BEFORE
THE PUBLIC UTILITIES COMMISSION OF OHIO

In The Matter Of The Determination Of The Existence Of Significantly Excessive Earnings For 2017 Under The Electric Security Plans Of Ohio Edison Company, The Cleveland Electric Illuminating Company, And The Toledo Edison Company.	)	Case No. 18-857-EL-UNC
In The Matter Of The Determination Of The Existence Of Significantly Excessive Earnings For 2018 Under The Electric Security Plans Of Ohio Edison Company, The Cleveland Electric Illuminating Company, And The Toledo Edison Company.	)	Case No. 19-1338-EL-UNC
In The Matter Of The Determination Of The Existence Of Significantly Excessive Earnings For 2019 Under The Electric Security Plans Of Ohio Edison Company, The Cleveland Electric Illuminating Company, And The Toledo Edison Company.	)	Case No. 20-1034-EL-UNC
In the Matter of the Quadrennial Review Required By R.C. 4928.143(E) For The Electric Security Plans Of Ohio Edison Company, The Cleveland Electric Illuminating Company, And The Toledo Edison Company.	)	Case no. 20-1476-EL-UNC

SUPPLEMENTAL DIRECT TESTIMONY OF MATTHEW I. KAHAL

ON BEHALF OF

OFFICE OF THE OHIO CONSUMERS' COUNSEL

65 East State Street, 7th floor
Columbus, Ohio 43215

July 23, 2021

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I. INTRODUCTION

Q1. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

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

Q2. HAVE YOU PREVIOUSLY SUBMITTED TESTIMONY IN THIS PROCEEDING?

A2. Yes. On April 5, 2021, I submitted Direct Testimony on behalf of OCC presenting a recommendation for the return on equity ("ROE") threshold to be employed in the Significantly Excessive Earnings Test ("SEET") to be applied to The Toledo Edison Company ("TE"), The Cleveland Electric Illumination Company ("CEI") and Ohio Edison Company ("OEC") for the years 2017, 2018 and 2019. These three utilities are all wholly-owned subsidiaries of FirstEnergy Corporation and are collectively referred to as the "FE Ohio Utilities."

Q3. WHAT IS THE PURPOSE OF YOUR SUPPLEMENTAL DIRECT TESTIMONY?

A3. I am commenting on certain issues raised in the Direct Testimony of Mr. Lane Kollen, submitted on April 5, 2021 on behalf of the Ohio Energy Group. The main purpose of Mr. Kollen's testimony is to present his analysis of the earned ROEs for each of the FE Ohio Utilities for 2017, 2018 and 2019 after removing certain costs deemed to be non-utility, *i.e.*, legacy nuclear investment costs. He also presents his calculations of refund amounts due to consumers pertaining to FirstEnergy Ohio Utilities' excessive earnings.

In my supplemental testimony, I am addressing his recommendation that a proper SEET ROE calculation for the FE Ohio Utilities should remove the legacy nuclear financing costs that are on the books of those companies during 2017, 2018 and 2019.

My assessment is that in theory, it would be appropriate to remove the capitalization associated with the legacy nuclear costs in calculating the utility ROEs for SEET refund purposes. Those capitalization amounts are unrelated to the provision of utility distribution service. By including those legacy nuclear costs, the FE Ohio Utilities' calculated ROEs in those three years is artificially deflated. While I agree with Mr. Kollen's recommendation, I have not attempted to verify the accuracy of the data presented in his testimony or his ROE (or refund) calculations.

Q4. ARE YOU MAKING A REFUND RECOMMENDATION ON BEHALF OF THE OCC IN YOUR SUPPLEMENTAL DIRECT TESTIMONY?

A4. No, I am not. The OCC's utility earned ROE findings and recommended refunds for 2017, 2018 and 2019 in these dockets are sponsored by Dr. Daniel Duann in his April 5, 2021 Direct Testimony. I am only addressing Mr. Kollen's argument that it is appropriate to remove legacy nuclear costs on a theoretical level, and I make no numerical recommendation regarding either the earned utility ROEs or the refund amounts.

II. MR. KOLLEN'S EARNINGS AND ROE ANALYSIS

Q5. HOW DID THE FE OHIO UTILITIES PERFORM THE SEET SECOND STEP OF IDENTIFYING UTILITY EARNED ROES FOR 2017, 2018 AND 2019?

A5. It is first necessary to consider the FE Ohio Utilities' analysis since that analysis is in a sense a starting point for Mr. Kollen. As described on page 17 of Mr. Kollen's testimony, the FE Ohio Utilities earnings and ROEs (for each utility) is set forth in the testimony of Utilities' Witness Tracy Ashton.

According to Mr. Kollen, she begins with each utility's per books financial statements for each of the three SEET years and makes two types of adjustments: (a) removal of earnings associated with affiliate company earnings, and (b) the reversal of extraordinary items. These adjustments are made to both the per books annual earnings and the common equity balances in calculating the ROEs. After making these adjustments, she obtains ROEs of 10.7 to 12.3 percent for TE, 7.3 to 8.7 percent for CEI and 16.5 to 18.2 percent for OEC.[1]

Mr. Kollen's ROE calculations are shown for each utility and year on his Exhibit __(LK-2). He adjusts the results of Ms. Ashton's analysis for his proposed modification – the removal of the "legacy" nuclear financing costs that during 2017 – 2019 remained on the

[1] Kollen, Direct Testimony at 17.

books of TE and CEI. Please note that such costs are not present for OEC, and therefore he makes no changes to the ROEs calculated by Ms. Ashton for OEC.

Q6. WHAT IS THE RATIONALE USED BY MR. KOLLEN FOR THE REMOVAL OF THE LEGACY NUCLEAR COSTS FROM THE TE AND CEI FINANCIAL STATEMENTS IN CALCULATING THE RETURN ON EQUITY FOR SEET PURPOSES?

A6. Mr. Kollen's testimony goes into considerable detail discussing the origins of the legacy nuclear costs, the underlying accounting treatments that placed those costs on the books of TE and CEI and the PUCO's regulatory treatment of those costs for rate setting. Based on that detailed documented analysis, he concludes that adjustments are needed to remove those legacy nuclear costs from the books of the two utilities when calculating the earned ROEs for 2017, 2018 and 2019 so that those earnings meaningfully reflect the utility operations. As discussed in his testimony, TE and CEI operate and have operated in recent years purely as distribution electric utilities with the rates regulated by the PUCO. The nuclear plants (and the legacy nuclear plant costs) are not part of the TE/CEI utility operations, and the nuclear plants are not owned by either utility.

Q7. WHY ARE THE LEGACY NUCLEAR PLANT COSTS REFLECTED ON THE TE AND CEI FINANCIAL STATEMENTS IF THEY DO NOT OWN ANY NUCLEAR ASSETS?

A7. As Mr. Kollen explains, OE acquired TE and CEI through the Centerior merger in 1997, and under the merger accounting at that time, the Utilities' nuclear investments were written down, and an offsetting (non-cash) accounting write up was made to goodwill. That goodwill is reflected in each utility's equity balance. He further explains that in 2005 the nuclear plant assets were transferred to a corporate affiliate, FirstEnergy Nuclear Generation Corporation, at the net book value as of that date (i.e., reflecting the accounting write down).[2] However, the accounting goodwill amounts for TE and CEI did not transfer and remained (and continues to remain) on the books of the two utilities. In addition, Mr. Kollen assumes that the original TE and CEI nuclear investments were supported in part by long-term debt, but none of that debt is transferred to the nuclear corporate affiliate. That debt remains with TE and CEI. This is the basis of his finding that during 2017 – 2019 TE and CEI incurred financing costs associated with the legacy nuclear investments that must be netted out when calculating the relevant utility-based operating ROEs.

It is important to understand that "legacy nuclear costs", as referenced by Mr. Kollen does not in any way refer to the actual O&M costs, revenues or even the financing of the net book value of the operating nuclear plants during 2017 – 2019, as those costs and revenues would be reflected on the books of the unregulated nuclear affiliate – it merely refers to the accounting write up for the goodwill on the balance sheets of TE and CEI.

[2] *Id*., at 4-5.

Q8. HOW IS THE PUCO REGULATORY HISTORY OF THE LEGACY NUCLEAR FINANCING COSTS RELEVANT TO MR. KOLLEN'S FINDINGS?

A8. Mr. Kollen cites to PUCO orders at the time of the Centerior merger that accepted the proposed accounting (including the massive goodwill accounting write up), but also reflected an understanding and agreement by FirstEnergy that those accounting adjustments to create the goodwill would not be charged in customer rates.[3] In addition, he notes that in the FE Ohio Utilities' most recent base rate case, from more than a decade ago, nuclear and other power plant costs were not reflected in base rates set at that time, which he views as proper.[4]

I certainly do not find any of this surprising. Goodwill write ups to equity sometimes occur with electric utility mergers, but it is common regulatory treatment to prohibit charging them in customer rates. This appears to be the case for the nuclear-related goodwill in the most recent FE Ohio Utilities base rate case. One of Mr. Kollen's central points is that the SEET refund process is a regulatory action under PUCO jurisdiction and is part of the TE and CEI rate setting.[5] I agree with that perspective, and thus, if the legacy nuclear costs are excluded from base ratemaking, as both the PUCO and the Utilities accept, they also should be excluded from the SEET refund calculation process which is also a form of customer rate setting.

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[3] *Id*. at 8.

[4] *Id*. at 8-10.

[5] *Id*. at 13-14.

Q9. ARE THE LEGACY NUCLEAR COSTS, AS REFLECTED IN THE GOODWILL ACCOUNTING WRITE UP, LARGE?

A9. Yes, they are massive relative to the size of TE and CEI. For the 2017 – 2019 time period, Mr. Kollen identifies nuclear legacy financing costs of $528 million for TE and $1,045 million for CEI. For this same time period, I calculate that the total balance sheet capitalization (long-term debt plus common equity) averaged about $931 million for TE and $2,918 million for CEI.[6] Thus, the legacy nuclear financing costs reflected in the accounting write up is more than half of TE's total capitalization and about a third of that of CEI. It should be further noted that CEI's total goodwill on its balance sheet for this time period is actually $1,689 million, an amount far larger than Mr. Kollen's $1,045 million associated just with the legacy nuclear costs. He does not make any adjustment for that additional more than $600 million of goodwill when calculating CEI's earnings and ROE.

Q10. DOES THE COMMON EQUITY CREATED BY THE GOODWILL WRITE-UPS RELATING TO THE LEGACY NUCLEAR COSTS FINANCE UTILITY RATE BASE OF EITHER TE OR CEI?

A10. Assuming that the PUCO does not include goodwill in rate base (or a regulatory asset represented by the goodwill), then an accounting write-up for goodwill that increases equity does not and cannot finance rate base. This is because the goodwill is a non-cash accounting adjustment.

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[6] This is based on balance sheet values averaged for year-end 2016 -2019 and is inclusive of current maturities of long-term debt. Mr. Kollen's legacy nuclear costs are shown on his Exhibit __(LK-2).

The implication is that the common equity balance (the denominator in the ROE calculation) with substantial goodwill is likely to be overly inflated and far larger than the equity component that actually finances rate base. This has the effect of artificially depressing the measured per books ROE from utility operations. In the context of the significantly excessive earnings test, this would reduce (on paper only) the utility's calculated ROE, thus making it less likely that consumers will get a refund and/or reducing any refund that they might otherwise be entitled to.

Q11. HOW DOES MR. KOLLEN PROVIDE HIS CORRECTION TO ROE FOR THE REMOVAL OF THE LEGACY NUCLEAR COSTS?

A11. Mr. Kollen shows his nuclear legacy cost correction for TE and CEI for 2017, 2018 and 2019 on his Exhibit __(LK-2). As previously noted, no adjustment is needed for OEC as that utility includes no goodwill in equity. His analysis identifies $528 million in legacy nuclear investment costs for TE and $1,045 million for CEI as being included in each respective utility's capitalization. He implicitly assumes that the legacy nuclear investment is financed by both debt and equity in proportion to the debt and equity on each utility's balance sheet in each year. He then proceeds to remove the legacy nuclear-related debt and equity in order to calculate the ROEs on a utility basis – that is, excluding the legacy nuclear costs from capitalization. In the case of his debt adjustment, he increases book earnings (as restated by witness Ashton) by the (net of tax) interest expense associated with the debt component of the nuclear costs. For example, for 2017 this increases TE's earnings by $8.5 million and CEI's earnings by $21.7 million. In the case of equity, he removes from the book equity balance (again, as restated by Witness

Ashton) the equity portion of the legacy nuclear costs. For example, for the SEET year 2017 common equity is thereby reduced by $324 million for TE and $586 million for CEI. This correction means a smaller common equity denominator and therefore a higher calculated ROE. This is a good result for consumers because it more accurately shows how profitable these utilities were during the years in question, and it increases the amount of the refund that consumers would be entitled to, resulting from the FE Ohio Utilities' significantly excessive profits.

Q12. ARE YOU TESTIFYING TO THE ACCURACY OF MR. KOLLEN'S ROE ADJUSTMENTS OR CALCULATIONS?

A12. No, that is not the purpose of my Supplemental Direct Testimony. I have not attempted to verify the accuracy of the data or calculations shown on his Exhibit __(LK-2).

III. CONCLUSION

Q13. WHAT ARE YOUR MAIN CONCLUSIONS FROM YOUR REVIEW AND ANALYSIS OF MR. KOLLEN'S TESTIMONY?

A13. The purpose of my testimony at this time is to express my opinion over two crucial theoretical points which I believe may support making some kind of corrective adjustment to the earnings and/or book equity data. The first point is that for both companies (TE and CEI) during 2017 – 2019 the common equity balance includes massive amounts of goodwill which could distort the measure of the actual ROE from utility operations.

The second and related point is that the legacy nuclear costs are unrelated to the utility distribution operations for TE and CEI in 2017 – 2019 and therefore should not be included in setting utility rates, which I believe, including the determination of SEET refunds. Conceptually, Mr. Kollen's debt and equity adjustments, described in his testimony, may provide a more realistic depiction of earnings from regulated distribution utility operations during those three SEET years. If Mr. Kollen's recommendations regarding the legacy nuclear assets were adopted, it would be a favorable result for consumers because it would increase refunds to consumers resulting from the FE Ohio Utilities' significantly excessive profits.

Q14. DOES THIS CONCLUDE YOUR SUPPLEMENTAL DIRECT TESTIMONY?

A14. Yes, it does. However, I reserve the right to update and supplement my testimony as new information becomes available.

CERTIFICATE OF SERVICE

I hereby certify that a true copy of the foregoing *Supplemental Direct Testimony of Matthew I. Kahal, on Behalf of the Office of the Ohio Consumers' Counsel* was served via electronic transmission to the persons listed below on this 23rd day of July 2021.

/s/ Christopher Healey
Christopher Healey (0086027)
Assistant Consumers' Counsel

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SERVICE LIST

Werner.margard@OhioAGO.gov
Kyle.kern@OhioAGO.gov
mkurtz@BKLlawfirm.com
Kboehm@BKLlawfirm.com
jkylercohn@BKLlawfirm.com
mpritchard@mcneeslaw.com
rglover@mcneeslaw.com
bethany.allen@igs.com
joe.oliker@igs.com
michael.nugent@igs.com

Attorney Examiners:
Megan.adddison@puco.ohio.gov
Gregory.price@puco.ohio.gov
Jacqueline.st.john@puco.ohio.gov

bknipe@firstenergycorp.com
mrgladman@jonesday.com
mdengler@jonesday.com
radoringo@jonesday.com
gkrassen@bricker.com
dstinson@bricker.com
paul@carpenterlipps.com
bojko@carpenterlipps.com
mkl@smxblaw.com
jrb@smxblaw.com
dborchers@bricker.com
jspottswood@bricker.com

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Case No(s). 18-0857-EL-UNC, 19-1338-EL-UNC, 20-1034-EL-UNC, 20-1476-EL-UNC

Summary: Testimony Supplemental Direct Testimony of Matthew I. Kahal on Behalf of Office of the Ohio Consumers' Counsel electronically filed by Ms. Deb J. Bingham on behalf of Healey, Christopher Mr.