BEFORE THE

PUBLIC UTILITIES COMMISSION OF OHIO

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

Direct Testimony and Exhibits of

Christopher C. Walters

On behalf of

Sierra Club

Public Version

November 21, 2016

BRUBAKER & ASSOCIATES, INC.

Project 10330

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Table of Contents for the
Direct Testimony of Christopher C. Walters

List of Exhibits:

Exhibit CCW-1:	DP& L's Historical and Projected Credit Metrics
Exhibit CCW-2:	AES Acquisition on DPL's Financial Strength
Exhibit CCW-3:	Edison Electric Institute, "2015 Financial Review" (excerpt)
CONFIDENTIAL Exhibit CCW-4:	*Moody's Investors Service:* "Credit Opinion: Dayton Power & Light Company", August 11, 2016
CONFIDENTIAL Exhibit CCW-5:	*Standard & Poor's Global Credit Portal RatingsDirect*: "DPL Inc.," April 20, 2011
CONFIDENTIAL Exhibit CCW-6:	*Standard & Poor's Global Credit Portal RatingsDirect*: "Research Update: DPL Inc., Subsidiary Dayton Power & Light Downgraded To 'BBB-' From 'A-'; Outlooks Stable."
CONFIDENTIAL Exhibit CCW-7:	*Standard & Poor's RatingsDirect*: "Research Update: S&PCORRECT: DPL Inc., Dayton Power & Light Co. Lowered To 'BB' From 'BBB-'; Debt Ratings Also Cut; Outlook Stable," November 8, 2012
CONFIDENTIAL Exhibit CCW-8:	*Standard & Poor's RatingsDirect*: "S&P Global Ratings Tearsheet: DPL Inc." Accessed November 16, 2016

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Direct Testimony of Christopher C. Walters

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A Christopher C. Walters. My business address is 16690 Swingley Ridge Road, Suite 140, Chesterfield, Missouri 63017.

Q WHAT IS YOUR OCCUPATION?

A I am a Consultant in the field of public utility regulation of Brubaker & Associates, Inc., energy, economic, and regulatory consultants.

Q PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.

A This information is included in Appendix A to my testimony.

Q ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?

A I am appearing on behalf of Sierra Club.

Q WHAT IS THE SUBJECT OF YOUR DIRECT TESTIMONY?

A My testimony will address Dayton Power & Light Company's ("DP&L" or the "Company") claimed need for a non-bypassable Distribution Modernization Rider ("DMR") in its Electric Security Plan ("ESP") covering 2017 through 2023.

I. Summary

Q PLEASE SUMMARIZE YOUR TESTIMONY.

A The Commission should reject the proposed DMR. DP&L's proposed DMR is not used to fund distribution modernization investments. Rather it is meant to improve the financial strength of DP&L's immediate parent company, DPL. Most of DPL's financial woes and credit-related issues are directly related to AES's acquisition of DPL/DP&L five years ago. DPL's balance sheet doubled in size after the transaction because of acquisition related debt and a goodwill asset resulting from the acquisition price. DPL has subsequently written down the goodwill asset causing a negative retained earnings deficit. The Commission should not obligate DP&L's retail customers to pay through retail rates to financially strengthen its non-regulated parent company.

My testimony shows that the proposed DMR unnecessarily increases the costs to retail ratepayers now and in the future. Additionally, DP&L has not provided any customer protection or guaranteed benefits to justify its more than $1 billion request. Not only is there a lack of protections and guaranteed benefits, DP&L is authority to actually erode customer protections by excluding the DMR cash flows from the significantly excessive earnings test.

The Commission should reject the DMR. However, should the Commission approve the seven year ESP with the proposed DMR, it should do so conditionally. The conditions are set forth below.

II. The DMR as Proposed Does Not Fund Distribution Modernization Investments

Q PLEASE SUMMARIZE DP&L'S PROPOSED DISTRIBUTION MODERNIZATION RIDER.

A DP&L is requesting to collect $145 million per year through a non-bypassable DMR, without true-up, or a total of $1.015 billion over the seven year effective period. Company witness Jackson stated that the funds from the DMR will be used to: (a) pay interest obligations on existing debt at DPL Inc. ("DPL") and DP&L; (b) make discretionary debt prepayments at DPL & DP&L; (c) allow DP&L to make capital expenditures to modernize and/or maintain the Company's transmission and distribution infrastructure. Jackson Supp. Test. at pg. 12-13.

As proposed, the DMR is a plan to have ratepayers pay money to reduce debt at DP&L by approximately [redacted] and at DPL by [redacted]. In total, the DMR is designed to fund approximately [redacted] of debt reduction on a consolidated DPL basis which is about [redacted] of the planned DMR revenues. How DP&L would use the remaining [redacted] of the DMR cash flows is unclear.

Q UNDER THE PROPOSED DMR, HOW WILL DP&L USE THE FUNDS IT WOULD COLLECT TO FUND DEBT REDUCTIONS AT DPL?

A Under the Company's proposal and projections, DP&L will dividend DPL over [redacted] in cash payments over the proposed seven year ESP period. DPL will then use these dividend payments from the regulated utility to pay down debt at the unregulated holding company parent. The projections show, and Mr. Jackson explains, that DPL will be paying down approximately [redacted] in DPL specific debt. The dividends being pulled from the regulated utility represent approximately [redacted] of the debt pay down at DPL.

It is not explained where DPL will get the additional funds to pay down the remaining [redacted] in DPL debt although the Company's projections expect significant amounts of additional funding via forgiven taxes that DPL would otherwise pay to AES. [1] The primary driver of these taxes is DP&L's taxable income as only approximately 4% of DPL's consolidated revenues are produced by other affiliates.

Q WILL THESE DIVIDEND PAYMENTS IMPACT DP&L'S REGULATED RETAIL COST STRUCTURE?

A Yes, the projections call for DP&L to dividend up to DPL over [redacted] of its earnings, including the after-tax net income associated with DMR revenues over the seven year ESP period. During this time, DP&L would also reduce its outstanding debt while its rate base is growing. Mr. Jackson's projections show that DP&L's long-term debt as a ratio of total long-term debt and equity capital (including preferred stock) will decline from approximately [redacted] in 2017 to approximately [redacted] in 2023.

[1] See Jackson Supp. Test. at pg 12 and Malinak Supp. Test., Exh. RJM-10.

Correspondingly, DP&L's common equity ratio will increase from approximately [redacted] in 2017 and increasing materially to approximately [redacted] in 2023.

Common equity is the most expensive form of capital available to a utility. Significantly modifying DP&L's capital structure from being a reasonably mixed balance sheet to an equity-thick balance sheet will significantly increase DP&L's cost of capital, related income tax expense, and cost of service. In turn, this increased cost of service will unnecessarily increase rates charged to regulated retail customers.

Q IS THE PROPOSED DMR EXPECTED TO PROVIDE REGULATED RATE REVENUES TO RECOVER THE INVESTMENT COSTS OF DP&L'S REGULATED COST OF SERVICE?

A No. As proposed, the DMR annual revenue requirement is not based on recovery of DP&L's electric distribution cost of service. Rather, the DMR revenue requirement is based on a target funds from operations ("FFO") ratio that will produce enough cash flow to retire debt at DPL, and improve the FFO-to-debt ratio of DPL to an investment grade benchmark for this credit metric – FFO-to-debt.

Q DOES DP&L NEED THE DMR REVENUE TO FUND ITS PROJECTED CAPITAL EXPENDITURES DURING THE TERM OF THE DMR?

A No. DP&L's projected cash flow, excluding the DMR revenue, is adequate to fund a significant portion of DP&L's capital expenditures and fund debt retirements provided DP&L continues to use a reasonable mix of debt and equity capital to fund utility rate base investments. Rather, the DMR revenue is needed to fund DPL's targeted debt reductions and FFO/Debt improvement.

Q PLEASE EXPLAIN.

A DP&L's operations are expected to produce more than [redacted] in cash flow over the proposed seven year ESP. [2] During the same time period, DP&L is expected to invest approximately [redacted]. Funding the [redacted] in capital expenditures with a balanced amount of debt and internal cash flows should provide DP&L the financial flexibility to build up its retained earnings balance, maintain a balanced capital structure while investing in utility plant and equipment, and resume dividend payments to DPL.

Q IS THE DMR NEEDED TO RESTORE INVESTMENT GRADE CREDIT METRICS AT DP&L?

A Not based on the company's financial projections. The financial metrics excluding the DMR show that the implied Moody's rating ranges from A3 to Aa3 during the seven year ESP period. [3] A rating within that range is a very strong investment grade rating, and consistent with, or even stronger than electric utility industry average ratings. As explained in the Edison Electric Institute's 2015 Financial Review, the average credit rating for electric utilities is BBB+ (equivalent to a Moody's rating of Baa1). [4]

Additionally, according to the most recent summary analysis report for DP&L, S&P indicated that DP&L's standalone credit rating is 'BBB+', a strong investment grade rating. The DMR revenue is not needed at DP&L, but rather, the DMR revenue is needed to restore credit metrics at DPL.

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[2] *See* Malinak Supp. Test, Exh. RJM-16C.
[3] *See* Malinak Supp. Test, Exhibit RJM-3.
[4] See Exhibit CCW-3, Edison Electric Institute, "2015 Financial Review," page 71.

Q SHOULD THE COMMISSION REQUIRE DP&L'S REGULATED RETAIL CUSTOMERS TO PAY FOR THE REDUCTION OF DPL'S DEBT THROUGH THE PROPOSED DMR ?

A No, the Commission should only obligate DP&L's customers to pay rates that fully reflect DP&L's reasonable and prudent cost of providing utility service. The Commission should not obligate regulated customers to pay over $1 billion in DMR charges to fund debt reductions at DPL.

Q HAS THE COMPANY SHOWN THAT THE DEBT AT DPL RELATES TO THE COST OF PROVIDING UTILITY SERVICE AT DP&L?

A No. The Company has not shown that DPL's debt reflects DP&L's cost of providing utility service. DPL is DP&L's immediate parent company. Besides DP&L, DPL's other significant subsidiaries include AES Ohio Generation, which owns and operates peaking generating facilities from which it sells all of its energy and capacity into the wholesale market, MVIC, a captive insurance company that provides insurance services to DPL and its subsidiaries, and DPL Capital Trust II, a wholly owned business trust, which was formed to issue trust capital securities to investors. See Malinak Supp. Test. at pg. 23. These other subsidiaries account for about 4% of DPL's consolidated revenues, which support approximately 60% of DPL's consolidated debt.

Additionally, DPL's debt may have been used to fund its equity investment in DP&L, but importantly DPL's capitalization funds other investments. For example, DPL could have issued debt and provided a capital infusion to its unregulated subsidiaries. Another source of cash flow for DPL to infuse the other subsidiaries with is provided in the form of DP&L's dividends to DPL. DPL's debt is not related to the cost of providing electric distribution utility service. The cost of providing utility service is based on DP&L's costs, not those of DPL. Hence, DP&L's regulated retail customers should not be obligated to pay the debt service on debt used to fund non-utility plant and equipment.

Further, as I will explain later in this testimony, DPL's financial distress originated at the time AES acquired DPL's stock. As explained above and further below, DPL's excessive debt is not related to the cost of providing utility service.

III. There Are Several Other Concerns With The DMR As It Is Proposed.

Q ARE THERE ANY OTHER CONCERNS WITH THE REASONABLENESS OF THE PROPOSED DMR PLAN?

A Yes, there are several. First, the projected debt retirement at DP&L will result in an over-weighted equity utility capital structure. This proposed change to DP&L's capital structure is not reasonable and will unjustifiably inflate the utility's cost of service and retail rates.

Second, if it were appropriate to charge regulated customers for debt reduction at DPL, which I believe it is not, the planned debt reduction at DPL is not likely to improve either DPL or DP&L's credit rating without substantial ring-fencing separations. Hence, as I will explain throughout the balance of my testimony, the proposed DMR plan is not likely to reduce DP&L's cost of capital or improve its access to capital to fund its utility infrastructure and working capital obligations. Hence, the DMR has significant costs while running a substantial risk of not producing meaningful or quantifiable net benefits to DP&L's retail customers.

Third, there is a lack of customer protections and guarantees in the Company's plan to reduce debt at the unregulated parent, DPL. In fact, the Company even proposes to exclude the DMR cash flows from a mechanism currently in place to protect customers. As explained later, this is a material erosion of customer protections, especially considering the lack of guaranteed benefits under the proposed DMR.

Fourth, the Commission's Order approving the Stipulation and Agreement in the AES acquisition proceeding prohibits DP&L from having a negative retained earnings balance.[5] As of its most recent SEC 10-Q filing for the period ending September 30, 2016, DP&L has a negative retained earnings balance of ($31.2) million. It is not clear that the DPL debt reduction plan is allowed at this time because of the Company's commitment to maintain a positive retained earnings balance.

Fifth, with or without the proposed DMR, DPL services its debt obligations almost exclusively with cash flow from DP&L. That is because, all of DPL's other subsidiaries combined only produce approximately 4% of DPL's consolidated revenues in 2015.[6] DP&L's share of DPL's [redacted] consolidated interest expense,[7] is approximately [redacted] (Exhibit RJM-17A) in 2017. This leaves about [redacted] of interest expense to be covered by DPL and its other affiliates. Including the DMR revenues, DP&L is projected to account for [redacted] (Exhibit RJM-17A) of DPL's [redacted] in consolidated revenues (Exhibit RJM-15A). This leaves the other affiliates accounting for approximately [redacted] of DPL's consolidated revenues. DPL's consolidated cash flow from operations in 2017 is approximately [redacted]. DP&L is approximately [redacted] of that cash flow, or [redacted] in 2017. Assuming the remaining [redacted] of DPL's consolidated cash flow comes from the other affiliates, it will not be enough to cover the remaining interest expense at DPL.

[5] Finding and Order, Case No. 11-3002-EL-MER, dated November 22, 2011.
[6] *See* Malinak Supp. Test. at pg. 23.
[7] *See* Malinak Supp. Test., Exh. RJM-15A.

Q PLEASE DESCRIBE THE IMPACT ON DP&L'S CAPITAL STRUCTURE UNDER THE PROPOSED DMR.

A Mr. Jackson's projections show that DP&L's common equity ratio will increase from approximately [redacted] in 2017 to approximately [redacted] in 2023. This significant change in DP&L's projected capital structure comes at a time of rate base growth. Should DP&L actually achieve this projected capital structure, and should the PUCO authorize a rate of return based on DP&L's actual capital structure, it would be the highest common equity ratio in the regulated electric utility industry as far as I am aware.

Q WHY IS A CAPITAL STRUCTURE WITH AN EXCESSIVE EQUITY RATIO NOT REASONABLE?

A A capital structure too heavily weighted with common equity would unnecessarily increase DP&L's claimed revenue deficiencies in future rate cases because common equity is the most expensive form of capital and is subject to income tax expense. For example, if DP&L's authorized return on equity is set at 9.0%, the revenue requirement cost to customers would be approximately 14.0%, or 9.0% adjusted by a tax revenue conversion factor of approximately 1.56x. In contrast, the cost of debt capital is not subject to an income tax expense. DP&L's current embedded cost of debt is around 5.3%. Common equity is more than twice as expensive on a revenue requirement basis as debt capital.

A reasonable mix of debt and equity is necessary in order to balance DP&L's financial risk, support an investment grade credit rating, and permit DP&L access to capital under reasonable terms and prices. However, a capital structure too heavily weighted with common equity will unnecessarily increase its cost of capital and revenue requirement for ratepayers in future rate proceedings.

Q HAS DP&L COMMITTED TO NOT REQUEST RATEMAKING TREATMENT OF ITS PROJECTED CAPITAL STRUCTURE IN FUTURE RATE CASES?

A No, it has not. As I understand DP&L's filing, it has not proposed a ceiling, or a maximum, allowable common equity ratio that it would use in future rate cases. If DP&L were to actually achieve its targeted capital structure by 2023, and request ratemaking treatment with that capital structure, retail customers will unnecessarily have to pay significantly higher costs of capital because of DP&L's imprudent mix of capital.

Q CAN YOU QUANTIFY HOW MUCH OF A POTENTIAL IMPACT THIS CAPITAL STRUCTURE CAN HAVE ON RETAIL RATES FOR DP&L'S CUSTOMERS?

A Yes. In its most recent rate case proceeding, DP&L has requested an overall rate of return of 7.86%. This rate of return is based on a capital structure consisting of 47.8% / 2.2% / 50.0% long-term debt / preferred stock / common equity, respectively. Assuming the same cost of capital rates shown on page 2 of Mr. Jackson's Exhibit CLJ-7 apply in 2023, modifying DP&L's capital structure from what it has requested in its most recent rate case to the projected capital structure at the end of 2023, will increase retail rates by approximately $2.2 million for every $100 million in rate base. The rate base shown in DP&L's most recent rate case application is approximately $683.8 million. Hence, if the projected 2023 capital structure applied, DP&L's claimed revenue requirement would be increased by an additional $15.0 million, or $80.8 million total revenue deficiency.

Q PLEASE EXPLAIN WHY IMPROVEMENTS TO DPL AND DP&L CREDIT METRICS WILL PROBABLY NOT IMPROVE THEIR CREDIT RATINGS.

A The credit rating of DPL and DP&L are closely aligned with their ultimate parent company, AES Corp. ("AES"). Like DPL, AES is a highly leveraged company with weak credit. Without an improvement to AES' credit rating or a ring fence separation component , which separates the cash flows and credit rating of DP&L from both DPL and AES, improvements to DPL's credit metrics without improvement to AES' credit standing will not likely lead to an improved credit rating at DP&L.

Q UNDER THE PROPOSED DMR PLAN, WILL THE IMPROVEMENT TO DPL'S CREDIT METRICS ALONE PRODUCE BENEFITS TO DP&L'S RETAIL CUSTOMERS?

A No. The Company has not proposed any ring-fence or legal separation, protections that will isolate DP&L's cash flows from DPL and other affiliates of DP&L. There is no guarantee that the DMR will provide DP&L the opportunity to access capital markets at reasonable terms and prices. There is no guarantee that DP&L will prudently enhance, or modernize, its distribution infrastructure. There are no guaranteed benefits that DP&L's retail customers will experience as a result of the DMR. Rather, DP&L is requesting that its retail customers provide it with funds in excess of $1 billion to mostly pay down debt to *potentially* allow both companies to achieve investment-grade credit ratings by strengthening both balance sheets and cash flows which will *potentially* allow both companies to access the capital markets to *potentially* invest in modernizing its distribution infrastructure. All of the above-mentioned customer protections, which are currently lacking from DP&L's application, are warranted and necessary for the proposed DMR to potentially make any sense.

Q IS THE COMPANY PROPOSING TO EXCLUDE THE DMR CASH FLOWS FROM CUSTOMER PROTECTING MECHANISMS?

A Yes. DP&L is requesting authority to exclude the cash flows from the DMR from the Significantly Excessive Earnings Test ("SEET"). Mr. Jackson explains that if the DMR funds were subject to the SEET, there would be no assurance that these funds would be available to (a) refinance and/or retire debt, (b) make interest payments due on its debt, and/or (c) recapitalize its balance sheet and ensure the long-term viability of DPL and DP&L. Mr. Jackson goes on to contend that DP&L's financial stability and its ability to fund future investments is dependent on the financial strength of its parent DPL.

Q DO YOU AGREE WITH DP&L'S REQUEST TO EXCLUDE THE DMR FUNDS FROM THE SEET?

A No, I do not.

Q PLEASE EXPLAIN.

A DP&L is requesting regulated retail customers fund a plan to reduce debt at the unregulated parent, DPL. The Commission should not require retail customers to pay for non-regulated entities' debt, such as DPL's debt. This is particularly true if the Company is not providing any protections and guarantees, such as ring-fence separations between DPL and DP&L. However, not only is there no guaranteed benefit or additional protections provided for regulated retail customers, DP&L is requesting to remove more than $1 billion of revenues, and the associated earnings, funded by regulated retail customers from the currently existing customer protecting mechanism, SEET. Such a request is without merit and harmful to ratepayers.

Q DO YOU AGREE WITH MR. JACKSON'S REASONING FOR DP&L'S REQUEST TO EXCLUDE THE DMR FUNDS FROM THE SEET?

A No, I do not. Mr. Jackson's assertion that DP&L's financial stability and ability to access the debt capital markets is dependent on DPL's financial strength is without merit and the Commission should disregard it. Both S&P and Moody's make it abundantly clear that, on a standalone basis, DP&L is financially strong based on both historical and projected credit metrics. In Exhibit CCW-1, I provide the credit metrics on a historical basis from both S&P and Moody's for DP&L. I also provide the metrics forecasted by Moody's.

The credit metrics measured by both agencies show that DP&L, on a standalone basis, can support a strong investment grade corporate credit rating. A significant reason DP&L's actual ratings are not reflective of its standalone creditworthiness is due to the lack of meaningful ring-fencing separations. If sufficient ring-fence separations were in place between DPL and DP&L, DP&L's ratings would likely be higher than where they currently stand.

Moody's does note that DP&L's balance sheet will become highly leveraged should the Federal Energy Regulatory Commission approve the proposal to transfer ownership of its generation assets. As proposed, DP&L will transfer ownership of its generation assets to AES Ohio Generation but leave all associated debt at DP&L. [8] Under this proposal, regulated retail ratepayers will be obligated to pay rates to

[8] *See* CONFIDENTIAL Exhibit CCW-4, *Moody's Investors Service:* "Credit Opinion: Dayton Power & Light Company", August 11, 2016, at page 5.

service any debt that would be associated with the assets of an unregulated subsidiary of DPL.

Q WHAT DO YOU CONCLUDE?

A The DMR is not a distribution modernization rider. Rather it is a debt reduction and financial recovery plan for DPL. Moreover, it is unlikely to deliver any financial benefits even to DPL as there is inadequate ring fencing with its financially distressed parent company, AES. AES committing to not taking dividends or tax sharing payments from DPL does not constitute ring-fencing provisions since management at AES has the discretion to take that cash out of DPL. The Company has not provided any justification for charging customers more than $1 billion over seven years to reduce debt at DPL and restore its financial standing.

Finally, it appears that, as of now, DP&L would be unable to implement this strategy even if the Commission approved it because of its negative retained earnings balance and the terms DP&L/AES transaction and the Commission order regarding this transaction.

IV. <u>DPL Is A Highly Leveraged Company As A Result Of The AES Transaction.</u>

Q PLEASE DESCRIBE DPL.

A DPL is an indirect wholly-owned subsidiary of AES. DPL’s only reportable business segment is DP&L, the regulated electric utility. DPL’s other significant subsidiaries include AES Ohio Generation, which owns and operates peaking generating facilities from which it sells all of its energy and capacity into the wholesale market, MVIC, a captive insurance company that provides insurance services to DPL and its subsidiaries, and DPL Capital Trust II, which was formed to issue trust capital securities to investors..

Q HOW WERE DPL'S AND DP&L'S CREDIT RATINGS IMPACTED AFTER THE ACQUISITION OF DPL BY AES?

A The current credit ratings at DPL and DP&L are directly related to the 2011 acquisition of DPL Inc. by its now-parent company, AES Corp. DP&L has experienced a downgrade of five notches in its long-term issuer rating by S&P since the announcement of AES's acquisition of DPL.

Q HOW DID THE ACQUISITION PLAY A ROLE IN THE NEGATIVE IMPACTS ON DPL'S BALANCE SHEET AND CREDIT RATINGS?

A The deterioration of DPL's balance sheet, credit ratings, and financial integrity are the result of the AES acquisition of DPL and DP&L. At the end of the transaction, AES practically doubled the size of DPL's balance sheet with a $2.6 billion goodwill asset and approximately $1.3 billion of acquisition-related debt. As shown on my Exhibit CCW-2, DPL's debt grew from $1.2 billion to $2.6 billion from the third quarter of 2011 to the fourth quarter of 2011 when the acquisition was completed. This had the effect of lowering DPL's common equity to permanent capital ratio (excluding goodwill) from 49.9% to (7.1%) in one quarter.

DPL's accumulated retained earnings have gone from a positive $1.3 billion position in the third quarter of 2011 to a deficit of $2.4 billion as of September 30, 2016. As a result, DPL now has a negative common equity balance, causing its long-term debt to permanent capital ratio to be approximately 111%. This drastic change in DPL's accumulated retained earnings, and ultimately its common equity, is largely attributable to write-downs of the goodwill asset that resulted from the $3.5 billion AES acquisition. It appears that DPL has completely written down the balance of the intangible goodwill asset. The proposed use of the DMR funds is troublesome because DP&L/DPL agreed to never seek recovery of the acquisition premium or direct costs of the acquisition in retail rates.[9] By proposing to use the DMR funds to shore up DPL's balance sheet that has experienced detrimental impacts from goodwill impairment charges is the equivalent of requesting retail ratepayers to pay for the acquisition premium in retail rates.

Q PLEASE EXPLAIN WHY YOU MEASURED DPL'S CAPITAL STRUCTURE BY EXCLUDING GOODWILL.

A Goodwill is an intangible asset that represents the difference between the purchase price paid for an asset and its net book value. Goodwill is also a non-revenue producing asset that cannot be supported by debt. Hence, when a charge is taken against the asset, like an impairment charge, it only impacts the common equity balance. For these reasons, it is important to measure a company's common equity ratio excluding goodwill to better understand the financial health of that company.

Q HAS THE AES ACQUISITION OF DPL AND THE IMPACT ON ITS BALANCE SHEET SUBSEQUENTLY IMPACTED ITS CREDIT RATINGS?

A Yes. The acquisition has had significant impact on DPL's, and ultimately DP&L's, credit ratings.

[9] Finding and Order, Case No. 11-3002-EL-MER, dated November 22, 2011.

Q PLEASE EXPLAIN HOW THE ACQUISITION HAS IMPACTED DPL'S CREDIT RATINGS.

A Before the acquisition by AES was announced on April 20, 2011, DPL's long-term corporate rating from S&P was A- with a 'Stable' outlook. The day the announcement was made, S&P placed DPL on CreditWatch with 'negative' implications. Importantly, as explained by S&P, $1.25 billion of the purchase price was funded with DPL Inc. debt. In its report, S&P stated the following with regard to its ratings action:

> **Rationale**
>
> Standard & Poor's Ratings Services' ratings on utility holding company DPL Inc. and principal subsidiary Dayton Power & Light Co. (DP&L) are on CreditWatch with negative implications. The CreditWatch listing reflects AES Corp.'s (BB/Watch Neg/--) firm offer to purchase all of DPL Inc.'s common equity. The proposed $3.5 billion acquisition is being financed with $1.25 billion of DPL Inc. debt, about $1.37 billion of funds received from the China Investment Corporation (CIC), $680 million of AES debt, and $200 million of asset sale proceeds and cash on hand. In March 2010, AES received an aggregate $1.58 billion from the CIC for a 15% stake in AES.
>
> * * *
>
> Upon completion of the transaction, we will lower our ratings on DPL Inc. and DP&L several notches, reflecting the substantial amount of additional debt DPL will incur after the transaction. Moreover, we believe that the combination with an entity that has a significantly weaker business risk and financial risk profile demonstrates a lack of commitment to credit quality by DPL's management.
>
> AES has indicated its willingness to provide enhancements such as structural protections, covenants, a pledge of stock, and an independent director to create a level of separation for DPL and DP&L from the lower-rated parent AES. We will determine the notching between AES and the DPL family upon completion of the transaction based in part on AES's satisfactory and timely completion of these enhancements, as well as on our analysis of the cumulative value of these measures.[10]

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[10]*See* CONFIDENTIAL Exhibit CCW-5 *Standard & Poor's Global Credit Portal RatingsDirect*: "DPL Inc.," April 20, 2011, at 2.

On November 22, 2011, S&P lowered DPL's ratings three notches from A- to BBB-, which is the lowest investment grade rating on S&P's scale. In its November report, S&P stated the following:

> **Rationale**
>
> The ratings on DPL Inc. reflect its consolidated credit profile, which includes its association with the weaker credit quality of its soon to be new ultimate parent AES Corp. (BB-/Stable/--). DPL is the holding company for regulated electric utility Dayton Power & Light Co. (DP&L). The ratings also reflect DPL's excellent business risk profile and its post-merger aggressive financial profile.
>
> * * *
>
> DPL's and DP&L's ratings are higher than parent AES. AES has indicated its intent to put structural protections (separateness agreement), an independent director, and debt limitations and covenants that provide a degree of insulation to the subsidiary in place in a timely manner. DPL's and DP&L's ratings depend on satisfactory documentation of such enhancements to create separation for DPL and DP&L from the lower rated parent. Absent the satisfactory and timely completion of these insulating measures, we would rate DPL and DP&L on par with AES at 'BB-'.
>
> DPL's credit quality is heavily influenced by the substantial amount of additional debt and the adverse impact on the company's key financial metrics.[11]

Shortly after its three-notch downgrade, S&P took another ratings action on DPL by placing its long-term issuer rating on CreditWatch with negative implications in April 2012. S&P then lowered DPL's ratings by two additional notches to BB on November 8, 2012. This rating is two notches below the minimum investment grade rating on S&P's scale. In its November report, S&P stated the following on why it lowered DPL's ratings an additional two notches:

[11] *See* CONFIDENTIAL Exhibit CCW-6*, Standard & Poor's Global Credit Portal RatingsDirect*: "Research Update: DPL Inc., Subsidiary Dayton Power & Light Downgraded To 'BBB-' From 'A-'; Outlooks Stable," November 22, 2011, at 3.

> **Rationale**
>
> Standard & Poor's ratings on DPL Inc. reflect the company's consolidated credit profile, which includes its association with the weaker credit quality of its parent, The AES Corp. (BB-/Stable/--). DPL is the holding company for regulated electric utility DP&L. The ratings also reflect DPL's "strong" business risk profile and its "aggressive" financial risk profile, as defined in our criteria. (We rank business risk from "excellent" to "vulnerable" and financial risk from "minimal" to "highly leveraged.")
>
> We view DPL and DP&L's business risk profiles as "strong" based on the increased competition among Midwest energy retail providers and the expected growth of the unregulated retail business. In addition, we expect competition to increase because of lower wholesale electricity prices, which will materially reduce DPL's profit margins. The company's financial position has very little cushion due to the increased amount of acquisition debt from parent company AES. DPL recently announced that it will be taking an impairment charge of $1.85 billion on the goodwill associated with the AES purchase. Although we do not expect this impairment to affect cash flows, it will substantially weaken net income and earnings in 2012 as well as the total-debt-to-capital ratio. DPL's credit quality is heavily influenced by the substantial additional acquisition-related debt and its adverse impact on the company's key financial measures. Consequently, our baseline forecast calls for total debt to EBITDA of about 6.5x to 7.0x and adjusted FFO to total debt to be about 8% to 10%.
>
> Our ratings on DPL and DP&L are higher than our rating on parent AES, as structural protections (a separateness agreement, an independent director, and debt limitations and covenants) provide some insulation to the subsidiaries.[12]

V. DPL'S Credit Metrics

Q HOW WILL THE DMR IMPROVE DPL'S CREDIT METRICS?

A The DMR is designed to reduce a significant amount of the excessive debt at DPL, the parent company of DP&L. Should the Commission approve the DMR as proposed, DP&L will use cash provided via the DMR revenues to pay dividends up to the unregulated parent so that DPL can pay off a significant amount of debt. As Mr.

[12] *See* CONFIDENTIAL Exhibit CCW-7, *Standard & Poor's RatingsDirect*: "Research Update: S&PCORRECT: DPL Inc., Dayton Power & Light Co. Lowered To 'BB' From 'BBB-'; Debt Ratings Also Cut; Otlk Stable," November 8, 2012, at 3.

Jackson explains, the allowable amount of debt on DPL's balance sheet was a backed-in calculation based on an adjusted FFO-to-debt ratio requirement of 13%.

Q WOULD THE PROPOSED DMR DEBT REDUCTION PRODUCE A LOWER BORROWING COST AT DP&L AND/OR DPL IF THE CREDIT METRIC IMPROVEMENT AS PROJECTED BY WITNESSES JACKSON AND MALINAK ARE ACHIEVED?

A No, they likely would not. Improvement to the credit metrics at DPL may not improve the credit rating of DPL and/or DP&L. DPL's credit metrics may improve but the DPL/DP&L credit ratings likely will not. If the credit ratings do not improve, DP&L's cost to borrow will not be reduced, and its access to capital will not be improved.

Q WHY WOULD THE CREDIT METRICS AT DPL AND DP&L IMPROVE, BUT THE CREDIT RATINGS MAY NOT IMPROVE?

A Under S&P's group rating methodology, DPL and DP&L's credit ratings are tied to the credit ratings of its publicly traded parent company.AES Corp ("AES").. Until either AES improves its own long-term issuer corporate credit rating or improved financial separation of DPL/DP&L's from AES is created, DPL and DP&L'S credit rating will continue to be constrained.

Q WHAT EVIDENCE DO YOU HAVE TO SHOW THAT DPL'S S&P RATING IS TIED TO THE RATING OF ITS ULTIMATE PARENT, AES?

A A review of S&P's ratings tearsheet for DPL shows that its ratings are linked to that of its parent, AES, whose long-term issuer rating is 'BB'. In its tearsheet for DPL, S&P states the following:

> Our ratings on DPL incorporate our assessment of the company's group credit profile as a moderately strategic subsidiary of ultimate parent AES Corp. In addition, while we view the cumulative value of structural protections in place as potentially providing one notch of insulation between DPL and AES Corp., we ascribe no ratings distinction given that we rate AES Corp. at 'BB', the same stand-alone credit profile as DPL. Our business risk assessment for DPL reflects increased competition in the retail generation markets, including the company's relative small size, and lack of fuel diversity. This is partially mitigated by DP&L's lower-risk transmission and distribution (T&D) business that collectively results in a satisfactory business risk assessment for DPL. [13]

Q HAS MOODY'S MADE ANY COMMENT ON THE LACK OF SEPARATION BETWEEN DPL AND DP&L?

A Yes, it has. In its August 11, 2016 Credit Opinion on DP&L, Moody's stated the following:

> DP&L's Baa3 rating is constrained by the material amount of holding company debt of around $1.2 billion or 61.5% of the consolidated debt that is outstanding at its parent company DPL, Inc (DPL; Ba3 senior unsecured rating negative). This considers the fact that the PUCO did not impose any dividend restrictions on DP&L which historically was DPL's main source of cash flows. This limits the utility's financial flexibility which constrains its rating and drives the notching differential between the Ba3 senior unsecured ratings of DPL and DP&L's Baa3 Issuer rating. DPL's Ba3 rating also considers the group's exposure to weak power merchant market conditions but acknowledges the group's liquidity and the debt maturity profile. [14]

Q COULD AES AND DPL AGREE TO CONDITIONS THAT WOULD PRODUCE GREATER CREDIT RATING SEPARATION OF DP&L FROM DPL AND AES?

A Yes. AES could provide DPL with an equity infusion to fund debt reduction at DPL and strengthen its balance sheet. Doing so would alleviate DP&L from unnecessary financial stress to provide DPL with dividend payments and other cash flows to service its debt obligations. Additionally, DPL could implement ring fence insulation

[13] *See* CONFIDENTIAL Exhibit CCW-8, *Standard & Poor's RatingsDirect*: "S&P Global Ratings Tearsheet: DPL Inc." Accessed November 16, 2016. (emphasis added).

[14] *See* CONFIDENTIAL Exhibit CCW-4, *Moody's Investors Service:* "Credit Opinion: Dayton Power & Light Company", August 11, 2016. (emphasis added).

measures to protect and prioritize the assets and cash flows of DP&L for the needs of the utility first, and then allow cash flow payments (dividends, tax payments, etc.) upstream only after the utility's cash needs have been satisfied.

Q SHOULD THE PUCO APPROVE THE DMR AS REQUESTED, DOES THIS GUARANTEE THAT DPL'S RATINGS WILL IMPROVE?

A No. Because of the group ratings methodology used by S&P, DPL/DP&L's credit ratings improvements are, at best, problematic.

VI. Conclusion and Alternative Solutions.

Q DO YOU BELIEVE THE COMMISSION SHOULD APPROVE THE DMR AS IT IS PROPOSED?

A No. The Commission should reject the DMR as it is proposed. DP&L is requesting the Commission approve what equates to a financial bailout plan for its unregulated holding company, DPL, whose assets are capitalized with more than 100% debt (to say it another way: a negative equity balance). Though, the name of the proposed rider would have us believe otherwise. DP&L is making this request without providing any guaranteed benefits to ratepayers, and, in fact, has even gone as far as eroding customer protections by requesting the DMR cash flows be excluded from the SEET.

Additionally, if DP&L achieves its targeted capital structure, its cost of capital and cost of service will increase significantly. As I have explained previously, too much equity relative to long-term debt will unnecessarily increase the regulated cost of capital, income tax expense and cost of service which is ultimately passed on to ratepayers via increased retail rates.

There is no promise, or guarantee, from DPL and DP&L that the DMR will improve the ratings of either company. Rather, the Company has provided us with a financial forecast seven years into the future, which is problematic, at best. Beyond a couple years, financial forecasts have poor accuracy and should be given little weight. Very little, if any, of the DMR cash flows would be available for distribution modernization investments.

I have explained in detail that the financial woes and resulting junk credit ratings at DPL are the results of the AES transaction. S&P has made this much very clear in its reports since the announcement of the transaction. AES propped up the equity balance of DPL with a very large goodwill asset that was subsequently impaired, or written down, completely. The impairment of the goodwill asset is the largest contributing factor to the accumulated earnings deficit on DPL's balance sheet. AES also kept approximately $1.3 billion of acquisition related debt on DPL's balance sheet. The combination of these two actions has since resulted in an over-leveraged holding company that has experienced significant credit rating downgrades and is on the cusp of further downgrades. In turn, the Company has presented a DMR to mostly help solidify DPL's balance sheet which has been financially strained since the completion of the AES acquisition, even though DP&L agreed to never seek recovery of the acquisition premium or direct costs of the acquisition in retail rates.[15]

Additionally, the Company's projections, as well as those forecasted by the ratings agencies show that DP&L is financially strong on a standalone basis, with one caveat. Moody's has noted that DP&L will be highly leverageed should FERC approve the proposed transfer of generation assets. The current proposal for the transfer does not remove any debt from DP&L's balance sheet. Rather, DP&L's

[15]Finding and Order, Case No. 11-3002-EL-MER, dated November 22, 2011.

customers would likely be asked to pay for the debt service of unregulated generation assets if that proposal is approved also.

Furthermore, DP&L's regulated retail customers should only be responsible for the actual, prudently incurred, cost of electric distribution service. The Company has failed to prove that the [redacted] of DPL debt is related to providing safe and reliable regulated electric service. The [redacted] in proposed debt reduction at DP&L largely payoff the $200 million Pollution Control Bonds that mature in 2020, and the $100 million Pollution Control Bonds that are callable as of September 1, 2016.

Finally, it is not entirely clear whether DP&L is authorized to implement this strategy at the moment considering there is a negative retained earnings balance on its balance sheet as of September 30, 2016. One of the agreed to stipulations that was ultimately approved by this Commission in authorizing the AES transaction prohibits DP&L from having a negative retained earnings balance,[16] which is the case at this time.

The imprudent management of DPL's balance sheet should be a shareholder problem, not a ratepayer-funded solution. For the reasons detailed above, I urge the Commission to reject the DMR plan as proposed.

However, should the Commission approve the ESP plan as proposed with the DMR, it should do so conditionally and require certain customer protections and guaranteed quantifiable benefits for ratepayers, including: (a) include cash flows from the DMR in the SEET, (b) at a minimum, authorize the rider only after DP&L has demonstrated the adequate ring fencing between DPL and AES, as well as DPL and DP&L, has been put in place;, (c) require DP&L's common equity balance to be in the

[16]The Commission reaffirmed this requirement in its Order dated September 17, 2014 in Case No. 13-2420-EL-UNC at pages 18-19.

range of 45% to 55%, (d) institute credit metric and credit rating benchmarks that must be met throughout the ESP that require DPL and DP&L to actually achieve improved credit standing, (e) require a substantial portion of the DMR funds be spent on transmission and distribution modernization, and (f) require refunds or bill credits to customers should any of the aforementioned fail to be met.

Q DO YOU HAVE ANY ALTERNATIVE SOLUTIONS TO STRENGTHEN DPL'S FINANCIAL POSITION?

A Yes, I do. As a strategic subsidiary to AES, DPL plays an important role in AES's business plan. The acquisition strategy that was implemented in the AES transaction is ultimately the reason DPL is a highly leveraged company today. AES should show that it is dedicated to improving the financial health of the strategic subsidiary by providing ongoing equity infusions into DPL that can be used to reduce DPL debt until its credit metrics and ratings are strengthened and targeted improvements are met.

DPL's cash flows should be further insulated from AES, and DP&L's cash flows should be further insulated from DPL. This will help protect DP&L and its regulated customers from weak credit strength at DPL and AES. This should be a requirement, regardless of whether or not the Commission approves the DMR.

An additional alternative that, at least, merits a review for consideration would be the use of securitization bonds at DP&L. Securitization bonds are often much cheaper than corporate, or first mortgage, bonds, and are also treated differently than typical debt issuances by the ratings agencies based on the recovery mechanisms associated with securitized debt.

Q DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A Yes, it does.

Qualifications of Christopher C. Walters

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A Christopher C. Walters. My business address is 16690 Swingley Ridge Road, Suite 140, Chesterfield, MO 63017.

Q PLEASE STATE YOUR OCCUPATION.

A I am a Consultant in the field of public utility regulation with the firm of Brubaker & Associates, Inc. ("BAI"), energy, economic and regulatory consultants.

Q PLEASE STATE YOUR EDUCATIONAL BACKGROUND AND PROFESSIONAL EMPLOYMENT EXPERIENCE.

A I graduated from Southern Illinois University Edwardsville in 2008 where I received a Bachelor of Science Degree in Business Economics and Finance. I graduated with a Master of Business Administration Degree from Lindenwood University in 2011.

In January 2009, I accepted the position Financial Representative with American General Finance and was quickly promoted to Senior Assistant Manager. In this position I was responsible for assisting in the management of daily operations of the branch, analyzing and reporting on the performance of the branch to upper management, performing credit analyses for consumers and small businesses, as well as assisting home buyers obtain mortgage financing.

In January 2011, I accepted the position of Analyst with BAI. As an Analyst, I performed detailed analysis, research, and general project support on regulatory and competitive procurement projects. In July 2013, I was promoted to the position of Consultant. As a Consultant, I have performed detailed technical analyses and research to support regulatory projects including expert testimony, and briefing assistance covering various regulatory issues. At BAI, I have been involved with several regulated projects for electric, natural gas and water and wastewater utilities, as well as competitive procurement of electric power and gas supply. My regulatory filing tasks have included measuring the cost of capital, capital structure evaluations, assessing financial integrity, merger and acquisition related issues, risk management related issues, depreciation rate studies, other revenue requirement issues and wholesale market and retail regulated power price forecasts. Since 2011, I have been working with BAI witnesses on utility rate of return filings. Specifically, I have assisted BAI witnesses in analyzing rate of return studies, drafting discovery requests and analyzing responses, drafting rate of return testimony and exhibits and assisting with the review of the briefs.

BAI was formed in April 1995. BAI and its predecessor firm have participated in more than 700 regulatory proceedings in 40 states and Canada.

BAI provides consulting services in the economic, technical, accounting, and financial aspects of public utility rates and in the acquisition of utility and energy services through RFPs and negotiations, in both regulated and unregulated markets. Our clients include large industrial and institutional customers, some utilities and, on occasion, state regulatory agencies. We also prepare special studies and reports, forecasts, surveys and siting studies, and present seminars on utility-related issues.

In general, we are engaged in energy and regulatory consulting, economic analysis and contract negotiation. In addition to our main office in St. Louis, the firm also has branch offices in Phoenix, Arizona and Corpus Christi, Texas.

Q HAVE YOU EVER TESTIFIED BEFORE A REGULATORY BODY?

A Yes. I have sponsored testimony on cost of capital before state regulatory commissions including: Arkansas, Kansas, Michigan, and Oklahoma. I have also filed an affidavit before the Federal Energy Regulatory Commission ("FERC").

Q PLEASE DESCRIBE ANY PROFESSIONAL REGISTRATIONS OR ORGANIZATIONS TO WHICH YOU BELONG.

A I earned the Chartered Financial Analyst ("CFA") designation from the CFA Institute. The CFA charter was awarded after successfully completing three examinations which covered the subject areas of financial accounting and reporting analysis, corporate finance, economics, fixed income and equity valuation, derivatives, alternative investments, risk management, and professional and ethical conduct. I am a member of the CFA Institute and the CFA Society of St. Louis.

Dayton Power & Light Company

DP&L's Historical and Projected Credit Metrics

S&P Metrics[1]

Description	Risk Score	3-Year Average	As of: 2015	2014	2013
FFO-to-Debt (%)	Intermediate	29.1	27.4	27.6	32.2
Debt/EBITDA (x)	Intermediate	2.7	2.8	2.9	2.5
Business Risk	Strong				
Indicated	BBB+				
Actual Rating	BB				

Moody's Metrics[2]

	As of 3/31/16	Indicated Rating	12-18 Month Forecast	Indicated Rating
CFO pre-WC + Interest/Interest	8.5x	Aaa	4.5x - 5.5x	A
CFO pre-WC / Debt	30.10%	Aa	24% - 27%	A
CFO pre-WC - Dividends / Debt	17.20%	A	24% - 27%	Aa
Debt Capitalization	32.50%	Aa	0% - 55% Baa	
Indicated Rating		A3		Baa1
Actual Rating				Baa3

Sources:
[1]S&P Capital IQ, CreditStats direct, accessed November 16, 2016.
[1]Moody’s Investors Service: “Credit Opinion: Dayton Power & Light Company”, August 11, 2016.

Dayton Power & Light Company

AES Acquisition on DPL's Financial Strength

	DPL Inc.[1]			DP&L[2]		
	3Q 2011	4Q 2011	3Q 2016	3Q 2011	4Q 2011	3Q 2016
Goodwill	$ -	$ 2,576	$ -	$ -	$ -	$ -
Total Assets	$ 3,677	$ 6,136	$ 2,950	$ 3,420	$ 3,538	$ 2,461
Long-term Debt	$ 1,224	$ 2,629	$ 1,835	$ 903	$ 903	$ 745
Accumulated Retained Earnings (Deficit)	$ 1,296	$ (6)	$ (2,426)	$ 584	$ 589	$ (31)
Total Common Equity	$ 1,220	$ 2,231	$ (177)	$ 1,352	$ 1,358	$ 751
Common Equity to Permanent Capital Ratio - excluding goodwill	49.9%	-7.1%	-10.7%	60.0%	60.1%	50.2%
Common Equity to Permanent Capital Ratio - including goodwill	49.9%	45.9%	-10.7%	60.0%	60.1%	50.2%
Common Equity to Total Assets	33.2%	36.4%	-6.0%	39.5%	38.4%	30.5%

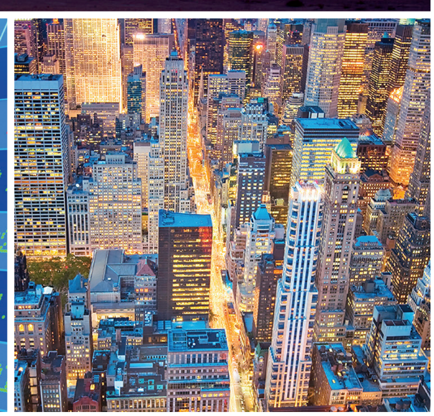
Sources:
[1]DPL SEC 10Q and 10K, various dates
[2]DP&L SEC 10Q and 10K, various dates

Ex. CCW-3

Edison Electric INSTITUTE

2015 Financial Review

Annual Report of the U.S. Investor-Owned Electric Utility Industry



Ex. CCW-3

Credit Ratings

The industry's average credit rating was BBB+ in 2015, remaining for a second straight year above the BBB average that had previously held since 2004. Ratings activity, at 50 changes, matched 2008's level as the lowest annual total back to 2001. Upgrades were a very favorable 70.0% of total actions, the third-highest annual figure in our dataset; the last three years have produced the three highest upgrade percentages. In 2014, Moody's upgraded the majority of regulated utilities by one notch, resulting in a record high 97.2% upgrade percentage for the year. EEI captures upgrades and downgrades at the subsidiary level; multiple actions within a single parent holding company are included in the upgrade/downgrade totals. The industry's average credit rating and outlook are based on the unweighted averages of all Standard & Poor's (S&P) parent company ratings and outlooks.

While the industry's average rating was unchanged at BBB+, the underlying data showed modest strength. Five companies received upgrades at the parent level versus only one that was downgraded. Upgrades resulted from companies' increased focus on regulated operations, achieved through spin-offs and divestitures, as well as the effective management of regulatory risk. At January 1, 2016, 74.5% of companies' ratings outlooks were "stable", 9.8% were "positive" or "watch-positive" and 15.8% were "negative" or "watch-negative".

Upgrades Reflect Regulated Focus

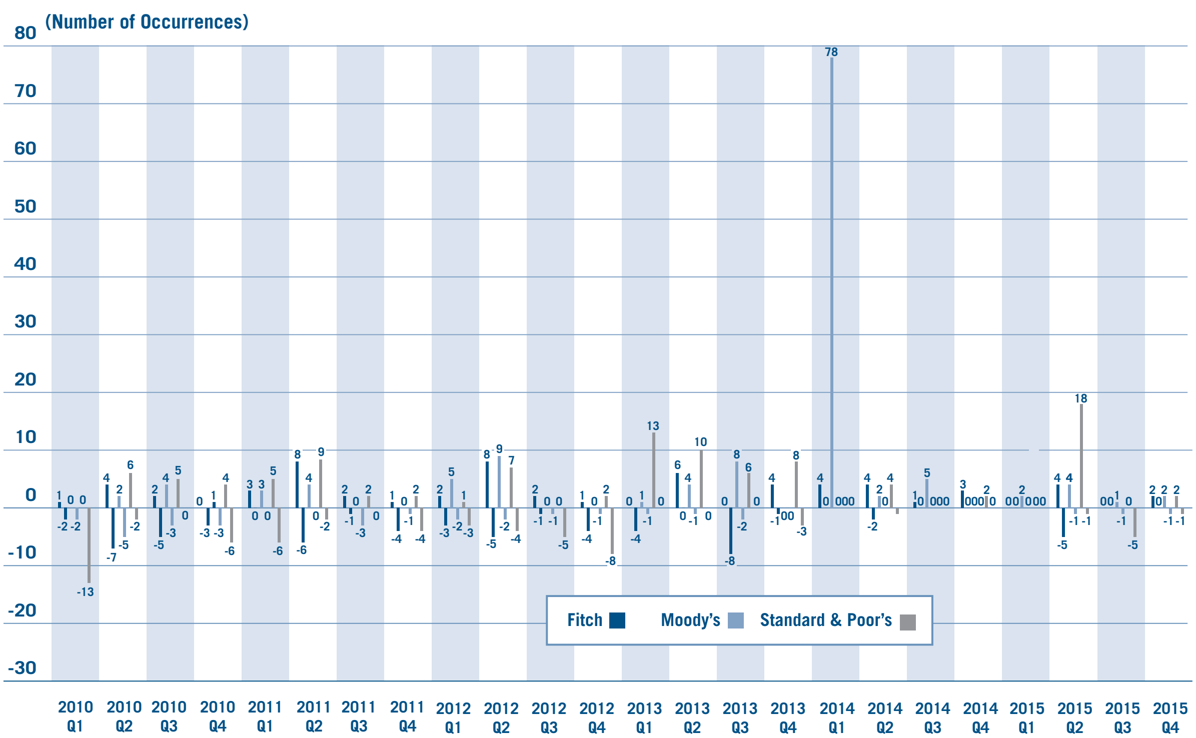
Ratings actions at the parent company-level in 2015 included five upgrades and only one downgrade.

Duke Energy

On April 2, S&P raised its corporate credit rating for Duke Energy and subsidiaries to A- from BBB+. The upgrade was based on Duke's sale of merchant power and formerly

Credit Rating Agency Upgrades and Downgrades 2010 Q1-2015 Q4

U.S. INVESTOR-OWNED ELECTRIC UTILITIES



Note: Data presents the number of occurrences and includes each event, even if multiple actions occurred for a single company.

Source: Fitch Ratings, Moody's, and Standard & Poor's

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