

EXHIBIT NO. _____

BEFORE
THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Application Seeking)	
Approval of Ohio Power Company's)	
Proposal to Enter Into Renewable Energy)	Case No. 18- 1392-EL-RDR
Purchase Agreements for Inclusion in the)	
Renewable Generation Rider)	
In the Matter of the Application of Ohio)	Case No. 18-1393-EL-ATA
Power Company to Amend its Tariffs)	

DIRECT TESTIMONY OF
STEVEN M. FETTER
ON BEHALF OF
OHIO POWER COMPANY

Filed: September 27, 2018

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STEVEN M. FETTER

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ON BEHALF OF
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1 **INTRODUCTION AND BACKGROUND**

2 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

3 A. My name is Steven M. Fetter. My business address is 1240 West Sims Way, Port
4 Townsend, Washington 98368.

5 **Q. ON WHOSE BEHALF ARE YOU PROVIDING DIRECT TESTIMONY?**

6 A. I am testifying on behalf of the Ohio Power Company (“AEP Ohio” or “Company”).

7 **Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?**

8 A. I am President of Regulation UnFettered, a utility advisory firm I started in April 2002.
9 Prior to that, I was employed by Fitch, Inc. (“Fitch”), a credit rating agency based in New
10 York and London. Prior to that, I served as Chairman of the Michigan Public Service
11 Commission (“Michigan PSC”).

12 **Q. PLEASE BRIEFLY DESCRIBE YOUR EDUCATIONAL BACKGROUND.**

13 A. I graduated with high honors from the University of Michigan with an A.B. in
14 Communications in 1974. I graduated from the University of Michigan Law School with
15 a J.D. in 1979.

16 **Q. PLEASE DESCRIBE YOUR SERVICE ON THE MICHIGAN PUBLIC SERVICE**
17 **COMMISSION.**

18 A. I was appointed as a Commissioner to the three-member Michigan PSC in October 1987
19 by Democratic Governor James Blanchard. In January 1991, I was promoted to

1 Chairman by incoming Republican Governor John Engler, who reappointed me in July
2 1993. During my tenure as Chairman, timeliness of commission processes was a major
3 focus and my colleagues and I achieved the goal of eliminating the agency's case backlog
4 for the first time in 23 years. While on the Michigan PSC, I also served as Chairman of
5 the Board of the National Regulatory Research Institute ("NRRI"), the research arm of
6 the National Association of Regulatory Utility Commissioners, which was then located at
7 The Ohio State University. After leaving regulatory service, I was appointed to the NRRI
8 Board as a public member.

9 **Q. WHAT WAS YOUR ROLE IN YOUR EMPLOYMENT WITH FITCH?**

10 A. I was Group Head and Managing Director of the Global Power Group within Fitch. In
11 that role, I served as group manager of the combined 18-person New York and Chicago
12 utility team. I was originally hired to interpret the impact of regulatory and legislative
13 developments on utility credit ratings, a responsibility I continued to have throughout my
14 tenure at the rating agency. In April 2002, I left Fitch to start Regulation UnFettered.

15 **Q. HOW LONG WERE YOU EMPLOYED BY FITCH?**

16 A. I was employed by Fitch from October 1993 until April 2002. In addition, Fitch retained
17 me as a consultant for a period of approximately six months shortly after I resigned.

18 **Q. PLEASE DESCRIBE YOUR ROLE AS PRESIDENT OF REGULATION**
19 **UNFETTERED.**

20 A. I formed a utility advisory firm to use my financial, regulatory, legislative, and legal
21 expertise to aid the deliberations of regulators, legislative bodies, and the courts, and to
22 assist them in evaluating regulatory issues. My clients have included investor-owned and
23 municipal electric, natural gas and water utilities, state public utility commissions and

1 consumer advocates, non-utility energy suppliers, international financial services and
2 consulting firms, and investors.

3 **Q. HOW DOES YOUR EXPERIENCE RELATE TO YOUR TESTIMONY IN THIS**
4 **PROCEEDING?**

5 A. My experience as Chairman and Commissioner on the Michigan PSC and my subsequent
6 professional experience with financial analysis and ratings of the U.S. electric and natural
7 gas sectors – in jurisdictions involved in restructuring activity as well as those still
8 following a traditional regulated path – have given me solid insight into the importance of
9 a regulator’s role vis-à-vis regulated utilities, both in setting their rates as well as the
10 appropriate terms and conditions for the service they provide. In addition, for almost 20
11 years I have served as a member of the Wall Street Utility Group, an organization
12 comprised of debt and equity analysts assigned to cover and make recommendations on
13 companies within the utility sector.

14 **Q. HAVE YOU PREVIOUSLY GIVEN TESTIMONY BEFORE REGULATORY**
15 **AND LEGISLATIVE BODIES?**

16 A. Since 1990, I have testified on numerous occasions before the U.S. Senate, the U.S.
17 House of Representatives, the Federal Energy Regulatory Commission, federal district
18 and bankruptcy courts, and various state and provincial legislative, judicial, and
19 regulatory bodies on the subjects of credit risk and cost of capital within the utility sector,
20 electric and natural gas utility restructuring, fuel and other energy cost adjustment
21 mechanisms, regulated utility mergers and acquisitions, construction work in progress
22 and other interim rate recovery structures, utility securitization bonds, and nuclear
23 energy. I have previously filed testimony before the Public Utilities Commission of Ohio

1 (“Commission”) on behalf of Vectren Energy Delivery of Ohio, Inc. in Case Nos. 04-
2 571-GA-AIR and 04-794-GA-AAM (related to decoupling), Cinergy/Cincinnati Gas &
3 Electric Company and Duke Energy Corporation in their Merger Case Nos. 05-732-EL-
4 MER/05-733-EL-AAM, AEP Ohio in Case Nos. 14-1693-EL-RDR/14-1694-EL-AAM
5 (related to PPA and PPA Rider), and Duke Energy Ohio in Case Nos. 17-872-EL-
6 RDR/17-873-EL-ATA et al. (related to PSR Rider and proposed stipulation).

7 My full educational and professional background is presented in Exhibit SMF-1.

8 **PURPOSE OF TESTIMONY**

9 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?**

10 A. AEP Ohio has asked me to review its debt equivalency cost recovery proposal related to
11 the solar renewable energy purchase agreements [“REPAs”] that are under consideration
12 in this proceeding, and, utilizing my past experience as a state utility commission
13 chairman, head of a major utility credit rating practice, and utility consultant to regulated
14 utilities, utility commissions, and consumer advocates, offer an opinion as to whether
15 Commission approval of that debt equivalency cost recovery as part of the cost associated
16 with entering into a prudent REPA aligns with the public interest in Ohio.

17 **Q. WHAT DID YOU CONCLUDE?**

18 A. In reviewing the Company’s proposal, I focused on the following factors:
19 • In choosing the REPAs to meet future renewable energy needs, the Company is
20 forgoing the options of utility or affiliate partial or complete ownership of alternative
21 means of providing that capacity, thereby taking advantage of a lower price than
22 ownership (even with debt equivalency cost recovery), while also supporting Ohio
23 energy policies as explained by AEP Ohio witness Jon Williams;

- 1 • By committing to the long-term REPAs, AEP Ohio, a financially-strong contract
2 counterparty, will be facilitating the ability of small developers to secure financing
3 for their renewable projects and proceed with facility construction and operation;
- 4 • In the view of the rating agencies, the execution of the long-term REPAs under
5 consideration in this case will create downward pressure on the Company's credit
6 profile, barring steps taken by the Commission to mitigate the downward pressure on
7 the Company's credit ratings of the increased "imputed debt" load triggered by those
8 REPAs; and
- 9 • In the absence of the debt equivalency cost recovery, or other mitigative steps such as
10 increasing the Company's authorized equity level or overall return on equity, AEP
11 Ohio will be committing to long-term financial risks with no countervailing benefit,
12 including less than full compensation for all of the costs of the REPAs.

13 Accordingly, I conclude that AEP Ohio's debt equivalency cost recovery proposal is
14 consistent with the public interest and should be approved.

15 **CREDIT RATINGS AND THEIR IMPORTANCE TO REGULATED UTILITIES**

16 **Q. YOU HIGHLIGHT CREDIT RATINGS ABOVE. COULD YOU EXPLAIN**
17 **WHAT A CREDIT RATING IS AND WHY IT IS IMPORTANT?**

18 A. A credit rating reflects an independent judgment of the general creditworthiness of an
19 obligor or of a specific debt instrument. While credit ratings are important to both debt
20 and equity investors for a variety of reasons, their most important purpose is to
21 communicate to investors the financial strength of a company or the underlying credit
22 quality of a particular debt security issued by that company.

Credit rating determinations are made by credit rating agencies through a committee process involving individuals with knowledge of a company, its industry, and its regulatory environment. Corporate rating designations of Standard and Poor's ("S&P") and Fitch have 'AAA', 'AA', 'A' and 'BBB' category ratings within the investment-grade ratings sphere, with 'BBB-' as the lowest investment-grade rating and 'BB+' as the highest non-investment-grade rating. Comparable rating designations of Moody's Investors Service ("Moody's") at the investment-grade dividing line are 'Baa3' and 'Ba1', respectively. The following chart illustrates the comparability of ratings between the three agencies.

CHART 1

Ratings Categories – Comparability Between Agencies

Investment Grade		Below Investment Grade	
<u>S&P and Fitch</u>	<u>Moody's</u>	<u>S&P and Fitch</u>	<u>Moody's</u>
AAA	Aaa	BB+	Ba1
AA+	Aa1	BB	Ba2
AA	Aa2	BB-	Ba3
AA-	Aa3	B+	B1
A+	A1	B	B2
A	A2 (¹)	B-	B3
A- (²)	A3	CCC	Caa
BBB+	Baa1	CC	Ca
BBB	Baa2	C	C
BBB-	Baa3	D	[C]

Corporate credit rating analysis considers both qualitative and quantitative factors to assess the financial and business risks of fixed-income debt issuers. A credit rating is an indication of an issuer's ability to service its debt, both principal and interest, on a

¹ AEP Ohio corporate rating from Moody's with a Stable outlook.

² AEP Ohio corporate rating from S&P with a Stable outlook.

1 timely basis. It also at times incorporates some consideration of ultimate recovery of
2 investment in case of default or insolvency. Ratings can also be used by contractual
3 counterparties to gauge both the short-term and longer-term financial health and viability
4 of a company, including decisions related to required collateral levels, with higher-rated
5 entities facing lower requirements.

6 **Q. WHAT CREDIT RATINGS DOES AEP OHIO NOW HOLD?**

7 A. As noted on the chart above, the Company currently holds corporate credit ratings of
8 “A2” with a Stable outlook from Moody’s and “A-” with a Stable outlook from S&P.
9 These “A” category ratings indicate a financially-strong regulated utility.

10 **Q. WHY ARE CREDIT RATINGS IMPORTANT FOR REGULATED UTILITIES**
11 **AND THEIR CUSTOMERS?**

12 A. A utility’s credit ratings have a significant impact on its ability to raise capital on a timely
13 basis and with reasonable terms. As economist Charles F. Phillips states in his treatise on
14 utility regulation, which is a widely-respected and reliable authority on utility regulatory
15 frameworks and policies, especially those related to financial issues:

16 Bond ratings are important for at least four reasons: (1) they are used by
17 investors in determining the quality of debt investment; (2) they are used
18 in determining the breadth of the market, since some large institutional
19 investors are prohibited from investing in the lower grades; (3) they
20 determine, in part, the cost of new debt, since both the interest charges on
21 new debt and the degree of difficulty in marketing new issues tend to rise
22 as the rating decreases; and (4) they have an indirect bearing on the status
23 of a utility’s stock and on its acceptance in the market.³
24

³ Phillips, Charles F., Jr., The Regulation of Public Utilities, Arlington, Virginia: Public Utilities Reports, Inc., 1993, at p. 250 (emphasis supplied). *See also* Public Utilities Reports Guide: “Finance,” Public Utilities Reports, Inc., 2004 at pp. 6-7 (“Generally, the higher the rating of the bond, the better the access to capital markets and the lower the interest to be paid.”).

1 I particularly agree with Dr. Phillips on his observation that a credit rating helps
2 drive a utility's debt costs. Thus, a utility with strong credit ratings is not only able to
3 access the capital markets on a timely basis at reasonable rates, it is also able to share the
4 benefit from those attractive interest rate levels with customers since cost of capital is
5 factored into customer rates. Conversely, but of equal importance, the lower a utility's
6 credit rating, the more the utility must pay to raise funds from debt and equity investors
7 to carry out its capital-intensive operations, which results in higher costs included in
8 customer rates.

9 **Q. WHAT QUALITATIVE FACTORS ARE USED IN THE CREDIT RATING**
10 **PROCESS?**

11 A. The most important qualitative factors are regulation, management and business strategy,
12 and access to energy, gas and fuel supply with recovery of associated costs, including
13 utility payments required under purchase power contracts.

14 **Q. WHAT ARE THE KEY QUANTITATIVE MEASURES THAT ARE USED BY**
15 **THE RATING AGENCIES TO ESTABLISH UTILITY CREDIT RATINGS?**

16 A. The rating agencies use several financial measures within their utility financial analysis.
17 S&P currently highlights the following two core financial ratios as its key indicators:
18 Funds from Operations to Debt (FFO / Debt), which focuses on cash flow; and Debt to
19 Earnings Before Interest, Taxes, Depreciation and Amortization (Debt / EBITDA), which
20 provides a comparative measure of leverage and profitability.⁴ A focus on these two
21 ratios is consistent with S&P's long-held belief that "Cash flow analysis is the single

⁴ S&P Research: "Corporate Methodology," November 19, 2013.

1 most critical aspect of all credit rating decisions.”⁵ Moody’s and Fitch place similar
2 reliance on cash flow within their ratings processes.⁶ Of significant relevance in this
3 proceeding, rating agencies often adjust these key ratios to reflect imputed debt and
4 interest-like fixed charges related to operating leases and certain other off-balance sheet
5 obligations, such as the REPAs at issue here. This “imputed debt” adjustment is known
6 within rating agency parlance as “debt equivalency,” which I will discuss in the next
7 section.

8 **DEBT EQUIVALENCY**

9 **Q. WOULD YOU PROVIDE SOME INTRODUCTORY COMMENTARY ON THE**
10 **CONCEPT OF “DEBT EQUIVALENCY?”**

11 A. Yes. Having served as both a state utility regulator and a utility bond credit rater, the two
12 issues that come first to my mind when the subject of resource planning needs is raised
13 are:

14 From the consumer side:

15 “What manner of procurement is most fair to the regulated utility’s customers?”

16 and

17 From the investor side:

18 “What risks accompany the two most prevalent means of meeting that increased need –
19 utility self-build or a utility entering into a PPA for a defined period of time?”

⁵ S&P Research: “A Closer Look at Ratings Methodology,” November 13, 2006.

⁶ See, for example, Moody’s Research: “Regulated Electric and Gas Utilities,” December 23, 2013, and Fitch Research: “Corporate Rating Criteria,” March 23, 2018.

1 The answers to these questions were becoming more complex as I was leaving my role as
2 head of the Fitch utility ratings group in 2002 and transitioning into my current status of
3 advisor to utilities, utility commissions, and consumers.

4 Of the three major rating agencies, S&P was the earliest to look more closely at
5 this issue during the 1990's, but a greater public focus came about following May 8,
6 2003, the date when S&P published a seminal report entitled, "Buy Versus Build: Debt
7 Aspects of Purchased-Power Agreements." With that report, the issue of PPAs and
8 imputed debt could be more easily analyzed by the entire financial community, along
9 with analysts at regulated utilities, as now they would be able to quantify and predict the
10 potential rating effects that would flow from specific utility supply procurement
11 decisions.⁷

12 **Q. YOUR DESCRIPTION OF THE S&P REPORT AS "SEMINAL" CONNOTES**
13 **THAT PROCESSES THEREAFTER BEGAN TO CHANGE?**

14 A. Yes, I think that is an accurate description. S&P started the 2003 report by explaining
15 that the agency:

16 "...views electric utility purchased-power agreements (PPA) as debt-like
17 in nature, and has historically capitalized these obligations on a sliding
18 scale known as a 'risk spectrum.' [S&P] applies a 0% to 100% 'risk
19 factor' to the net present value (NPV) of the PPA capacity payments, and
20 designates the amount of the debt equivalent."
21

22 Simply stated, S&P explained that, while several variables went into determination of the
23 appropriate risk factor, vertically integrated regulated utilities were well-positioned to

⁷ While all three of the major rating agencies utilize debt equivalency for PPAs in some fashion, S&P has been the most explicit in explaining its rationale and processes within their research reports cited in this testimony. Accordingly, S&P's methodology will be the primary focus of my discussion of debt equivalency and the use of imputed debt within the credit rating process.

1 recover their PPA costs, since their “tariffs are typically set by regulators to recover
2 costs,” and their customer base and obligation to serve those customers rendered
3 purchased power similar to capital costs and fuel costs, and thus properly includible in
4 tariffs as a cost of service. Thus, debt equivalency allowed S&P to evaluate “The
5 benefits and risks of purchased power by adjusting a purchasing utility’s reported
6 financial statements to allow for more meaningful comparisons with utilities that build
7 generation.”

8 **Q. HAS S&P REFINED ITS DEBT EQUIVALENCY PROCESS OVER TIME?**

9 A. Yes it has. Four years later, S&P expounded upon the concept of debt equivalency with a
10 more nuanced discussion of the mechanics of PPA debt imputation.⁸ Stating that “a
11 utility that has entered into a PPA has contracted with a supplier to make the financial
12 investment on its behalf,” S&P concluded that “PPA fixed obligations, in the form of
13 capacity payments, merit inclusion in a utility’s financial metrics as though they are part
14 of a utility’s permanent capital structure [to be] incorporated in our assessment of a
15 utility’s creditworthiness.” S&P noted, however, that the burden on the utility’s credit
16 profile also came with benefits: “PPAs will typically shift various risks to the suppliers,
17 such as construction risk and most of the operating risk [, and] can also provide utilities
18 with asset diversity that might not have been achievable through self-build” – leaving the
19 principal risk to be borne by the utility the ability to recover those PPA costs in rates, the
20 most important consideration in S&P’s setting of a risk factor.

⁸ S&P Research: “Standard & Poor’s Methodology for Imputing Debt for U.S. Utilities’ Power Purchase Agreements,” May 7, 2007.

1 **Q. HOW DID THAT UNCERTAINTY ABOUT COST RECOVERY ENTER INTO**
2 **S&P'S METHODOLOGY?**

3 A. S&P would set risk factors based upon "the strength and availability of regulatory or
4 legislative vehicles for the recovery of the capacity costs associated with power supply
5 arrangements." S&P typically sets these factors on a scale from 0% to 50%, with the
6 strongest recovery mechanisms pointing toward the low end, while the weakest can
7 approach 100%. For example, the existence of a power cost adjustment mechanism that
8 provides ongoing recovery of prudent PPA costs between rate cases would point toward a
9 25% risk factor, while a requirement that such recovery can only be determined within a
10 periodic rate case likely leading to a 50% factor or worse, depending upon the reputation
11 of the utility commission for constructive regulation within its decision-making. It is
12 important to note that S&P views "legislatively created cost recovery mechanisms as
13 longer lasting and more resilient to change than regulatory cost recovery vehicles," thus
14 often leading to risk factors in the 0% to 15% range.

15 **Q. WOULD YOU EXPLAIN HOW S&P UTILIZES ITS RISK FACTORS?**

16 A. Yes. First, the agency calculates the net present value ("NPV") of the stream of capacity
17 payments the utility will pay under the PPA, using a discount rate equal to the utility's
18 average cost of debt. That NPV is then multiplied by the risk factor to arrive at a
19 quantum that is added to the utility's debt on its balance sheet, along with implied interest
20 and depreciation expenses that are used by the agency to calculate the utility's key
21 financial ratios that are analyzed within the ratings process. [AEP Ohio Exhibit SMF-2
22 includes a chart from S&P's May 2007 report illustrating how the adjustments are made.]

1 **Q. HAS S&P PROVIDED FURTHER AFFIRMATION OF THE CONTINUING**
2 **VITALITY OF ITS DEBT EQUIVALENCY METHODOLOGY?**

3 A. Yes it has. On November 19, 2013, S&P published a report entitled, “Key Credit Factors
4 for the Regulated Utilities Industry,” in which it tracked the debt equivalency process the
5 agency had been utilizing, providing some additional descriptive detail for clarity sake.
6 [See AEP Ohio Exhibit SMF-3]. Further, on June 5, 2018, S&P reviewed and
7 republished that report, so the language included in that report clearly represents the
8 agency’s current thinking on the issue of debt equivalency.

9 **Q. HOW SHOULD THE PROCESS DELINEATED ABOVE ENTER INTO THE**
10 **COMMISSION’S DELIBERATIONS IN THIS PROCEEDING?**

11 A. AEP witness William Allen has utilized the approach explained in S&P’s 2013 report to
12 illustrate the downward pressure on the Company’s credit ratings that would occur upon
13 AEP Ohio entering into the long-term REPAs under consideration here – that is, *if* no
14 mitigation of that impact were to be approved by the Commission in the form of the debt
15 equivalency cost recovery proposal, or alternatively by means of an increase in the
16 Company’s authorized equity level or overall return on equity.

17 **Q. DO YOU ENVISION THAT THE DOWNWARD PRESSURE THAT MR. ALLEN**
18 **HAS CALCULATED IN HIS TESTIMONY WILL LEAD TO AN ACTUAL**
19 **DOWNGRADE FOR AEP OHIO?**

20 A. Due to AEP Ohio’s strong “A”-category ratings from S&P and Moody’s, both with
21 Stable outlooks, at this point in time I do not believe that a downgrade would result.
22 However, I do wish to note a misconception that I have had to respond to in many of the
23 cases in which I have testified. The balance sheet effects of a REPA are not only

1 measured in terms of downgrades. Even in the absence of a downgrade, a negative
2 decision in this case would weaken the strong credit profile now held by the Company, so
3 that later misfortunes -- be they weather-related or operational, financial or regulatory
4 setbacks -- could lead to a downgrade that would not have occurred if the decision here
5 was more supportive of the Company's strategy. As Moody's stated in its July 23, 2018
6 report on the Company:

7 The stable outlook acknowledges that beyond 2018, diminished cash flow
8 due to federal tax reform and the loss of transition riders will cause cash
9 flow credit metrics to decline significantly from their current robust levels.
10 However, we anticipate metrics will remain supportive of the utility's
11 current credit quality.⁹
12

13 It is important to note that Moody's, in that same report, stated that its position is
14 predicated on its opinion that this Commission and the Supreme Court of Ohio are
15 "generally supportive of utility credit quality, and [Moody's] anticipate[s] that this
16 supportive relationship will continue." A decision here not to fully compensate AEP
17 Ohio for the true costs of the REPAs would represent further stress on the Company's
18 current credit profile.

19 The Brattle Group, a respected utility consulting firm, opined as much in a 2008
20 report on the very topic at issue in this proceeding:

21 Imputed debt increases a utility's financial risk and weakens its financial
22 ratios. If the credit ratios weaken enough, the utility's credit rating may be
23 downgraded or may be prevented from being upgraded. The increased cost
24 of debt from a credit rating downgrade would be clear evidence of the
25 adverse impact of imputed debt, but if there were no credit downgrade, is
26 there any effect from imputed debt?
27

⁹ Moody's Research: "Ohio Power Company: Update to Credit Analysis," July 23, 2018.

1 Yes. Debt holders and equity holders will require a higher return to
2 compensate for the increased risk of default and increased financial risk.
3 Debt ratings are discrete, but the range of ratios for any particular rating is
4 continuous. As a company's ratios weaken, the utility's credit strength
5 approaches the next lower credit rating. If the ratios are allowed to continue
6 to deteriorate, the credit rating will ultimately be downgraded. Moreover,
7 the utility's credit ratios are known to the market. As the ratios weaken
8 (strengthen), debt costs will increase (decrease) commensurately even
9 though the credit rating has not yet been affected. The same logic applies to
10 the cost of equity... As financial risk increases, investors will require a
11 higher expected rate of return... The increased cost of debt and equity from
12 imputed debt cannot be avoided because the market will require
13 compensation one way or another...

14
15 One task for regulators is to ensure that decisions regarding whether the
16 utility should build a generator or sign a PPA are not unfairly weighted in
17 favor of a PPA by ignoring the risk transfer to the utility.¹⁰
18

19 **Q. DO YOU SEE PUBLIC POLICY BENEFITS FLOWING FROM THE**
20 **COMPANY'S PROPOSAL IN THIS PROCEEDING THAT WOULD JUSTIFY**
21 **APPROVAL OF DEBT EQUIVALENCY COST RECOVERY?**

22 A. Yes I do. I understand that the Company had many options it could choose in this case,
23 including meeting capacity needs through utility or unregulated affiliate partial or
24 complete ownership of new supply. By voluntarily supporting third-party renewable
25 projects, AEP Ohio is in tune with the policy goals of the Commission and the Ohio
26 General Assembly, as further explained by AEP Ohio witness Williams.

27 **Q. HOW SO?**

28 A. On my first day as a regulator in 1987, I and my colleagues were confronted with dozens
29 of small project developers attempting to compete with the Midland Cogeneration
30 Venture, then the largest cogeneration facility in the world, 50% owned by the local

¹⁰ The Brattle Group (for the Edison Electric Institute), "Understanding Debt Imputation Issues," June 3, 2008 (footnotes excluded).

1 utility Consumers Power. We saw firsthand how difficult it was for small projects to
2 move forward in the absence of utility cooperation. The situation is very different here.
3 The fact that AEP Ohio is such a strong creditworthy counterparty to the REPAs, and one
4 supportive of the proposed renewable capacity additions, means that the small developers
5 should be able to structure their projects with less equity (and higher leverage) and upon
6 more favorable financing terms. In the absence of the debt equivalency cost recovery
7 proposal (or other mitigative financial steps), all that AEP Ohio would be receiving here
8 would be twenty years of having to meet payment commitments under the REPAs, while
9 bearing the risk of inadequate cost recovery over the life of the contracts. Even if the
10 current Commission is fully supportive, such risk carries forward subject to the views of
11 future commissions whose membership cannot be foreseen or predicted. I believe the
12 debt equivalency cost recovery proposal strikes a fair balance under the structure
13 envisioned in this case: development of economic renewable projects for the benefit of
14 retail customers, coupled with maintenance of the Company's financial stability.

15 **CONCLUSION**

16 **Q. DO YOU HAVE CONCLUDING THOUGHTS?**

17 A. Yes I do. Regulatory decision-making calls for a careful weighing of facts and law, the
18 assessment of risks, and the setting of a fair risk-adjusted return on investment. Under the
19 structure proposed here, a quantum of risk exists which has to go somewhere. In the
20 absence of an executed PPA, the risk starts at the small developer level – where, in most
21 cases it will also end, because financing would likely not be possible without a long-term
22 offtake commitment from a creditworthy entity. So the next step is transference of a
23 portion of that risk to the contractual counterparty, here AEP Ohio. That utility is taking

1 on the risk of long-term contractual payments for which it will seek recovery from the
2 Commission – which even under the best of regulatory circumstances, entails a degree of
3 regulatory lag. The Commission is then in a position to limit that risk through regulatory
4 support that hopefully will continue when other policymakers are appointed to serve in
5 that role in the future. Under the sequence I have just described, the small project
6 developers benefit from the involvement of the creditworthy Company, and regulators
7 benefit from having such a financially-strong utility facilitating the creation of new
8 capacity supply, while furthering policy goals. The only entity that would not benefit is
9 the Company, which lends support for the projects' funding and construction, and pays
10 the bills when due. All it gets is a diminution of the strength of its credit profile. Based
11 upon my experience on all sides of the regulatory process, I conclude that AEP Ohio's
12 debt equivalency cost recovery proposal fills that gap in a fair and appropriate manner.

13 **Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?**

14 **A.** Yes it does.

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Founder of advisory firm providing regulatory, legislative, financial, legal and strategic planning advisory services for the energy, water and telecommunications sectors, including public utility commissions and consumer advocates; federal and state testimony; credit rating advisory services; negotiation, arbitration and mediation services; skills training in ethics, negotiation, and management efficiency.

Service on Boards of Directors of: Central Hudson (Fortis Inc. subsidiary) (Chairman, Governance and Human Resources Committee); and Previously CH Energy Group (Lead Independent Director; Chairman, Audit Committee, Compensation Committee, and Governance and Nominating Committee); National Regulatory Research Institute (Chairman); Keystone Energy Board; and Regulatory Information Technology Consortium; Member, Wall Street Utility Group; Participant, Keystone Center Dialogues on RTOs and on Financial Trading and Energy Markets.

October 1993 – April 2002

Group Head and Managing Director; Senior Director -- Global Power Group, Fitch IBCA Duff & Phelps -- New York / Chicago

Manager of 18-employee (\$15 million revenue) group responsible for credit research and rating of fixed income securities of U.S. and foreign electric and natural gas companies and project finance; Member, Fitch Utility Securitization Team.

Led an effort to restructure the global power group that in three years' time resulted in 75% new personnel and over 100% increase in revenues, transforming a group operating at a substantial deficit into a team-oriented profit center through a combination of revenue growth and expense reduction.

Achieved national recognition as a speaker and commentator evaluating the effects of regulatory developments on the financial condition of the utility sector and individual companies; Cited by Institutional Investor (9/97) as one of top utility

analysts at rating agencies; Frequently quoted in national newspapers and trade publications including The New York Times, The Wall Street Journal, International Herald Tribune, Los Angeles Times, Atlanta Journal-Constitution, Forbes and Energy Daily; Featured speaker at conferences sponsored by Edison Electric Institute, Nuclear Energy Institute, American Gas Assn., Natural Gas Supply Assn., National Assn. of Regulatory Utility Commissioners (NARUC), Canadian Electricity Assn.; Frequent invitations to testify before U.S. Senate (on C-Span) and House of Representatives, and state legislatures and utility commissions.

Participant, Keystone Center Dialogue on Regional Transmission Organizations; Member, International Advisory Council, Eisenhower Fellowships; Author, "A Rating Agency's Perspective on Regulatory Reform," book chapter published by Public Utilities Reports, Summer 1995; Advisory Committee, Public Utilities Fortnightly.

March 1994 – April 2002

Consultant -- NYNEX -- New York, Ameritech -- Chicago, Weatherwise USA -- Pittsburgh

Provided testimony before the Federal Communications Commission and state public utility commissions; Formulated and taught specialized ethics and negotiation skills training program for employees in positions of a sensitive nature due to responsibilities involving interface with government officials, marketing, sales or purchasing; Developed amendments to NYNEX Code of Business Conduct.

October 1987 - October 1993

Chairman; Commissioner -- Michigan Public Service Commission -- Lansing

Administrator of \$15-million agency responsible for regulating Michigan's public utilities, telecommunications services, and intrastate trucking, and establishing an effective state energy policy; Appointed by Democratic Governor James Blanchard; Promoted to Chairman by Republican Governor John Engler (1991) and reappointed (1993).

Initiated case-handling guideline that eliminated agency backlog for first time in 23 years while reorganizing to downsize agency from 240 employees to 205 and eliminate top tier of management; MPSC received national recognition for fashioning incentive plans in all regulated industries based on performance, service quality, and infrastructure improvement.

Closely involved in formulation and passage of regulatory reform law (Michigan Telecommunications Act of 1991) that has served as a model for other states; Rejuvenated dormant twelve-year effort and successfully lobbied the Michigan Legislature to exempt the Commission from the Open Meetings Act, a controversial step that shifted power from the career staff to the three commissioners.

Elected Chairman of the Board of the National Regulatory Research Institute (at Ohio State University); Adjunct Professor of Legislation, American University's Washington College of Law and Thomas M. Cooley Law School; Member of NARUC Executive, Gas, and International Relations Committees, Steering Committee of U.S. Environmental Protection Agency/State of Michigan Relative Risk Analysis Project, and Federal Energy Regulatory Commission Task Force on Natural Gas Deliverability; Eisenhower Exchange Fellow to Japan and NARUC Fellow to the Kennedy School of Government; Ethics Lecturer for NARUC.

August 1985 - October 1987

Acting Associate Deputy Under Secretary of Labor; Executive Assistant to the Deputy Under Secretary -- U.S. Department of Labor -- Washington DC

Member of three-person management team directing the activities of 60-employee agency responsible for promoting use of labor-management cooperation programs. Supervised a legal team in a study of the effects of U.S. labor laws on labor-management cooperation that has received national recognition and been frequently cited in law reviews (U.S. Labor Law and the Future of Labor-Management Cooperation, w/S. Schlossberg, 1986).

January 1983 - August 1985

Senate Majority General Counsel; Chief Republican Counsel -- Michigan Senate -- Lansing

Legal Advisor to the Majority Republican Caucus and Secretary of the Senate; Created and directed 7-employee Office of Majority General Counsel; Counsel, Senate Rules and Ethics Committees; Appointed to the Michigan Criminal Justice Commission, Ann Arbor Human Rights Commission and Washtenaw County Consumer Mediation Committee.

March 1982 - January 1983

Assistant Legal Counsel -- Michigan Governor William Milliken -- Lansing

Legal and Labor Advisor (member of collective bargaining team); Director, Extradition and Clemency; Appointed to Michigan Supreme Court Sentencing Guidelines Committee, Prison Overcrowding Project, Coordination of Law Enforcement Services Task Force.

October 1979 - March 1982

Appellate Litigation Attorney -- National Labor Relations Board -- Washington DC

Other Significant Speeches and Publications

Filing for Bankruptcy Isn't the Right Solution for Puerto Rico (Forbes Online, November 2015)

The "A" Rating (Edison Electric Institute Perspectives, May/June 2009)

Perspective: Don't Fence Me Out (Public Utilities Fortnightly, October 2004)

Climate Change and the Electric Power Sector: What Role for the Global Financial Community (during Fourth Session of UN Framework Convention on Climate Change Conference of Parties, Buenos Aires, Argentina, November 3, 1998) (unpublished)

Regulation UnFettered: The Fray By the Bay, Revisited (National Regulatory Research Institute Quarterly Bulletin, December 1997)

The Feds Can Lead...By Getting Out of the Way (Public Utilities Fortnightly, June 1, 1996)

Ethical Considerations Within Utility Regulation, w/M. Cummins (National Regulatory Research Institute Quarterly Bulletin, December 1993)

Legal Challenges to Employee Participation Programs (American Bar Association, Atlanta, Georgia, August 1991) (unpublished)

Proprietary Information, Confidentiality, and Regulation's Continuing Information Needs: A State Commissioner's Perspective (Washington Legal Foundation, July 1990)

Illustration Of The PPA Adjustment Methodology

The calculations of the debt equivalents, implied interest expense, depreciation expense, and adjusted financial metrics, using risk factors, are illustrated in the following example:

Example Of Power-Purchase Agreement Adjustment							
(\$000s)	Assumption	Year 1	Year 2	Year 3	Year 4	Year 5	Thereafter
Cash from operations	2,000,000						
Funds from operations	1,500,000						
Interest expense	444,000						
Directly issued debt							
Short-term debt	600,000						
Long-term due within one year	300,000						
Long-term debt	6,500,000						
Shareholder's Equity	6,000,000						
Fixed capacity commitments	600,000	600,000	600,000	600,000	600,000	600,000	4,200,000*
NPV of fixed capacity commitments							
Using a 6.0% discount rate	5,030,306						
Application of an assumed 25% risk factor	1,257,577						
Implied interest expense¶	75,455						
Implied depreciation expense	74,545						
Unadjusted ratios							
FFO to interest (x)	4.4						
FFO to total Debt (%)	20.0						
Debt to capitalization (%)	55.0						
Ratios adjusted for debt imputation							
FFO to interest (x)§	4.0						
FFO to total debt (%)**	18.0						
Debt to capitalization (%)¶¶	59.0						

*Thereafter approximate years: 7. ¶ The current year's implied interest is subtracted from the product of the risk factor multiplied by the current year's capacity payment.
§Adds implied interest to the numerator and denominator and adds implied depreciation to FFO. **Adds implied depreciation expense to FFO and implied debt to reported debt. ¶¶Adds implied debt to both the numerator and the denominator. FFO--Funds from operations. NPV--Net present value.

Excerpted from S&P Research: “Key Credit Factors for the Regulated Utilities Industry,”

November 19, 2013:

Purchased power adjustment

57. We view long-term purchased power agreements (PPA) as creating fixed, debt-like financial obligations that represent substitutes for debt-financed capital investments in generation capacity. By adjusting financial measures to incorporate PPA fixed obligations, we achieve greater comparability of utilities that finance and build generation capacity and those that purchase capacity to satisfy new load. PPAs do benefit utilities by shifting various risks to the electricity generators, such as construction risk and most of the operating risk. The principal risk borne by a utility that relies on PPAs is recovering the costs of the financial obligation in rates.

58. We calculate the present value (PV) of the future stream of capacity payments under the contracts as reported in the financial statement footnotes or as supplied directly by the company. The discount rate used is the same as the one used in the operating lease adjustment, i.e., 7%. For U.S. companies, notes to the financial statements enumerate capacity payments for the coming five years, and a thereafter period. Company forecasts show the detail underlying the thereafter amount, or we divide the amount reported as thereafter by the average of the capacity payments in the preceding five years to get an approximation of annual payments after year five.

59. We also consider new contracts that will start during the forecast period. The company provides us the information regarding these contracts. If these contracts represent extensions of existing PPAs, they are immediately included in the PV calculation. However, a contract sometimes is executed in anticipation of incremental future needs, so the energy will not flow until some later period and there are no interim payments. In these instances, we incorporate that contract in our projections, starting in the year that energy deliveries begin under the contract. The projected PPA debt is included in projected ratios as a current rating factor, even though it is not included in the current-year ratio calculations.

60. The PV is adjusted to reflect regulatory or legislative cost-recovery mechanisms when present. Where there is no explicit regulatory or legislative recovery of PPA costs, as in most European countries, the PV may be adjusted for other mitigating factors that reduce the risk of the PPAs to the utility, such as a limited economic importance of the PPAs to

the utility's overall portfolio. The adjustment reduces the debt-equivalent amount by multiplying the PV by a specific risk factor.

61. Risk factors based on regulatory or legislative cost recovery typically range between 0% and 50%, but can be as high as 100%. A 100% risk factor would signify that substantially all risk related to contractual obligations rests on the company, with no regulatory or legislative support. A 0% risk factor indicates that the burden of the contractual payments rests solely with ratepayers, as when the utility merely acts as a conduit for the delivery of a third party's electricity. These utilities are barred from developing new generation assets, and the power supplied to their customers is sourced through a state auction or third parties that act as intermediaries between retail customers and electricity suppliers. We employ a 50% risk factor in cases where regulators use base rates for the recovery of the fixed PPA costs. If a regulator has established a separate adjustment mechanism for recovery of all prudent PPA costs, a risk factor of 25% is employed. In certain jurisdictions, true-up mechanisms are more favorable and frequent than the review of base rates, but still do not amount to pure fuel adjustment clauses. Such mechanisms may be triggered by financial thresholds or passage of prescribed periods of time. In these instances, a risk factor between 25% and 50% is employed. Specialized, legislatively created cost-recovery mechanisms may lead to risk factors between 0% and 15%, depending on the legislative provisions for cost recovery and the supply function borne by the utility. Legislative guarantees of complete and timely recovery of costs are particularly important to achieving the lowest risk factors. We also exclude short-term PPAs where they serve merely as gap fillers, pending either the construction of new capacity or the execution of long-term PPAs.

62. Where there is no explicit regulatory or legislative recovery of PPA costs, the risk factor is generally 100%. We may use a lower risk factor if mitigating factors reduce the risk of the PPAs on the utility. Mitigating factors include a long position in owned generation capacity relative to the utility's customer supply needs that limits the importance of the PPAs to the utility or the ability to resell power in a highly liquid market at minimal loss. A utility with surplus owned generation capacity would be assigned a risk factor of less than 100%, generally 50% or lower, because we would assess its reliance on PPAs as limited. For fixed capacity payments under PPAs related to renewable power, we use a risk factor of less than 100% if the utility benefits from government subsidies. The risk factor reflects the degree of regulatory recovery through the government subsidy.

63. Given the long-term mandate of electric utilities to meet their customers' demand for electricity, and also to enable comparison of companies with different contract lengths, we may use an evergreening

methodology. Evergreen treatment extends the duration of short- and intermediate-term contracts to a common length of about 12 years. To quantify the cost of the extended capacity, we use empirical data regarding the cost of developing new peaking capacity, incorporating regional differences. The cost of new capacity is translated into a dollars-per-kilowatt-year figure using a proxy weighted-average cost of capital and a proxy capital recovery period.

64. Some PPAs are treated as operating leases for accounting purposes—based on the tenor of the PPA or the residual value of the asset on the PPA's expiration. We accord PPA treatment to those obligations, in lieu of lease treatment; rather, the PV of the stream of capacity payments associated with these PPAs is reduced to reflect the applicable risk factor.

65. Long-term transmission contracts can also substitute for new generation, and, accordingly, may fall under our PPA methodology. We sometimes view these types of transmission arrangements as extensions of the power plants to which they are connected or the markets that they serve. Accordingly, we impute debt for the fixed costs associated with such transmission contracts.

66. Adjustment procedures:

- Data requirements:
- Future capacity payments obtained from the financial statement footnotes or from management.
- Discount rate: 7%.
- Analytically determined risk factor.
- Calculations:
- Balance sheet debt is increased by the PV of the stream of capacity payments multiplied by the risk factor.
- Equity is not adjusted because the recharacterization of the PPA implies the creation of an asset, which offsets the debt.
- Property, plant, and equipment and total assets are increased for the implied creation of an asset equivalent to the debt.
- An implied interest expense for the imputed debt is determined by multiplying the discount rate by the amount of imputed debt (or average PPA imputed debt, if there is fluctuation of the level), and is added to interest expense.
- We impute a depreciation component to PPAs. The depreciation component is determined by multiplying the relevant year's capacity payment by the risk factor and then subtracting the implied PPA-related interest for that year. Accordingly, the impact of PPAs on cash flow measures is tempered.
- The cost amount attributed to depreciation is reclassified as capital spending, thereby increasing operating cash flow and funds from operations (FFO).
- Some PPA contracts refer only to a single, all-in energy price. We identify an implied capacity price within such an all-in energy

price, to determine an implied capacity payment associated with the PPA. This implied capacity payment is expressed in dollars per kilowatt-year, multiplied by the number of kilowatts under contract. (In cases that exhibit markedly different capacity factors, such as wind power, the relation of capacity payment to the all-in charge is adjusted accordingly.)

- Operating income before depreciation and amortization (D&A) and EBITDA are increased for the imputed interest expense and imputed depreciation component, the total of which equals the entire amount paid for PPA (subject to the risk factor).
- Operating income after D&A and EBIT are increased for interest expense.

CERTIFICATE OF SERVICE

I hereby certify that a service copy of the foregoing was sent by, or on behalf of, the undersigned counsel to the following parties of record this 27th day of September, 2018, via electronic transmission.

/s/ Steven T. Nourse

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Summary: Testimony of Steven M. Fetter electronically filed by Mr. Steven T Nourse on behalf of Ohio Power Company