**BEFORE THE**

**PUBLIC UTILITIES COMMISSION OF OHIO**

**THE DAYTON POWER AND LIGHT COMPANY**

**CASE NO. 20-0680-EL-UNC**

**SIGNIFICANTLY EXCESSIVE EARNINGS TEST/**
**MORE FAVORABLE IN THE AGGREGATE TEST**

**DIRECT TESTIMONY**
**OF GUSTAVO GARAVAGLIA M.**

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

**PUBLIC VERSION**

**BEFORE THE**

**PUBLIC UTILITIES COMMISSION OF OHIO**

**DIRECT TESTIMONY OF**

**GUSTAVO GARAVAGLIA M.**

**ON BEHALF OF**
**THE DAYTON POWER AND LIGHT COMPANY**

## TABLE OF CONTENTS

# I. INTRODUCTION

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

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

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

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

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

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

**Q. What are your responsibilities in your current position?**

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

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

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

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

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

**Q. What are the purposes of this testimony?**

A. The purposes of this testimony are to:

a. demonstrate that any return on equity threshold for the significantly excessive earnings test should be increased by 100 basis points;

b. demonstrate that a financial integrity charge would be approved if DP&L filed an application for a Market Rate Offer under R.C. 4928.142 ("MRO");

c. demonstrate that DP&L's financial integrity would be in jeopardy if the Commission were to invalidate the Rate Stability Charge ("RSC") in this proceeding;

d. demonstrate that a default by DPL Inc. on its debts would create a default by DP&L on its debts;

e. explain that AES, DPL Inc. and DP&L have taken significant steps to improve DP&L's financial condition; and

f. support DP&L's financial forecasts through 2023, which Witness Malinak uses in his testimony.

## II. ANY SEET RETURN ON EQUITY THRESHOLD SHOULD BE INCREASED BY 100 BASIS POINTS

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

A. The testimony of Witness Malinak demonstrates that the SEET threshold for DP&L should be 15.6%. In prior Commission cases, the Commission has increased the SEET threshold based on company-specific factors, including whether the utility was subject to unusual risks. The purpose of this section of my testimony is to demonstrate that the Commission should increase the SEET threshold calculated by Witness Malinak by 100 basis points, so that the actual final threshold is 16.6%.

**Q. Can you please describe DP&L's capital commitments and future capital requirements?**

A. Yes. From 2020-2023, DP&L plans to invest [redacted] to improve its aging infrastructure and implement SmartGrid. DP&L's infrastructure is aging, and very much needs additional investment. For example, 45% of DP&L's substation assets are over 30 years old, while 24% of those assets are over 50 years old. Over 45% of DP&L's distribution poles are more than 40 years old, 35% are over 50 years old, and almost 20% of the distribution poles on the system are over 60 years old. Also, a large portion of DP&L's meters are obsolete electromechanical meters and DP&L's system includes 0% rollout of advanced metering infrastructure. These are just a few examples of how DP&L is woefully behind its brethren utilities that have been making significant capital investments in their system through years of recovery through distribution investment riders as well as smart grid. DP&L's planned capital investments include basic essential upgrades to the system as well as smartgrid investment that brings DP&L and its customers on par with the rest of the state of Ohio.

In addition, despite the significant risks to which DP&L is subject (see below), AES plans to invest $300 million in DP&L over the next two years. That investment will be made in two parts, with half coming this year and half next year. AES plans to make those investments because DP&L needs that money to fund necessary infrastructure improvements including SmartGrid investments and improve DP&L's capital structure. Of course, AES plans to make those investments only if AES believes that DP&L is positioned to return to being a financially sound utility. The injection of $300 million in equity by AES into DP&L will help DP&L to make needed investments and to return to sound financial footing.

DP&L's plans to make substantial investments in its infrastructure demonstrate that the Commission should increase the SEET threshold for DP&L.

**Q. Is DP&L more risky than a typical utility?**

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

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

DP&L is thus either below investment grade (S&P) or barely investment grade (Fitch and Moody's). It is highly unusual for a utility in this country to have such low credit ratings.

For example, of the 29 utilities that Moody's rates, only two have lower credit ratings than DP&L.

DP&L's credit ratings demonstrate that it is more risky than a typical utility, which means that its return on equity threshold should be higher.

**Q. Is DP&L subject to regulatory risks to which other Ohio utilities are not?**

A. Yes. DP&L is subject to the following regulatory risks to which other Ohio utilities are not:

1. No Distribution Investment Rider: The Commission has approved riders that allow other Ohio utilities to recover distribution investments in select FERC accounts through a rider, so that those investments are recovered on a near real-time basis. In the Matter of the Application of Duke Energy Ohio, Inc., Dec. 19, 2018 Opinion and Order, ¶¶ 113-16, 201-02 (Case Nos. 17-32-EL-AIR, et al.); In the Matter of the Application of the Ohio Power Co. for Authority to Establish a Standard Service Offer, April 25, 2018 Opinion and Order, ¶ 45-49, 189-91 (Case Nos. 16-1852-EL-SSO, et al.); In the Matter of the Application of the Ohio Edison Co., the Cleveland Illuminating Co. and the Toledo Edison Co. for Authority to Provide for a Standard Service Offer, Oct. 12, 2016 Fifth Entry on Rehearing, ¶ 249-50 (Case No. 14-1297-EL-SSO).

   However, DP&L currently does not have a rider to collect those amounts, which exposes DP&L to greater risk in comparison to its Ohio peers. Further, DP&L has aging infrastructure, and without a DIR (or approved SmartGrid plan), there are risks that infrastructure will fail and that DP&L will have limited access to funds to replace equipment.

2. No Decoupling Rider: The Commission has approved decoupling riders for other Ohio utilities, so that they are not as subject to certain volumetric risks (e.g., unusual weather, energy efficiency measures). In the Matter of the Application of Duke Energy Ohio, Inc., for Approval of a Distribution Decoupling Rider, June 5, 2019 Finding & Order, ¶ 1, Case No. 11-5905-EL-RDR; In the Matter of the Application of Columbus Southern Power Company and Ohio Power Company, Dec. 14, 2011 Opinion and Order, p. 6 (Case No. 11-351-EL-AIR); In the Matter of the Application of Ohio Edison Company, The Cleveland Electric Illuminating Company and The Toledo Edison Company for Approval of a Decoupling Mechanism, Jan. 15, 2020 Finding & Order, Case No. 19-2080-EL-ATA. However, DP&L does not currently have a decoupling rider in place, which creates additional risks for DP&L. At the time of this filing, DP&L has a pending request at the PUCO to defer distribution decoupling costs. However, while approval of a deferral would resolve the income statement impact of the lack of a Decoupling Rider, DP&L's cash flow and liquidity will remain diminished until DP&L can begin recovery of that deferral.

3. No Uncollectible Rider: The Commission has approved riders to allow other Ohio utilities to collect their uncollectible expenses. In the Matter of the Application of Duke Energy Ohio Inc., to Adjust and Set Its Electric Uncollectible Recovery Rate for Rider UE-ED, Oct. 23, 2019 Finding and Order

(Case No. 19-1280-EL-UEX); In the Matter of the Review of the Distribution Uncollectible Rider of Ohio Edison Company, The Cleveland Electric Company, and The Toledo Edison Company, Dec. 18, 2019 Finding and Order, ¶ 1 (Case No. 17-2279-EL-RDR); In the Matter of the Application of The Ohio Power Company for Authority to Establish a Standard Service Offer, Apr. 25, 2018 Opinion and Order, p. 45 (Case No. 16-1852-EL-SSO). However, DP&L does not have a currently approved rider to allow it to collect those amounts. The lack of such a rider creates additional risks for DP&L.

**Q. Has the loss of these riders and the Distribution Modernization Rider ("DMR") affected DP&L's financial outlook?**

A. Yes. The lack of consistent recovery mechanisms as well as the invalidation of the DMR has resulted in over [redacted] in reduced cash flow on an annual basis at DP&L. That loss creates additional risk at DP&L, as it experiences greater regulatory lag in recovery of cash investments and is therefore required to fund more of its investments and expenses using external funding.

**Q. Has the COVID-19 virus created risks for DP&L that other utilities do not face?**

A. Yes. Due to COVID-19 and the associated financial crisis, all utilities face increased risks, including risk that customer usage will decline significantly and that the customers will be unable to pay their bills. While all utilities face those issues, those issues create particular risks for DP&L due to DP&L's poor financial condition. Unlike other utilities that have strong balance sheets and ample reserve cash available, DP&L was already on the edge of financial distress and COVID-19 significantly increases the threat of that distress.

**Q. Do cost-containment measures of AES, DPL Inc. and DP&L demonstrate that DP&L's return on equity threshold should be increased beyond that recommended by Witness Malinak?**

A. Yes. As discussed in more detail below, AES, DPL Inc. and DP&L have engaged in significant efforts to cut DP&L's costs. DP&L is thus very lean, and any significant disruption to DP&L's recovery of its projected revenue would significantly disrupt DP&L's ability to operate reliably. DP&L is thus subject to higher-than-usual operational risks, which demonstrates that DP&L's return on equity threshold should be higher.

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

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

## III. A FINANCIAL INTEGRITY CHARGE SHOULD BE APPROVED UNDER A HYPOTHETICAL MRO; DP&L WOULD BE IN FINANCIAL DISTRESS WITHOUT THE RSC

### A. DP&L Is at the "Ragged Edge" of Investment Grade

**Q. Has the Commission held that a financial integrity charge would be approved if DP&L filed an application for an MRO?**

A. Yes, in evaluating whether DP&L's ESP III was more favorable in the aggregate as compared to an MRO, the Commission held that a financial integrity charge would be approved if DP&L had filed an application for an MRO:

> "While OCC submits the DMR and other riders would not be available under an MRO, the Commission finds that equivalent riders would also be available under R.C. 4928.142. Under and MRO, pursuant to R.C. 4928.142 the Commission may assess such charges as the Commission 'determines necessary to address any emergency that threatens the utility's financial integrity or to ensure that the resulting revenue available to the utility for providing the standard service offer is not so inadequate as to result, directly or indirectly in a taking of property without compensation pursuant to Section 19 of Article I Ohio Constitution.' Additionally, the Commission notes that electric utilities can seek emergency rate relief under R.C. 4909.16, and the Commission has provided factors for determining whether emergency rate relief can be granted. *In re Cleveland Elec. Illum. Co.*, Case No. 88-170-EL-AIR, et al., Opinion and Order (Aug. 23, 1988), 1988 WL 1617994 (Ohio P.U.C.). We have previously identified that these factors specified by the Commission for cases brought under R.C. 4909.16 may provide guidance for factors the Commission may examine in a hypothetical application for a charge under R.C. 4928.142. *In re FirstEnergy*, Case No. 14-1297-EL-SSO, Fifth Entry on Rehearing (October 12, 2016) at 161-163.
>
> One of the factors the Commission has previously considered under R.C. 4909.16 is whether the utilities' bonds are considered investment grade. There, we found a utility on the 'ragged edge' of investment grade would qualify under R.C. 4909.16. *In re Cleveland Elec. Illum. Co.*, at 8. Similarly, under FirstEnergy's

> ESP versus MRO comparison, the Commission found that an electric utility still operating above investment grade would likely meet the standards applied by the Commission under R.C. 4909.16. *In re FirstEnergy*, at 163. Here, it is well established that <u>DP&L and DPL Inc.'s credit ratings were respectively, at and even below the 'ragged edge' of investment grade</u> (Co. Ex. 105). Thus, it is likely that the Commission would grant relief in response to a hypothetical application under R.C. 4928.142(D). Accordingly, we agree with DP&L and Staff witness Donlon (Staff Ex. 2 at 6) that the DMR should be excluded from a quantitative analysis as the associated charges would be available under either an MRO or an ESP."

Oct. 10, 2017 Opinion and Order, pp. 44-45 (emphasis added) (Case No. 16-0395-EL-SSO).

**Q. What are the current issuer credit ratings for DP&L and DPL Inc.?**

A. The current issuer credit ratings are as follows:

**<u>DP&L</u>**

S & P: BB (two notches below investment grade), negative outlook

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

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

**<u>DPL Inc.</u>**

S & P: BB (two notches below investment grade), negative outlook

Fitch: BB+ (one notch below investment grade), negative outlook

Moody's: Ba1 (one notch below investment grade), negative outlook

All ratings are thus at or below the "ragged edge" of investment grade, and all of the outlooks are negative.

**Q. What conclusions do you draw from DP&L's current credit ratings?**

A. I draw two principal conclusions.

<u>First</u>, in a hypothetical MRO, the Commission would approve a financial integrity charge

for the same reasons that the Commission identified in its October 10, 2017 Order in ESP III.

Second, any order in this proceeding that invalidated the RSC would cause DP&L's credit rating to fall well below investment grade. As discussed below, it is critical that DP&L has an investment grade credit rating from all three ratings agencies.

Both of these points are discussed in more detail in the testimony of Witness Malinak.

**Q. Over time, have DP&L's credit ratings changed based upon recent decisions by the Commission?**

A. Yes, the line graph attached as Exhibit 1 shows that DP&L's issuer credit rating improved significantly after the Commission's October 20, 2017 Opinion and Order in Case No. 16-395-EL-SSO ("ESP III") that approved a DMR for DP&L, and declined significantly after the Commission's November 21, 2019 Supplemental Opinion and Order in that same case that invalidated the DMR.

**Q. What conclusions do you draw from DP&L's historic credit ratings?**

A. DP&L's historic credit ratings have been highly responsive to Commission orders. That trend confirms that the Commission would approve a financial integrity charge under a hypothetical MRO and that any order in this case that invalidated the RSC would have a drastic effect on DP&L and its credit rating.

**Q. Is it critical that DP&L has investment grade credit ratings?**

A. Yes. Investment grade credit ratings allow DP&L to finance its long-term debt in the low-cost investment grade bond market. If DP&L had a rating that was below investment grade, then it would be forced to finance its debt in the high-yield junk bond market, which would be much more expensive for DP&L and its customers in the form of higher interest rates and a higher cost of capital.

Further, debt that is issued in the junk bond market may include restrictive covenants and conditions. For example, the debt that DP&L issued on August 24, 2016, "Term Loan B" was issued in the junk bond market and included conditions that greatly limited the amount of new debt that DP&L could issue and contained financial covenants that would not have been required if the debt had been issued in the investment grade bond market. Such restrictions would significantly constrain DP&L's ability to operate and would preclude DP&L from pursuing grid modernization, as DP&L will need to issue debt as part of the plan to finance the needed investments.

An example can be seen in comparing the terms of the Term Loan B that DP&L issued in the junk bond market with the terms of DP&L debt that was issued in 2019 to re-finance the Term Loan B. On June 6, 2019, DP&L issued $425M of first mortgage bond, "FMB", debt in the investment grade bond markets once it had achieved investment grade credit ratings following the Commission's October 20, 2017 Opinion and Order in Case No. 16-395-EL-SSO ("ESP III") that approved a Distribution Modernization Rider ("DMR"). The Term Loan B was variable rate debt that had a term of 5 years. The Term Loan B had an interest rate of 4.49% at the time it was paid off in June 2019 following the issuance of the first mortgage bonds. The FMB's have a term of 30 years and a fixed interest rate of 3.95%. The presence of investment grade credit ratings allowed DP&L to reduce the interest rate on its FMB debt by 54 basis points while also extending the tenor by 25 years in comparison to the Term Loan B. This resulted in $2.7 million savings in interest expense per year.

**Q: Would the amount of a financial integrity charge under a hypothetical MRO be the same as the RSC under DP&L's current ESP?**

A: Not likely. DP&L's current RSC was established in Case No. 05-276-EL-AIR to compensate DP&L for provider of last resort risks to which DP&L was subject. As discussed in the testimony of Witness Malinak, a financial integrity charge will allow DP&L to make necessary debt payments and capital expenditures. I thus would not expect those amounts to be equal.

**Q. Does the financial integrity of DPL Inc. have an impact on DP&L?**

A. Yes. DP&L must maintain its financial integrity to ensure that it can (a) make the necessary capital investment and operating expenses that are required in the normal course of business; (b) access debt markets to refinance existing debt obligations; (c) attract debt and equity to finance the investments required to maintain reliability and modernize its transmission and distribution infrastructure; and (d) maintain reasonably priced debt and equity capital to ensure reasonable rates to customers.

If DPL Inc. cannot maintain its financial integrity, it will (a) need to minimize capital and operating expenditures at DP&L (that otherwise would be necessary to ensure safe and reliable service) in order to ensure that its own financial obligations can be met; (b) not have funds, or access to funds, that may be required to invest in DP&L and to ensure that DP&L can maintain its existing infrastructure; (c) not have funds, or access to funds, that will be required to invest in DP&L to provide the ability to modernize DP&L's

distribution grid and the associated benefits for DP&L's customers and society as a whole; and (d) adversely affect its own credit ratings and the credit ratings of DP&L (all of the major credit ratings agencies "notch" the utility and the utility holding company, so that the utility credit ratings are directly linked to that of the utility holding company), which will increase the borrowing costs for DP&L and DPL Inc. and decrease cash available to operate and maintain DP&L's assets, or to invest in infrastructure modernization projects.

**Q. Have the credit rating agencies stated that DP&L's rating would be downgraded if DPL's rating was downgraded?**

A. Yes, as follows:

S & P Global: S & P Global gives the same credit rating to DP&L that it gives to DPL Inc. Thus, any downgrade of DPL Inc. will downgrade DP&L.

Fitch: In its December 23, 2019 rating report, Fitch stated as to DPL Inc. that "[d]eteriorating regulatory relationship or successful challenges from stakeholders over approved rate plans in the future will result in negative rating actions." Fitch further stated that as to DP&L, "[a] downgrade at DPL [Inc.] could potentially lead to negative rating actions at DP&L."

Moody's: In its December 30, 2019 credit opinion, Moody's stated that "DP&L's credit quality is constrained by the significant amount of holding company debt that DPL . . . ."

**Q. Would DP&L be able to provide safe and reliable service without a financial integrity charge under an MRO or if the RSC was invalidated in this proceeding?**

A. No, without a financial integrity charge in the MRO or the RSC under the ESP, DP&L would not have sufficient funds to pay its operating expenses, make needed capital expenditures and make required debt payments. DP&L would need to make deep and distressing cuts to its operating expenses and capital investments. Without a financial integrity charge or the RSC, the cash flows at DP&L and DPL Inc. would be insufficient to both meet debt obligations and maintain normal operations.

Specifically, DP&L needs to spend between [redacted] in operating expenses per year, and make approximately [redacted] in capital expenditures each year. This includes maintaining the base capital investments of approximately [redacted] per year as well as incremental grid modernization investments. As previously mentioned, DP&L's system is in desperate need of updates and investment to prevent service degradation and its customers languishing behind the rest of the state's investment in "modern technologies" that have become mainstream. DP&L's customers are suffering from the Company's inability to upgrade its grid. The dramatic COVID-19 pandemic has highlighted the limited capabilities of DP&L's system where the absence of advanced meter infrastructure limits the ability to remote read meters in a time when it is not safe for meter reading to take place, which could have significant negative consequences for customers impacted by the current economic shutdown. Absent some alternative billing proxy approved by the Commission, this would include C&I customers that are no longer able to operate, but will still continue to be billed at their most recently read demand rate because their actual demand cannot be read remotely and can never be known due to the lack of AMI and related enabling technology investments. Witness Malinak further explains the chasm between DP&L's capital investments compared to those of other similar utilities.

DP&L would need to cut those amounts without a financial integrity charge under an MRO or the RSC under and ESP. Without those expenditures, DP&L could not operate its system, meaning that it would not be able to provide safe and reliable service. Alternatively, DP&L would have to cut debt payments, which as explained below, results in a threat to DP&L's ability to provide safe and reliable service.

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

A. Yes, for example and as discussed above, the financial crisis caused by COVID-19 creates risks for DP&L that customers will use less electricity and/or be unable to pay their bills. Reduced usage is an issue because some of DP&L's rates, charges, and riders, such as the RSC, TCRR-N, and Legacy Generation Resource Rider, are volumetrically based, while the underlying expenses they are designed to recover are not necessarily reduced due to decreased usage. As a result of the state of emergency in Ohio, DP&L expects to see significantly reduced revenues. This Commission has gone to extensive lengths to "ensure service continuity" for Ohio's utility customers because utility service has been deemed an essential service by the Governor and Ohio Department of Health. This situation that we are all currently facing demonstrates the importance of utilities having sufficient cash flows to maintain safe and reliable service in times of crisis. DP&L was already in a difficult financial situation, and COVID-19 has made that situation worse. COVID-19 thus increases DP&L's need for a financial integrity charge under a hypothetical MRO and for the RSC under DP&L's ESP.

The historic storm that saw fifteen tornadoes rip through the DP&L service territory in May 2019 provides another example of why a financially healthy utility is important to providing essential services to customers. In order to timely restore transmission and distribution services to customers, DP&L had to have sufficient cash to make [redacted] in capital expenditures to restore the system, which will not be recovered until a future rate case. DP&L also had to have the cash to make [redacted] in operational expenses to restore services.

## B. A Default by DPL Inc. on Its Debt Would Create a Default by DP&L on Its Debt

**Q. Would a default by DPL Inc. on its debt create a default by DP&L on its debt?**

A. Yes, as described in more detail below, a default by DPL Inc. on its debt would likely trigger a default by DP&L on its debt, as a result of the following process:

1. If DPL Inc. fails to pay its debts, then its lenders have rights to take control of DP&L.
2. Two of DP&L's debt instruments have "Change of Control" terms, which establish that DP&L would be in default under those instruments as a result of the change of control of DP&L, and the lenders would have rights to make the debt under those instruments become immediately due. DP&L would not be able to pay those amounts if called by the lenders.

3. DP&L's remaining debt instruments for its secured debt have acceleration provisions that give lenders rights to make all of DP&L's secured debt immediately due and payable if DP&L is in default on its secured debt. DP&L would not be able to pay those amounts, which could create a further default.

**Q. Please explain how a default by DPL Inc. would likely result in a change of control at DP&L.**

A. DPL Inc. is a party to a June 19, 2019 "Amended and Restated Credit Agreement" with certain banks ("DPL Inc. Revolver"). Section 8.01(a) of that DPL Inc. Revolver provides that DPL Inc. would be in default if it fails to pay any amount due under the DPL Inc. Revolver.

DPL Inc. is also a party to a June 19, 2019 "Amended and Restated Pledge Agreement" with a Collateral Agent for the banks that are parties to the DPL Inc. Revolver ("DPL Inc. Pledge Agreement"). Under Section 2(a)(i) of the DPL Inc. Pledge Agreement, to secure DPL Inc.'s obligations under the DPL Inc. Revolver, DPL Inc. granted the Collateral Agent a security interest in "all" of DP&L's stock. Further, under Section 6(e) of the DPL Inc. Pledge Agreement, if DPL Inc. is in default, the Collateral Agent would be able to exercise all voting and dividend rights in DP&L stock that DPL Inc. formerly possessed. In addition, under Section 12(a) of that same Agreement, if DPL Inc. is in default, the Collateral Agent would have rights to transfer DPL Inc.'s shares in DP&L into the Collateral Agent's name and to sell those shares. A default by DPL Inc. on its debt is thus likely to result in a change of control of DP&L.

**Q. Please explain how that change of control at DP&L would then create a default under two of DP&L's debt instruments.**

A. DP&L has two debt instruments that have change-of-control provisions. The first is the June 19, 2019 "Amended and Restated Credit Agreement" between DP&L and certain banks ("DP&L Revolver"). Section 8.01(l) of the DP&L Revolver provides that DP&L would be in default if there is a "Change in Control." A "Change of Control" is defined on page 5, paragraph (c) to exist if DPL Inc. ceases to own 100% of DP&L's stock. As discussed above, a default by DPL Inc. would likely cause a transfer of DP&L's shares, thus triggering a Change of Control default under the DP&L Revolver. Further, under Section 8.02(b) of the DP&L Revolver, after a default, the lenders would likely declare all amounts owed by DP&L under the DP&L Revolver to be immediately due and payable.

Second, DP&L is a party to an August 1, 2015 "Bond Purchase and Covenants Agreement" with certain lenders associated with its tax-exempt bonds ("BPCA"). The BPCA has an identical "Change of Control" clause (Section 8.01(l)), an identical definition of "Change of Control" (page 3, ¶ (c)) and a right to declare all amounts owed by DP&L to be immediately due upon default (Section 8.02(1)).

In short, a failure by DPL Inc. to pay its debts would trigger "Change of Control" defaults under two of DP&L's debt instruments, meaning that all amounts owed under those instruments would likely become due immediately.

As of March 31, 2020, DP&L owes [redacted] on the DP&L Revolver and $140 million on debts associated with the BPCA. It is highly unlikely that DP&L would have sufficient liquidity to pay off either amount, and certainly not both of them at the same time. Nor is it likely that DP&L could refinance those amounts, since lenders would be unlikely to loan money to a utility that is in financial distress and in default on its loans.

**Q. Please explain how a default by DP&L on the DP&L Revolver and BPCA would then lead to a default on DP&L's remaining debt.**

A. In its October 1, 1935 "First and Refunding Mortgage" ("First Mortgage"), DP&L granted to a trustee a mortgage in substantially all of DP&L's assets. Under Article 12, Sections 1(a) and (b) of the First Mortgage, a failure by DP&L to pay principal (immediately) or interest (after 90 days) due on amounts secured by the First Mortgage would constitute a default. Upon default, the trustee or bondholders would likely declare all debt amounts owed by DP&L under the First Mortgage to be immediately due and payable. Id. p. 89.

DP&L's tax-exempt bonds associated with the BPCA are secured by the First Mortgage, so after those bonds were accelerated, and DP&L failed to pay them, there would be a default under the First Mortgage, as described in the prior paragraph. As a result, the trustee or bondholders would have the right to accelerate all of DP&L's secured debt.

Although the DP&L Revolver is not secured by the First Mortgage, there is no difference in the likely result. Specifically, assume for a moment that DP&L's tax-exempt bonds and the BPCA did not contain a Change-of-Control clause, but the DP&L Revolver still did. After the lenders to the DP&L Revolver declared a default and all amounts owed were immediately due and payable, those lenders could execute on DP&L's assets. Most of DP&L's assets are secured by the First Mortgage, so the lenders on DP&L's Revolver would not have priority on them. However, DP&L's cash and receivables are not secured by the First Mortgage, so the lenders on DP&L's Revolver could execute on those assets. As those lenders took DP&L's cash and receivables, DP&L would not be able to pay amounts secured by its First Mortgage, which would trigger a default.

As of March 31, 2020, $425 million is secured by DP&L's First Mortgage (excluding the tax-exempt bonds). DP&L could not pay that amount if it became immediately due.

**Q. Could DP&L continue to provide safe and reliable service if it was in default on its debts?**

A. No, not likely. DPL Inc.'s lenders would control DP&L and would attempt to recover as much cash as possible to recover amounts owed to them. At the same time, DP&L's lenders would be attempting to recover amounts owed to them. Under these circumstances, DP&L would not have enough cash left to continue to provide safe and reliable service.

**Q. Even if DP&L could avoid a default in the event of DPL Inc. default, would DP&L be able to provide safe and reliable service?**

A. No, not likely. If DPL Inc. were to default on its debt, any new owner would control DPL Inc. This default would likely result in the new owner trying to extract the maximum amount of dividends out of its subsidiaries – the principal one being DP&L. This would result in dramatically reduced capital and operational expenditures at DP&L. This is of particular concern given the lean operational budget and aging infrastructure of DP&L as I previously mentioned.

**Q. What conclusions do you reach from the facts above?**

A. The facts above confirm that (1) the Commission would approve a financial integrity charge under an MRO; and (2) the Commission should not alter the RSC in this matter.

## C. AES, DPL Inc. and DP&L Have Taken Significant Steps to Improve DP&L's Financial Integrity

**Q. Have AES, DPL Inc. and DP&L taken steps to improve DP&L's financial integrity?**

A. Yes. Those steps fall broadly into the following categories:

1. Steps that AES, DPL Inc. and DP&L initiated in 2012.
2. Steps that AES, DPL Inc. and DP&L have taken pursuant to the now-terminated ESP III Stipulation;
3. Additional steps that AES, DPL Inc. and DP&L have taken since 2017; and
4. AES plans to invest $150 million into DP&L this year, and another $150 million next year.

**Q. Please describe the first category of steps that AES, DPL Inc. and DP&L have taken to improve DP&L's financial integrity?**

A. Since approximately 2012, AES, DPL Inc. and DP&L have taken strategic actions to improve DP&L's financial integrity, including:

1. <u>Operational Actions</u>: DP&L implemented cost controls, travel restrictions and other measures to reduce its ongoing operating expenses;
2. <u>Financing Actions</u>: DP&L lowered its consolidated interest expenses by selectively refinancing with short-term variable-rate instruments. Subsequently, in 2019 both DP&L and DPL Inc further lowered their consolidated interest

expenses by refinancing with long-term fixed-rate instruments at relatively low cost; and

3. AES commitments: DPL has not paid any dividends or made tax sharing payments to AES since the end of 2012, allowing those funds instead to be used to service debt at DPL and DP&L.

4. Asset Sales: DP&L sold its ownership interests in East Bend generating station in December 2014 and sold its competitive retail businesses (MC Squared Energy Services, LLC in April 2015 and DPL Energy Resources, LLC in January 2016), which sale proceeds totaled [redacted] The net proceeds were used to pay debt at DPL Inc. and DP&L;

**Q. Please describe the second category of steps AES, DPL Inc. and DP&L have taken to improve DP&L's financial integrity.**

A. AES, DPL Inc. and DP&L have taken the following steps to improve DP&L's financial integrity consistent with its commitments in the ESP III Stipulation:

1. DPL Inc. has made no contractually-required tax-sharing payments to AES and the tax-sharing liability has been converted into an equity investment in DPL Inc. (id. at ¶ II.1.b). Shortly after the ESP III Stipulation was approved, $107.5 million in tax sharing liabilities were converted into equity; since then, the amount of tax-sharing payments that have been foregone and converted to equity is $29.6 million as of December 31, 2019, adding to a total of $137.1 million. These amounts represent a significant equity investment in DPL Inc. by AES.

2. DP&L transferred its generation assets and non-debt liabilities to AES Ohio Generation (id. at ¶ II.1.c);
3. DPL Inc., through its subsidiary AES Ohio Generation, commenced a sales process for Conesville, Miami Fort and Zimmer Stations (id. at ¶ II.1.c). Miami Fort and Zimmer Stations were sold in December 2017 for approximately [redacted] in net proceeds, and those proceeds were used to retire debt at DPL Inc.;
4. DP&L established a separate account to appropriately track the DMR and its uses, and has subsequently deposited cash from the DMR funds into that account to:
    a. Pay interest obligations on existing debt at DPL Inc. and DP&L;
    b. Make discretionary debt prepayments at DPL Inc. and DP&L; and
    c. Position DP&L to make capital expenditures to modernize and/or maintain transmission and distribution infrastructure (id. at ¶ II.1.e).

**Q. Please describe the third category of steps that AES, DPL Inc. and DP&L have taken to improve DP&L's financial integrity.**

A. Since 2017, in addition to the items described above, AES, DPL Inc. and DP&L have taken the following significant steps to improve the financial condition of DP&L:

1. DP&L settled its distribution rate case (Case No. 15-1830-EL-AIR);
2. DP&L further reduced O&M expenses through workforce reductions;
3. DPL Inc., through its subsidiary AES Ohio Generation, sold 100% of its interest in merchant peaking generation assets (Hutchings Unit 7, Tait, Montpelier, Sidney, Yankee, and Monument generating stations) for approximately [redacted] in net proceeds in March 2018. The net proceeds from the sale were kept within the DPL Inc. complex and were used to reduce outstanding debt, pay

related accrued and unpaid interest, and early redemption premiums on the redeemed debt;

4. DPL Inc., through its subsidiary AES Ohio Generation, closed 2,936 MW of generation assets, which would have required significant environmental capital investment and continued exposure to market risks if they continued to operate; and

5. AEP, the operator of Conesville Unit #4, plans to close the unit at the end of May 2020. DPL Inc., through its subsidiary AES Ohio Generation, is a minority owner of the plant.

**Q. Please describe the fourth category regarding an AES equity investment.**

A. As mentioned above, AES plans to invest a total of $300 million in DP&L, half this year and half next year. AES decided to make this investment to enable DP&L to improve its infrastructure and to modernize its grid. This financial injection will provide DP&L the liquidity needed to simultaneously balance its normal operating expenses and debt payments while also investing in a safer, smarter, and more reliable grid.

**Q. How much debt have DPL Inc. and DP&L paid down as a result of all of the actions that you describe?**

A. The actions listed above, along with the use of existing operating cash flows, enabled DPL and DP&L to pay down approximately $1.1 billion in consolidated indebtedness between January 1, 2012 and December 31, 2019.

## IV. DP&L'S FINANCIAL PROJECTIONS THROUGH 2023

**Q. Did DP&L provide financial projections used by Witness Malinak in developing his financial model for this case?**

A. Yes. DP&L provided two sets of projections to Witness Malinak for the period 2020 to 2023: (1) DP&L's projection for its ESP, for DP&L and DPL Inc.; and (2) DP&L's projection for a hypothetical MRO for DP&L and DPL Inc. Those projections are DP&L's best estimates of expected results.

**Q. What are the differences between the models for DP&L's ESP and a hypothetical MRO?**

A. There are three differences:

1. In the ESP model, DP&L recovers its Smart Grid investments on an accelerated basis through the Infrastructure Investment Rider ("IIR") that was approved in Case No. 08-1094-EL-SSO. However, the IIR is not available under an MRO, so Smart Grid investments would be recovered through a future distribution rate case. Those investments are projected to be started in [redacted], and DP&L does not project to have a distribution rate case during the remaining modeled years ([redacted]). The hypothetical MRO model thus does not include recovery of those Smart Grid investments during the modeled years.
2. As I stated above, in the ESP model, AES makes $150 million in equity investments this year, and another $150 million next year. However, the $150 million scheduled for next year is to enable Smart Grid investment and is contingent on the existence of the IIR, so that AES could receive an accelerated

return on its investment. The hypothetical MRO model thus does not include an equity investment next year.

3. The hypothetical MRO model assumes that DP&L would recover a [redacted] financial integrity charge instead of the RSC. Witness Malinak supports the calculation of the financial integrity charge under a hypothetical MRO.

**Q. What methodology and associated processes were used to develop the financial projections?**

A. The projections were developed consistently with the methodology and process used by the Company for preparing its normal operating forecast. This methodology is a "bottom up" approach to forecasting that requires input and assumptions from a variety of areas within DP&L. The assumptions, which include distribution sales, Standard Service Offer sales, operating cost projections, capital expenditures and financing assumptions, among others, are reviewed with the business areas to determine the most reasonable set of assumptions to be incorporated into the forecasts. As we progress through the business year, we track and monitor actual results compared to the forecasts. Based on actual results combined with potential changes in business and market conditions, the forecasts are adjusted as needed. The process makes the forecasts reliable.

**Q. What are the major components of the financial forecasts?**

A. The inputs and assumptions received are used to derive the following major components of the forecasts: (1) Distribution baseline sales volumes; (2) Retail revenue estimates; (3) Operations and maintenance expense forecast; (4) Capital expenditures forecast; and (5) Financing Assumptions.

**Q. How are each of the above components developed?**

A. The development and methodology for each of these major components are as follows:

1. Distribution Baseline Sales Volumes: The distribution baseline sales volumes are in line with the Company's Long-Term Forecast.

2. Retail revenue estimates: The retail revenues reflected in the Company's pro forma financial statements include tariff rates as established in DP&L's Distribution Rate Case (Case No. 15-1830-EL-AIR et al.), revenues associated with ESP I (Case No. 08-1094-EL-SSO), and revenues associated with DP&L's Distribution Modernization Plan (Case No. 18-1875-EL-GRD). Additionally, retail revenues reflect the effects of future distribution and transmission rate increases to recover costs and investments expected to be incurred during the period 2020 through 2023. Finally, retail revenues incorporate the impacts from the Competitive Bid Process ("CBP"), which are completely offset by a corresponding expense.

3. Operations and Maintenance ("O&M") Expense Forecast: O&M expenses are forecasted by (and reviewed with) all of the business areas within the Company. Underlying the O&M forecasts are assumptions for various items such as projected salary increases and inflationary factors. Each area's O&M forecast includes staffing plans, labor costs, and other operational costs necessary to perform the functions of the specific area.

4. Capital Expenditures Forecast: Capital expenditures are forecasted by (and reviewed with) all of the business areas within the Company, although a substantial portion of the forecast is driven by the Company's operational groups:

Transmission and Distribution. The forecast includes specific projects, as well as dollars to fund smaller projects under a blanket capital budget. Included in this forecast is the aforementioned expenditures related to the Distribution Modernization Plan, as well as transmission projects intended to improve the reliability of the PJM bulk power system. The capital expenditures are used to estimate depreciation (book and tax) and capitalized interest.

5. Financing Assumptions: Financing assumptions, including but not limited to assumptions related to new financings, refinancings, debt retirements, and overall capitalization targets, are provided by DP&L's Treasury organization and reviewed by the finance leadership team. The forecasts include specific plans related to (a) known and measurable events, including the refinancing of near-term debt obligations, and (b) targeted use of excess (or discretionary) cash flows for debt reductions / retirements.

**Q. What was the effective date of the financial projections provided to Witness Malinak?**

A. The financial projections included information as of February 28, 2020; therefore, they do not reflect additional risk and financial impact associated with the current state of emergency declared as a result of COVID-19.

**Q. Do you anticipate issuing incremental long-term debt at DP&L over the forecast period?**

A. Yes, due to the significant capital investments DP&L anticipates making to improve and modernize the distribution and transmission infrastructure, the forecast projects [redacted]. This debt helps to finance these projects and is necessary to maintain the utility [redacted].

**Q. Does your testimony and the testimony of Witness Malinak refer to information constituting trade secrets of DP&L and DPL Inc.?**

A. Yes. Both Witness Malinak's testimony and my testimony refer to financial projections of DP&L and DPL Inc., including projected revenue, operating expenses, and capital expenditures, and to the proceeds of recent asset sales. Such information derives independent economic value from not being generally known to those outside DP&L and DPL Inc. who could obtain economic value from their disclosure. Moreover, DP&L and DPL Inc. internally limit the availability of such information to those who have a business need to know it, and do not disclose such information externally absent appropriate protective devices. This information is redacted in the publicly-available versions of my testimony and the testimony of Witness Malinak, but will be filed under seal with the Commission and will be available to parties who enter into protective agreements with DP&L.

## V. CONCLUSION

**Q. Does this conclude your direct testimony?**

A. Yes, it does.

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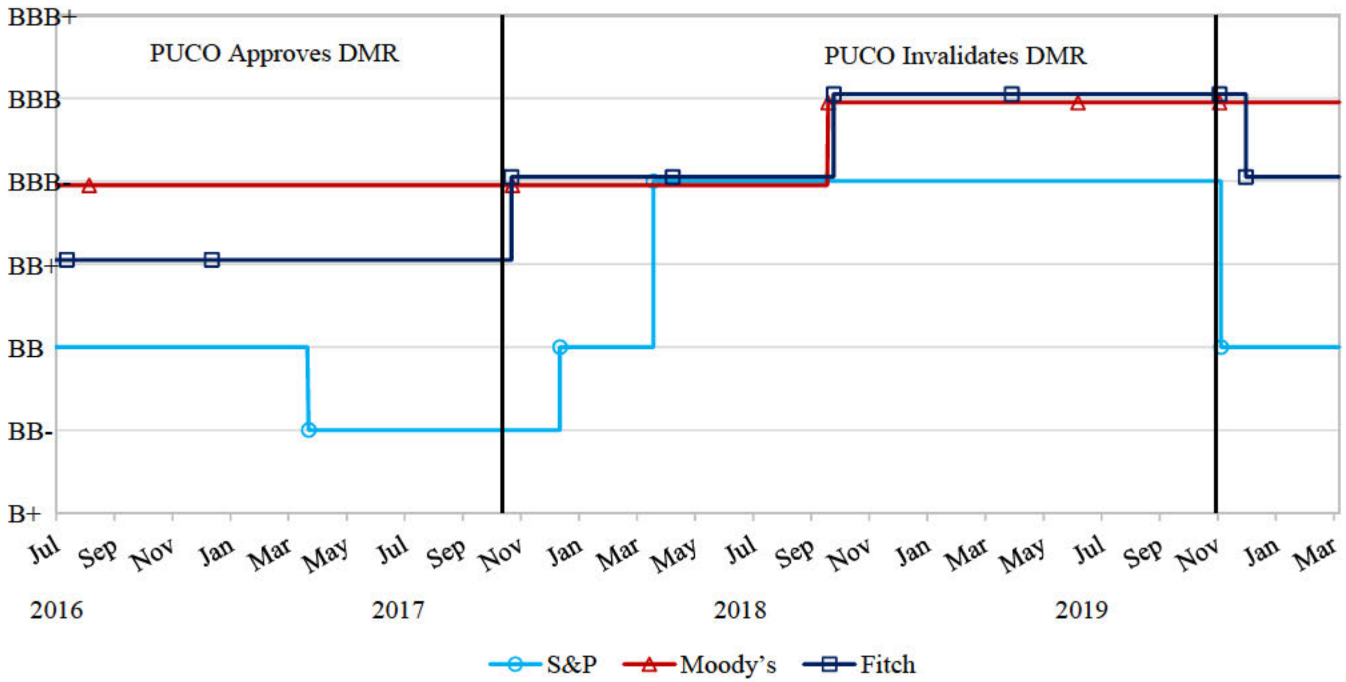
**DP&L CREDIT RATINGS**
**JULY 2016 – PRESENT**




<u>Notes & Sources</u>:

Ratings converted to S&P ratings scale using conversion from Corporate Credit Ratings: a Quick Guide, available at https://www.treasurers.org/ACTmedia/ITCCMFcorpcreditguide.pdf.

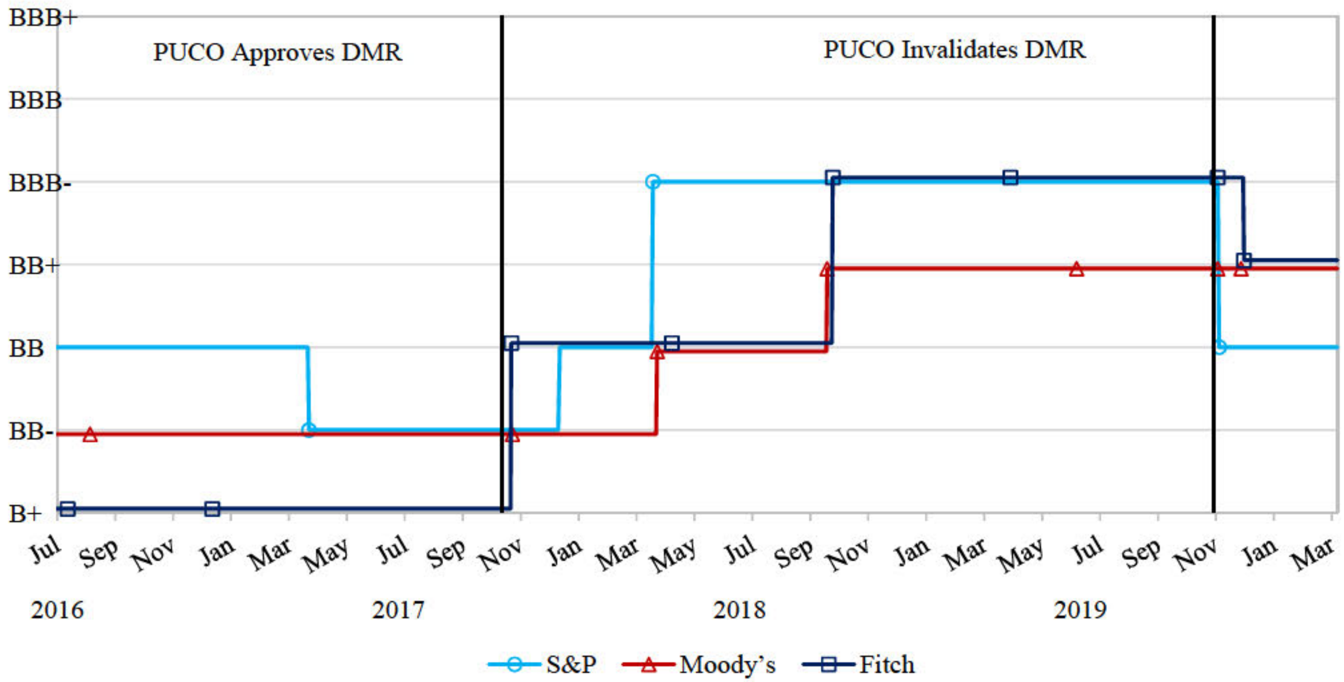
Standard and Poor's long term issuer ratings from S&P Global Market Intelligence.

Moody's long term issuer ratings from https://www moodys.com/credit-ratings/Dayton-Power-Light-Company-credit-rating-222000.

Fitch long term issuer default ratings from https://www fitchratings.com/site/issuers/80464205.

**EXHIBIT 1**

**DPL INC CREDIT RATINGS**
**JULY 2016 – PRESENT**




<u>Notes & Sources</u>:

Ratings converted to S&P ratings scale using conversion from Corporate Credit Ratings: a Quick Guide, available at https://www.treasurers.org/ACTmedia/ITCCMFcorpcreditguide.pdf.

Standard and Poor’s long term issuer ratings from S&P Global Market Intelligence.

Moody’s long term issuer ratings from https://www.moodys.com/credit-ratings/DPL-Inc-credit-rating-600042867.

Fitch long term issuer default ratings from https://www fitchratings.com/site/issuers/80464096.