

**BEFORE
THE PUBLIC UTILITIES COMMISSION OF OHIO**

In the Matter of the Application of)	
The Dayton Power and Light Company for)	Case No. 16-395-EL-SSO
Approval of Its Electric Security Plan.)	
)	
In the Matter of the Application of)	
The Dayton Power and Light Company for)	Case No. 16-396-EL-ATA
Approval of Revised Tariffs.)	
)	
In the Matter of the Application of)	
The Dayton Power and Light Company for)	Case No. 16-397-EL-AAM
Approval of Certain Accounting Authority)	
Pursuant to Ohio Rev. Code § 4905.13.)	

**DIRECT TESTIMONY
OF
DAVID J. EFFRON**

**On Behalf of the
The Office of the Ohio Consumers' Counsel**
*10 West Broad Street, Suite 1800
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November 21, 2016

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1 **I. INTRODUCTION**

2

3 **A. QUALIFICATIONS**

4

5 ***Q1. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.***

6 ***A1.*** My name is David J. Effron. My address is 12 Pond Path, North Hampton, New
7 Hampshire 03862.

8

9 ***Q2. WHAT IS YOUR PRESENT OCCUPATION?***

10 ***A2.*** I am a consultant specializing in utility regulation.

11

12 ***Q3. PLEASE SUMMARIZE YOUR PROFESSIONAL EXPERIENCE.***

13 ***A3.*** My professional career includes over thirty years as a regulatory consultant, two
14 years as a supervisor of capital investment analysis and controls at Gulf & Western
15 Industries and two years at Touche Ross & Co. as a consultant and staff auditor. I
16 am a Certified Public Accountant and I have served as an instructor in the business
17 program at Western Connecticut State College.

18

19 ***Q4. WHAT EXPERIENCE DO YOU HAVE IN THE AREA OF UTILITY RATE***
20 ***SETTING PROCEEDINGS AND OTHER UTILITY MATTERS?***

21 ***A4.*** I have analyzed numerous electric, gas, telephone, and water filings in different
22 jurisdictions. Pursuant to those analyses, I have prepared testimony, assisted

1 attorneys in case preparation, and provided assistance during settlement negotiations
2 with various utility companies.

3
4 I have testified in over three hundred cases before regulatory commissions in
5 Alabama, Colorado, Connecticut, Florida, Georgia, Illinois, Indiana, Kansas,
6 Kentucky, Maine, Maryland, Massachusetts, Missouri, Nevada, New Jersey, New
7 York, North Dakota, Ohio, Pennsylvania, Rhode Island, South Carolina, Texas,
8 Vermont, Virginia, and Washington.

9
10 ***Q5. PLEASE DESCRIBE YOUR OTHER WORK EXPERIENCE.***

11 ***A5.*** As a supervisor of capital investment analysis at Gulf & Western Industries, I was
12 responsible for reports and analyses concerning capital spending programs,
13 including project analysis, formulation of capital budgets, establishment of
14 accounting procedures, monitoring capital spending, and administration of the
15 leasing program. At Touche Ross & Co., I was an associate consultant in
16 management services for one year, and a staff auditor for one year.

17
18 ***Q6. HAVE YOU EARNED ANY DISTINCTIONS AS A CERTIFIED PUBLIC***
19 ***ACCOUNTANT?***

20 ***A6.*** Yes. I received the Gold Charles Waldo Haskins Memorial Award for the highest
21 scores in the May 1974 certified public accounting examination in New York State.

1 ***Q7. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND.***

2 ***A7.*** I have a Bachelor's degree in Economics (with distinction) from Dartmouth
3 College and a Master of Business Administration Degree from Columbia
4 University.

5

6 **B. PURPOSE OF TESTIMONY**

7

8 ***Q8. ON WHOSE BEHALF ARE YOU TESTIFYING?***

9 ***A8.*** I am testifying on behalf of the Office of the Ohio Consumers' Counsel ("OCC").

10

11 ***Q9. WHAT IS THE PURPOSE OF YOUR TESTIMONY?***

12 ***A9.*** On February 22, 2016, The Dayton Power and Light Company ("DP&L" or "the
13 Utility") filed an application with the Public Utilities Commission of Ohio
14 ("PUCO") seeking approval of its electric security plan ("ESP"). As part of this
15 application, DP&L is seeking to implement a Distribution Investment Rider
16 ("DIR") to recover the costs of additions to distribution plant in service, the costs
17 of a Danger Tree program, and the costs of 20 new engineering and technical
18 employees through a "Workforce Adaptation" component. In this testimony, I
19 address the components of the DIR related to the revenue requirement for
20 additions to distribution plant in service and for the Workforce Adaptation
21 component.

**Q10. SHOULD YOUR TESTIMONY ON THE UTILITY'S PROPOSALS
REGARDING ITS DIR BE INTERPRETED TO MEAN THAT YOU AGREE
THAT THE APPROVAL OF THE PROPOSED DIR WOULD BE
APPROPRIATE?**

A10. No. Riders allow regulated utilities to recover designated costs from customers outside of the context of traditional base rate cases, where all elements of the cost of service are examined. As a general matter, riders entailing the automatic collection of certain utility costs are contrary to sound ratemaking policy. As such, these mechanisms tend to either reduce or eliminate incentives to control costs, or can potentially result in incentives that have the perverse effect of encouraging uneconomic choices by the utilities. In addition, to the extent that costs covered by riders result in efficiencies or offsetting cost reductions, customers may end up paying for the cost increases without seeing the benefits of the related savings.

To the extent that such riders are approved, they should be limited to costs that are large, volatile, and outside of the utility's control. Examples of such costs could be purchased gas costs for a gas distribution utility or purchased power supply costs for an electric distribution utility.

DP&L has presented no evidence that the costs that it is seeking to collect through its proposed riders meet these criteria or that its financial integrity would be somehow compromised if those costs could be collected only through a traditional

1 base rate case where the costs would be subject to closer scrutiny and appropriate
2 incentives to control costs.
3

4 **II. DISTRIBUTION INVESTMENT RIDER**

5
6 **A. DISTRIBUTION PLANT ADDITIONS**
7

8 ***Q11. PLEASE DESCRIBE THE UTILITY'S PROPOSED DISTRIBUTION***
9 ***INVESTMENT RIDER AS IT RELATES TO ADDITIONS TO***
10 ***DISTRIBUTION PLANT IN SERVICE.***

11 ***A11.*** The purpose of this element of the proposed DIR is to collect the incremental
12 revenue requirement associated with increases in net distribution plant in specified
13 distribution plant accounts since September 30, 2015 (the date certain in Case No.
14 15-1830-EL-AIR).
15

16 ***Q12. WHAT ARE THE COMPONENTS OF THE DIR REVENUE REQUIREMENT***
17 ***ASSOCIATED WITH THE COST OF THE SPECIFIED DISTRIBUTION***
18 ***PLANT ADDITIONS?***

19 ***A12.*** There are three components of the distribution plant revenue requirement. The
20 first component is the return on the increase in net rate base, with rate base defined
21 as the increase in gross electric distribution plant in service in specified
22 distribution plant accounts, less the increase in related accumulated depreciation
23 and accumulated deferred income taxes. The second component is the

1 depreciation expense on the relevant additions to electric distribution plant in
2 service. The third component is the property tax expense on the relevant additions
3 to electric distribution plant in service.

4
5 ***Q13. ARE ALL OF THE COMPONENTS OF THE DIR REVENUE***
6 ***REQUIREMENT ASSOCIATED WITH THE COST OF DISTRIBUTION***
7 ***PLANT ADDITIONS, AS SHOWN ON EXHIBIT RJA-1, CALCULATED***
8 ***CORRECTLY?***

9 ***A13.*** No. The return component of the revenue requirement is not calculated correctly.
10 On Exhibit RJA-1, the Utility calculates the required return on rate base by
11 multiplying the “Distribution Rate Base for DIR” on Line 7 by the rate of return of
12 7.86% from Case No. 15-1830-EL-AIR and then applying the Gross Revenue
13 Conversion Factor on Line 13 to the product of that calculation to determine the
14 “Incremental Return on Rate Base (Post Tax)” on Line 15. In calculating the
15 required rate of return grossed up for income taxes, the weighted debt component
16 of the overall rate of return should not be grossed up for income taxes, as the cost
17 of debt (i.e., interest) is deductible for income taxes. The Utility’s method of
18 calculating the incremental return on rate base would result in the recovery of an
19 excess return because it does not take into account the benefit of the increased
20 income tax deduction associated with the long-term debt supporting the incremental
21 rate base.

**Q14. CAN YOU ILLUSTRATE HOW THE UTILITY'S METHOD OF
CALCULATING THE INCREMENTAL RETURN ON RATE BASE RESULTS
IN AN EXCESS RETURN?**

A14. Yes. Assume plant additions that result in an incremental net rate base of \$10,000,000. The return on this rate base at a rate of 7.86% equals \$786,000. Applying the gross revenue conversion factor of 1.5498 to this return produces revenues of \$1,218,143. After deducting the commercial activities tax of 0.26%, there remains \$1,214,976 to cover the return on rate base, including the weighted costs of long-term debt, preferred stock, and common equity. However, the incremental cost of debt related to the net increase in rate base is deductible for income taxes. The weighted cost of long-term debt included in the rate of return of 7.86% is 2.53%. Therefore, the incremental income tax deduction will be $2.53\% \times \$10,000,000$, or \$253,000, resulting in income before taxes of \$961,976. With an income tax rate of 35.306%, the income tax on this taxable income is \$339,635. The net income is then \$622,341. Of this amount, \$9,000 ($0.09\% \times \$10,000,000$) goes to cover the cost of preferred stock, leaving \$613,341 for the required return on common equity. The common equity ratio reflected in the 7.86% rate of return is 50%. Thus, the common equity supporting the incremental rate base is \$5,000,000 ($50\% \times \$10,000,000$). The net return on this balance of common equity is 12.26% ($\$613,341 / \$5,000,000$), which exceeds the Utility requested return on common equity of 10.5%.

**Q15. HOW SHOULD THE REQUIRED RATE OF RETURN GROSSED UP FOR
INCOME TAXES BE CALCULATED?**

A15. The Gross Revenue Conversion Factor should be applied to the net-of-tax rate of return, with the debt component stated on an after-tax basis. The weighted debt component included in the overall rate of return of 7.86% is 2.53%. With a combined income tax rate of 35.306%, the net-of tax weighted debt component is 1.637% ($2.53\% \times (1 - 35.306\%)$), and net-of-tax rate of return is 6.977% (adding the net-of- tax weighted debt component to the weighted preferred stock component of 0.09% and weighted common equity component of 5.25%). Applying the Gross Revenue Conversion Factor of 1.5498 to the net-of-tax rate of return of 6.977%, the factor to calculate the required incremental return on rate base is 10.81%. The actual factor to calculate the required incremental return on rate base should, of course, ultimately be based on the rate of return authorized by the Commission, not the Utility's requested rate of return.

Alternatively, the weighted preferred stock and common equity components of the overall rate of return could be grossed up for income taxes to calculate a pre-tax rate of return, and then that pre-tax rate of return grossed up for the commercial activities tax. The pre-tax rate of return with the preferred stock and common equity components grossed up for income taxes is 10.78424% (calculated as $(5.25\% + .09\%) / (1 - 35.306\%) + 2.53\%$). Grossing this pre-tax rate of return up for the commercial activities tax of 0.26%, the factor to calculate the required

1 incremental return on rate base is the same 10.81% (or 10.81236% before
2 rounding).

3

4 ***Q16. CAN YOU ILLUSTRATE HOW THIS METHOD OF CALCULATING THE***
5 ***INCREMENTAL RETURN ON RATE BASE RESULTS IN AN***
6 ***APPROPRIATE RETURN?***

7 ***A16.*** Yes. Again, assume plant additions that result in an incremental net rate base of
8 \$10,000,000. The grossed up return on this rate base of 10.81% produces revenues
9 of \$1,081,236 (unrounded). After deducting the commercial activities tax of
10 0.26%, there remains \$1,078,424 to cover the return on rate base. With the
11 incremental income tax deduction of \$253,000, the net income before taxes is now
12 \$825,424. With an income tax rate of 35.306%, the income tax on this taxable
13 income is \$291,424. The net income after taxes is then \$534,000. Of this amount,
14 \$9,000 goes to cover the cost of preferred stock, leaving \$525,000 for the required
15 return on common equity. The net return on the incremental balance of common
16 equity of \$5,000,000 is 10.50%, the Utility's requested return on common equity.

17

18 ***Q17. ARE YOU PROPOSING ANY OTHER MODIFICATIONS TO THE***
19 ***DISTRIBUTION INVESTMENT RIDER AS IT RELATES TO ADDITIONS***
20 ***TO DISTRIBUTION PLANT IN SERVICE?***

21 ***A17.*** I have not identified any other necessary technical corrections to the calculation
22 proposed DIR revenue requirement as it relates to additions to distribution plant
23 based any my review of the Utility's testimony, exhibits and responses to requests

1 for information. However, I believe that the Utility should be required to provide
2 additional support for certain elements of the incremental revenue requirement for
3 additions to distribution plant in service.

4
5 Accumulated deferred income taxes ("ADIT") are deducted from plant in service
6 in the calculation of the net incremental distribution rate base for the DIR. In
7 response to OCC Interrogatory 291, the Utility stated that the ADIT would be
8 calculated by multiplying the difference between the book basis and tax basis of
9 the relevant distribution plant accounts by the current income tax rate, with the net
10 tax basis including adjustments for basis differences between book and tax. The
11 Utility should include documentation supporting the tax basis for the relevant
12 distribution plant accounts and the adjustments for basis differences.

13
14 One of the elements of the total DIR revenue requirement is the property tax
15 expense on the relevant distribution plant additions. In response to OCC
16 Interrogatory 292, the Utility stated that the property tax expense will be calculated
17 by multiplying the relevant distribution plant accounts by an assessment
18 percentage and an average property tax rate, with true-ups for changes in the
19 average property tax rates as the rates become known. The Utility should be
20 required to provide documentation supporting the assessment percentage and
21 average property tax rate and workpapers supporting any true-up adjustments.

1 In addition, the method of calculating the increases in net distribution plant in the
2 specified distribution plant accounts since September 30, 2015 requires at least one
3 clarification. In the response to OCC Interrogatory 286, the Utility provided
4 support for the gross distribution plant of \$1,345,230,954 on Exhibit RJA-1.
5 Completed Construction not Classified (“CCNC”) is excluded from that total, the
6 base against which future plant balances will be compared for the purpose of
7 calculating the DIR revenue requirement. A footnote explaining the CCNC item
8 states that “The portion of the completed construction projects classified to
9 Account 106 which is applicable to the Distribution Investment Rider will not be
10 known until completed projects are unitized.” It appears from this note that it is
11 the Utility’s intent to include the CCNC in the base balance of September 30, 2015
12 distribution plant to which future balances will be combined. However it should
13 be clarified that the CCNC balance of \$61,957,745 as of September 30, 2015 will
14 be included in the base gross distribution plant as of that date to the extent that the
15 CCNC pertains to the plant accounts included in the DIR revenue requirement. If
16 CCNC is included in the future balance of DIR plant used to calculate the DIR
17 revenue requirement, then the CCNC should also be included in the September 30,
18 2015 plant balance, so that the balances used to calculate the incremental
19 distribution plant growth are stated on consistent basis.

1 ***Q18. IF THE COMMISSION APPROVES THE IMPLEMENTATION OF A***
2 ***DISTRIBUTION INVESTMENT RIDER, SHOULD THERE BE ANY***
3 ***MODIFICATIONS TO THE RIDER PROPOSED BY THE UTILITY?***

4 ***A18.*** Yes. While I do not think the Commission should approve the DIR, if the
5 Commission does approve the DIR, there should be at least two modifications.

6
7 First, the DIR should be subject to annual independent audit for accounting
8 accuracy, prudence, and compliance with the approved DIR plan.

9
10 Second, the annual revenue increases associated with the incremental DIR plant
11 should be subject to a cap.

12
13 ***Q19. HAVE YOU QUANTIFIED ANNUAL CAP THAT YOU WOULD***
14 ***RECOMMEND FOR THE DIR REVENUE REQUIREMENT RELATED TO***
15 ***DISTRIBUTION PLANT ADDITIONS?***

16 ***A19.*** Yes. I have quantified a recommended cap based on the Utility's actual experience
17 in 2015. The quantification of my recommended cap is shown on Schedule DJE-1.

18 First, I have calculated the increase in net distribution plant in service for 2015.

19 Because not all of the distribution plant is included in the DIR, I have applied the
20 ratio of DIR eligible plant to total distribution plant (based on the response to OCC
21 Interrogatory 286) to the 2015 increase in net distribution plant in service. I then
22 calculated the relevant balance of accumulated deferred income taxes ("ADIT) by
23 applying the ratio of ADIT to net distribution plant, as shown on Exhibit RJA-1.

1 To calculate the return requirement, I applied the grossed-up rate of return of
2 10.81% (as described above) to the DIR incremental rate base of \$25.3 million to
3 calculate an incremental DIR return requirement of \$2.7 million.

4
5 To calculate the incremental depreciation expense, I applied the composite
6 depreciation rate of 3.02%, based on Exhibit RJA-1, to the incremental gross DIR
7 plant of \$66.9 million. The resulting incremental depreciation expense is \$2.0
8 million.

9
10 To calculate the incremental property tax expense, I applied the ratio of property
11 tax expense to net distribution plant, from Exhibit RJA-1, to the incremental net
12 DIR plant of \$66.9 million. The resulting incremental property tax expense is \$2.1
13 million.

14
15 Finally, I added in the commercial activities tax on depreciation and property
16 taxes, although this is not a material component of my proposed cap.

17
18 I have calculated a total DIR revenue requirement based on the Utility's actual
19 2015 experience of \$6.8 million. Rounding this number off, I am recommending
20 an annual cap on DIR revenue increases related to distribution plant additions of
21 \$7 million.

B. WORKFORCE ADAPTATION

Q20. PLEASE DESCRIBE THE WORKFORCE ADAPTATION COMPONENT OF THE UTILITY'S PROPOSED DIR.

A20. As described in the testimony of Company Witness Hall, DP&L is planning to hire and train 20 new engineering and technical employees. The Workforce Adaptation component of the Utility's proposed DIR would recover these new employees' salaries and training costs.

Q21. SHOULD THE UTILITY'S PROPOSAL TO INCLUDE THE WORKFORCE ADAPTATION COST IN THE DIR BE APPROVED?

A21. No. The costs to be collected through Workforce Adaptation element do not meet any of the above described criteria for costs that should be subject to recovery through a rider. First, the expenses of new employees are clearly within the control of the Utility. Second, the expense of new employee positions is not volatile or subject to unpredictable fluctuations. Third, while the expenses associated with new employees may not be immaterial, for a utility the size of DP&L, they are not expenses of a magnitude that should qualify for recovery by means of an automatic recovery through a rider.

Finally, if the addition of employees is subject to recovery through a rider, this might create an incentive for the Utility to add employees rather than implement a potentially less costly alternative.

1 The Workforce Adaption recovery being proposed by DP&L is similar to the
2 Sustained and Skilled Workforce Rider (“SSWR”) proposed by AEP Ohio in Case
3 No. 13-2385-EL-SSO. In rejecting the proposed SSWR in that case, the
4 Commission found that such, “labor expense is more appropriately reviewed as
5 part of a more comprehensive analysis in the context of a distribution rate case. A
6 comprehensive review of AEP Ohio's overall labor expense in a distribution rate
7 case, rather than approving the SSWR as a provision of the ESP merely to expedite
8 cost recovery, will ensure that the Company is prudent and cost-effective with its
9 labor costs and management.”¹ As the recovery of Workforce Adaptation costs
10 through the DIR being proposed by DP&L would in principle have the same effect
11 as the SSWR proposed by AEP Ohio, the Commission’s conclusion should be the
12 same.

13
14 ***Q22. HAS THE UTILITY EXPLAINED SPECIFICALLY HOW IT WILL***
15 ***IDENTIFY ELIGIBLE WORKFORCE ADAPTATION EMPLOYEES FROM***
16 ***OTHER EMPLOYEE ADDITIONS?***

17 ***A22.*** No. In response to OCC Interrogatory 295, the Utility stated that when the DIR is
18 approved it will establish processes and procedures to identify the eligible
19 Workforce Adaptation employees and the costs associated with those employees.
20 In other words, DP&L requesting approval of the Workforce Adaptation
21 component of the DIR even before it has determined how the new eligible
22 Workforce Adaptation employees would be identified.

¹ Case No. 13-2385-EL-SSO, et al., *Ohio Power Company*, Opinion and Order, February 25, 2015, at 59

1 ***Q23. WHAT DO YOU RECOMMEND REGARDING THE PROPOSED***
2 ***WORKFORCE ADAPTATION COMPONENT OF THE DIR?***

3 ***A23.*** DP&L has not established that its Workforce Adaptation proposal is either
4 necessary or appropriate or that such a rider is the proper mechanism to collect
5 new employee costs from customers. It should not be approved.

6

7 **III. CONCLUSION**

8

9 ***Q24. PLEASE SUMMARIZE YOUR TESTIMONY.***

10 ***A24.*** The PUCO should reject the proposed DIR. However, if the PUCO approves the
11 proposed DIR, the method of calculating the return component should be modified
12 as described above. Additionally, DP&L should be required to provide additional
13 information supporting certain elements of the distribution revenue requirement.
14 Finally, the DIR should be subject to annual audit, and the annual revenue increases
15 associated with the incremental DIR plant should be subject to a cap. The proposal
16 to recover Workforce Adaption costs through the DIR should not be approved.

17

18 ***Q25. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?***

19 ***A25.*** Yes. However, I reserve the right to incorporate new information that may
20 subsequently become available.

CERTIFICATE OF SERVICE

It is hereby certified that a true copy of the foregoing *Direct Testimony of David J. Effron on Behalf of the Office of the Ohio Consumers' Counsel* was served via electronic transmission to the persons listed below this 21st day of November 2016.

/s/ William J. Michael

William J. Michael
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