMERS WITH COMMENSURATE BENEFITS?

A5. No, there is no such cost/benefit or cost-effectiveness analysis. In fact, there is no convincing demonstration that charging Ohio utility customers $131 million per year for three or more years will protect or improve credit ratings for FE Corp.

Q6. WHAT IS YOUR POSITION REGARDING THIS PROPOSAL TO CHARGE OHIO CUSTOMERS ABOUT $400 TO $650 MILLION TO PROVIDE CREDIT SUPPORT TO FE CORP?

A6. To begin with, I concur with Mr. Buckley that it is an important and appropriate corporate goal for FE Corp to improve its relatively weak credit ratings. However, I strongly disagree with this proposal. It will inappropriately provide FE Ohio Utilities with excessive monopoly profits. The weak credit ratings cited by Witness Buckley are, in fact, the direct result of FE Corp management's own past corporate decisions (and its unregulated operations), and not by Ohio regulation. It is unfair to hold utility customers accountable for those FE Corp

[4] Buckley Rehearing Testimony at 4.

policy decisions and force them to subsidize shareholders and FE Corp's unregulated operations.

Q7. WHAT ARE YOUR PRINCIPAL FINDINGS AND CONCLUSIONS THAT LEAD YOU TO OPPOSE THE STAFF PROPOSAL?

A7. My review and analysis reaches the following findings and conclusions:

1. The weak FE Corp credit ratings are due to a combination of a weak corporate balance sheet and extensive but risky unregulated operations. Measures should be targeted and implemented by FE Corp management to address these core problems. Throwing vast amounts of money, collected from Ohio consumers, at FE Corp is not the answer.
2. Witness Buckley appears to implicitly assume that other FE regulatory jurisdictions and business segments will provide similar enhanced revenue/cash flow support. There is no basis for this assumption, nor is it plausible. For this reason, the Staff proposal may not be effective in protecting or improving the FE Corp credit ratings.
3. The FE Ohio Utilities presently operate and under ESP IV will operate under a very high authorized return on equity ("ROE") for its base rates and the various investment-related rate riders. The Staff proposal therefore is both unneeded and would exacerbate this inequity embedded in consumers' rates.

4. If the Staff proposal succeeds in effecting a credit rating improvement for the FE Ohio Utilities (which seems doubtful), the resulting annual interest expense savings would be modest and would be only a small percentage of the $131 million per year cost to customers.

5. While the FE Corp or issuer credit ratings are lower than desired, the ratings for the three FE Ohio Utilities ' secured debt are at the top end of the triple B range (or higher). These ratings clearly are adequate to issue new debt on reasonable terms, particularly in today's very favorable capital market environment.

6. Neither the FE Ohio Utilities in this docket nor the PUCO Staff have put on a case or made a claim that extraordinary measures are needed to address the FE Corp (or subsidiary) credit ratings. Nor is there evidence in the record that they will be unable to access needed capital on reasonable terms.

Q8. YOU OPPOSE THE STAFF PROPOSAL. DO YOU HAVE AN ALTERNATIVE RECOMMENDATION?

A8. Yes. I urge the Commission to find that protecting and improving the credit ratings are management's responsibility not that of its utility customers. The captive Ohio customers of the FE Ohio Utilities should not be forced to shoulder that responsibility. In that regard, I recommend that the FE Ohio Utilities prepare and file a report with the Commission identifying measures to address this credit rating problem. At a minimum, this should include possible measures to strengthen the FE Corp balance sheet (as needed) and ring-fencing measures to protect the Ohio utilities (and their customers) from parent and affiliate financial and business risks, particularly those of its merchant power plant operations.

II. DISCUSSION OF THE CRITICISMS

Q9. WHAT IS YOUR CONCERN WITH THE PUCO STAFF'S RECOMMENDATION THAT CUSTOMERS FUND CREDIT SUPPORT FOR FE CORP?

A9. The actual "distribution modernization" rider proposal is not explained in detail in the staff testimony. It appears, however, that the proposed annual $131 million annual rate charge to utility customers is not intended to provide recovery of additional utility costs or revenue requirements. If that were the case, then it would not contribute to predicted improvement in the cfo/debt ratio. After all, additional grid investments imply increased debt outstanding. The problem with staff's proposal is that at its core it allocates to captive FE Ohio Utilities' customers a share of the responsibility for the parent's (FE Corp's) financial problems which are not the fault of these customers.

Q10. WILL THE STAFF PROPOSAL ACHIEVE ITS OBJECTIVE?

A10. It seems doubtful. The objective is to support and protect the credit ratings for FE Corp because credit rating agencies (to varying degrees) evaluate credit ratings on a consolidated basis, not stand-alone for the utility subsidiaries. Witness Buckley is targeting a 14.5 CFO/Debt percent ratio and assigning 22 percent of the incremental target cash flow responsibility of the FE Ohio Utilities. This means that to achieve the 14.5 percent ratio, other FE subsidiaries and jurisdictions must account for the other 78 percent.

The problem here is that we have no information suggesting that any other entity within the FE Corp or any "constituents" will similarly contribute to the solution. There is no evidence that any rate or earnings enhancement initiative in other jurisdictions will be forthcoming comparable to the Ohio customer funding Staff has proposed in this case. No such initiative outside of Ohio was identified by witness Buckley, and I am not aware of any. The ability of FE's unregulated operations to contribute greater cash flow will depend to some degree on future energy market conditions which are difficult to predict.

My conclusion is that there is no persuasive reason to believe that the Staff proposal will be effective in supporting the FE Corp credit ratings.

Q11. WILL CUSTOMERS RECEIVE BENEFITS COMMENSURATE WITH THE ROUGHLY $400 TO $650 MILLION IN CHARGES THEY WOULD PAY UNDER THE STAFF PROPOSAL?

A11. No, that is very unlikely. Staff believes that the benefits of its proposal would be an FE Corp credit rating protection or improvement which somehow would improve the Ohio Utilities'cost of accessing capital. However, there has been no demonstration that the FE Utilities will be unable to access capital needed for necessary utility capital investments. In fact, the FE Ohio Utilities are apparently willing to absorb $561 million of losses from the proposed Modified Rider RRS rather than accept Staff's proposal that is intended to provide them with $400 - $655 million cash flow improvement over three to five years. As noted above, it is far from clear that the Staff proposal would succeed in achieving any FE Corp credit rating protection or improvement.

Assume, however, that the Staff proposal succeeds in improving FE Corp's credit ratings by one notch. (Note that an improvement from middle triple B to middle single A is three notches.) Further assume that over a relevant planning horizon the FE Utilities issue $1 billion in new debt to help fund investment (and replace maturing debt), and one notch improvement reduces interest rates by 0.2 percent (20 basis points). When the full $1 billion is issued (which likely would be over a period of several years), this is an interest rate expense savings of $2 million per year—a tiny fraction of the $131 million (or more) ratepayer cost. While those savings would continue beyond the first three to five years, they would remain a small portion of the $400 million to $650 million cost customers are expected to pay under Staff's proposal.

Q12. ARE THE FE OHIO UTILITIES ABLE TO ISSUE NEW LONG-TERM DEBT ON REASONABLE TERMS?

A12. Yes. While they currently have weak corporate or issuer ratings reflecting the FE affiliate problems, the three utilities also have strong, high triple B credit ratings on secured debt (i.e., BBB+ and Baa(1) or higher). These strong credit ratings are documented in the recent Moody's and S&P reports attached to witness Buckley's testimony.

Q13. DO THE WEAK FE CREDIT RATINGS RESULT FROM OHIO REGULATION?

A13. No, not at all. I have reviewed the FE credit rating reports, and those reports make it clear that Ohio regulation is viewed as credit supportive, and the FE Ohio Utilities have very low business risks. Rather, the weak credit ratings for FE are due to management financial decisions and the fortunes (or misfortunes) of its substantial unregulated merchant generation business. Several years ago, FE expanded such business and invested considerable capital with management's decision to acquire Allegheny Energy and its extensive coal generation.

Q14. PLEASE EXPLAIN YOUR CONCERN WITH FE FINANCIAL DECISIONS.

A14. Attachment A to this testimony includes the FE balance sheet data for December 31, 2013, 2014, and 2015. It also includes Key Financial Statistics for FE, with both documents provided by Yahoo!Finance.com on July 12, 2016.

The December 31, 2015 balance sheet for FE, which is under management's control, is quite weak. It shows total debt (inclusive of $3.0 billion of short-term debt) of $22.4 billion, and common equity of $12.42 billion. This is a very weak 36 percent equity ratio.[5] Excluding short-term debt, the equity ratio increases to only 39 percent. This is well below the target equity ratio for a typical electric utility and partly explains the weak credit ratings. Moreover, it appears that the FE Corp balance sheet has actually weakened between 2013 and 2015, which is a disturbing trend.

A closer inspection of the 2015 balance sheet reveals further trouble. About half of the $12.4 billion of common equity ($6.4 billion) is represented by "Goodwill" which is a non-cash accounting write-up. It represents for FE the premiums over market that it paid in connection with past mergers such as the Allegheny Energy and GPU acquisitions. It does not represent assets like plant and equipment that are part of a utility's rate base and that generate cash flow. FE's equity ratio excluding the non-cash Goodwill is only in the 20 to 25 percent range, which

[5] Please note that about $800 million of FE debt is securitized. Removing this debt slightly improves the equity ratio.

clearly is inadequate. It appears that FE consolidated is a badly undercapitalized corporation.

Customers should not be punished and be held accountable for FE management decisions, its unregulated operations, and past mergers.

Q15. WHAT DO THE KEY STATISTICS REVEAL?

A15. They show a market share price for FE of $36.11 and a book value per share of $29.34. Thus, FE shares sell at a healthy premium to book value. This suggests that FE has the capability to strengthen its balance sheet through equity share sales.

Q16. IN YOUR OPINION, WOULD THE STAFF PROPOSAL REQUIRE CUSTOMERS TO SUBSIDIZE SHAREHOLDERS?

A16. Yes, it would. While the intent of the Staff proposal is one of protecting the FE corporate credit ratings, it does so by increasing shareholder profits. This proposal also has the effect of utility customers subsidizing FE unregulated operations as those operations share in the benefit of improved or protected credit ratings. Even if it does not achieve the credit rating improvement objective, the Staff proposal would have the effect of increasing FE Corp profits, making more cash available to pay increased dividends to shareholders.

Staff's proposal to protect FE Corp's credit ratings with ratepayer funds also benefits merchant plant operations through reduced collateral requirements. I show the FE collateral exposure, utility and non-utility, with an excerpt from an FE management presentation on the second page of my Attachment B. (Source: FE 1st quarter earnings call, April 27, 2016.) This presentation shows a total collateral exposure of up to $406 million with the vast majority (about 90 percent) being non-utility. Collateral posting is a normal practice and business expense in unregulated energy markets as a way of providing counter party financial protection. This cost, however, is often linked to the credit ratings of the market participants. Hence, protection or improvement of the FE credit ratings provides an important and tangible benefit to the unregulated operations, providing an expense savings (or even the avoidance of contract default if collateral cannot be posted as required). This is simply another form of utility customer subsidy of the non regulated operations under the Staff proposal.

That said, I share Staff's goal of protecting the credit ratings, but I believe that is best done by FE management actions and not subsidized earnings through either Rider RRS or the Distribution Modernization Rider proposal. Achieving this goal is FE management's responsibility. I have already mentioned the need for FE management to strengthen the balance sheet. Management should also be required to explore the ring fencing of the FE Ohio Utilities to protect them (and their customers) from the risky unregulated merchant plant operations and the parent financial policies.

Q17. WHY DO YOU BELIEVE THAT RING FENCING MAY HELP PROTECT THE FE OHIO UTILITIES AND THEIR CUSTOMERS

A17. Credit-rating agencies are concerned with the potential for bond holder losses due to default and bankruptcy. It is for this reason that S&P and Moody's are concerned with affiliate risk issues when assigning ratings to the FE Ohio Utilities, and this is why they employ a consolidation criterion. It is possible to address this problem by putting in place structural separation measures that can help protect the FE Ohio Utilities from such affiliate and parent financial and bankruptcy risk. Such measures (if needed) would be far less expensive than the $400 million to $650 million customer cost recommended by witness Buckley.

Q18. ARE YOU RECOMMENDING RING FENCING STRUCTURAL SEPARATION AT THIS TIME?

A18. No, that would be premature. I am merely identifying ring fencing as a low-cost option to address the problem. As an alternative to witness Buckley's proposal, I recommend that the FE Ohio Utilities conduct a study of the costs and benefits of protective ring fencing measures for this Commission's consideration. I note that another FirstEnergy electric utility regulator, the New Jersey Board of Public Utilities, required such a study in its most recent rate case order for Jersey Central Power and Light Company (BPU Docket No. ER12111052).

Q19. DOES THIS CONCLUDE YOUR REHEARING REBUTTAL TESTIMONY?

A19. Yes, it does. However, I reserve my right to update or revise my testimony based on the availability of pertinent new information.

CERTIFICATE OF SERVICE

I hereby certify that a true copy of the foregoing *Rehearing Rebuttal Testimony of Matthew I. Kahal, on Behalf of the Office of the Ohio Consumers' Counsel* was served via electronic transmission this 15th day of July 2016 upon the parties below.

/s/ Larry S. Sauer
Larry S. Sauer
Deputy Consumers' Counsel

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FirstEnergy Corp. (FE) - NYSE ★ **Watchlist**

36.11 ↑0.09(0.25%) Jul 11, 4:01PM EDT

Balance Sheet

Get Balance Sheet for: GO

View: **Annual Data** | Quarterly Data

All numbers in thousands

Period Ending	Dec 31, 2015	Dec 31, 2014	Dec 31, 2013
Assets			
Current Assets			
Cash And Cash Equivalents	131,000	85,000	218,000
Short Term Investments	-	-	-
Net Receivables	1,595,000	1,779,000	2,284,000
Inventory	785,000	817,000	752,000
Other Current Assets	529,000	677,000	759,000
Total Current Assets	**3,040,000**	**3,358,000**	**4,013,000**
Long Term Investments	2,788,000	3,222,000	3,104,000
Property Plant and Equipment	37,214,000	35,783,000	33,487,000
Goodwill	6,418,000	6,418,000	6,418,000
Intangible Assets	-	-	-
Accumulated Amortization	-	-	-
Other Assets	1,348,000	1,411,000	1,854,000
Deferred Long Term Asset Charges	1,379,000	1,456,000	1,548,000
Total Assets	**52,187,000**	**51,648,000**	**50,424,000**
Liabilities			
Current Liabilities			
Accounts Payable	1,928,000	2,098,000	2,086,000
Short/Current Long Term Debt	2,980,000	2,770,000	4,930,000
Other Current Liabilities	694,000	693,000	621,000
Total Current Liabilities	**5,602,000**	**5,561,000**	**7,637,000**
Long Term Debt	19,389,000	19,393,000	16,121,000
Other Liabilities	7,210,000	6,909,000	6,145,000
Deferred Long Term Liability Charges	7,564,000	7,363,000	7,826,000
Minority Interest	1,000	2,000	3,000
Negative Goodwill	-	-	-
Total Liabilities	**39,766,000**	**39,228,000**	**37,732,000**
Stockholders' Equity			
Misc Stocks Options Warrants	-	-	-
Redeemable Preferred Stock	-	-	-
Preferred Stock	-	-	-
Common Stock	42,000	42,000	42,000
Retained Earnings	2,256,000	2,285,000	2,590,000
Treasury Stock	-	-	-
Capital Surplus	9,952,000	9,847,000	9,776,000
Other Stockholder Equity	171,000	246,000	284,000
Total Stockholder Equity	**12,421,000**	**12,420,000**	**12,692,000**
Net Tangible Assets	**6,003,000**	**6,002,000**	**6,274,000**

Currency in USD.

FirstEnergy Corp. (FE) - NYSE ★ Watchlist

36.11 ↑0.09(0.25%) Jul 11, 4:01PM EDT

Key Statistics

Get Key Statistics for: GO

Data provided by Capital IQ, except where noted.

Valuation Measures	
Market Cap (intraday)[5]:	15.34B
Enterprise Value (Jul 12, 2016)[3]:	37.55B
Trailing P/E (ttm, intraday):	22.40
Forward P/E (fye Dec 31, 2017)[1]:	14.27
PEG Ratio (5 yr expected)[1]:	-5.37
Price/Sales (ttm):	1.05
Price/Book (mrq):	1.23
Enterprise Value/Revenue (ttm)[3]:	2.57
Enterprise Value/EBITDA (ttm)[6]:	9.19

Financial Highlights	
Fiscal Year	
Fiscal Year Ends:	Dec 31
Most Recent Quarter (mrq):	Mar 31, 2016
Profitability	
Profit Margin (ttm):	4.69%
Operating Margin (ttm):	17.25%
Management Effectiveness	
Return on Assets (ttm):	2.99%
Return on Equity (ttm):	5.51%
Income Statement	
Revenue (ttm):	14.59B
Revenue Per Share (ttm):	34.51
Qtrly Revenue Growth (yoy):	-0.50%
Gross Profit (ttm):	8.85B
EBITDA (ttm)[6]:	4.08B
Net Income Avl to Common (ttm):	684.00M
Diluted EPS (ttm):	1.61
Qtrly Earnings Growth (yoy):	47.70%
Balance Sheet	
Total Cash (mrq):	146.00M
Total Cash Per Share (mrq):	0.34
Total Debt (mrq):	22.36B
Total Debt/Equity (mrq):	179.38
Current Ratio (mrq):	0.51
Book Value Per Share (mrq):	29.34
Cash Flow Statement	
Operating Cash Flow (ttm):	3.89B
Levered Free Cash Flow (ttm):	721.25M

View Financials
Income Statement - Balance Sheet - Cash Flow

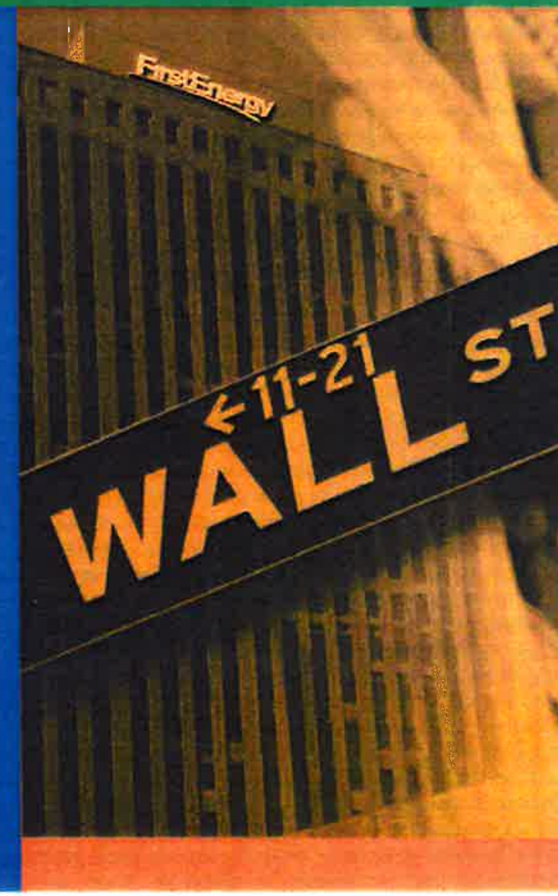
Trading Information	
Stock Price History	
Beta:	0.26
52-Week Change[3]:	7.41%
S&P500 52-Week Change[3]:	1.79%
52-Week High (Mar 30, 2016)[3]:	36.54
52-Week Low (Nov 9, 2015)[3]:	28.89
50-Day Moving Average[3]:	33.80
200-Day Moving Average[3]:	33.79
Share Statistics	
Avg Vol (3 month)[3]:	4,161,700
Avg Vol (10 day)[3]:	3,396,680
Shares Outstanding[5]:	424.71M
Float:	423.54M
% Held by Insiders[1]:	16.18%
% Held by Institutions[1]:	61.30%
Shares Short (as of Jun 15, 2016)[3]:	8.29M
Short Ratio (as of Jun 15, 2016)[3]:	2.63
Short % of Float (as of Jun 15, 2016)[3]:	2.26%
Shares Short (prior month)[3]:	6.93M
Dividends & Splits	
Forward Annual Dividend Rate[4]:	1.44
Forward Annual Dividend Yield[4]:	4.00%
Trailing Annual Dividend Yield[3]:	1.44
Trailing Annual Dividend Yield[3]:	4.00%
5 Year Average Dividend Yield[4]:	4.82%
Payout Ratio[4]:	89.42%

FirstEnergy

Quarterly HighLIGHTS
1Q 2016 Earnings Call

Charles E. Jones, President and CEO
James F. Pearson, EVP and CFO

April 27, 2016



Financial –
Collateral Dependent on Investment Grade Rating

($M)

Collateral Provisions As of March 31, 2016	FES/AE Supply (Tied to FE Corp. Rating)	FES/AE Supply (Tied to FES Rating)	Utilities	Total
Split Rating (One Rating Agency below investment grade)	$25*	$173	$40	$238
Non-Investment Grade Ratings (All Rating Agencies at or below BB+/Ba1)	$25	$200	$40	$265
Total Exposure from Contractual Obligations	$25	$341	$40	$406

*Exists due to FE Corp.'s current Unsecured Rating of BB+ by Standard & Poors

Note: Surety Bonds (not tied to a rating) of $283M and $94M exist at FES and Utilities, respectively. Surety Bonds impact assumes maximum contractual obligations (typical obligations require 30 days to cure).