BEFORE THE PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission, *et. al.*	:	R-2016-2537349, *et al.*
v.	:	
Metropolitan Edison Company	:	
Pennsylvania Public Utility Commission, *et. al.*	:	R-2016-2537352, *et al.*
v.	:	
Pennsylvania Electric Company	:	
Pennsylvania Public Utility Commission, *et. al.*	:	R-2016-2537355, *et. al.*
v.	:	
Pennsylvania Power Company	:	
Pennsylvania Public Utility Commission, *et. al.*	:	R-2016-2537359, *et al.*
v.	:	
West Penn Power Company	:	

DIRECT TESTIMONY

OF

RALPH C. SMITH

ON BEHALF OF
OFFICE OF CONSUMER ADVOCATE

JULY 22, 2016

PUBLIC VERSION

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I. STATEMENT OF QUALIFICATIONS

Q. Please state your name, position and business address.

A. Ralph C. Smith. I am a Senior Regulatory Consultant at Larkin & Associates, PLLC, 15728 Farmington Road, Livonia, Michigan 48154.

Q. Please describe Larkin & Associates.

A. Larkin & Associates is a Certified Public Accounting and Regulatory Consulting firm. The firm performs independent regulatory consulting primarily for public service/utility commission staffs and consumer interest groups (public counsels, public advocates, consumer counsels, attorneys general, etc.). Larkin & Associates has extensive experience in the utility regulatory field as expert witnesses in over 600 regulatory proceedings including numerous telephone, water and sewer, gas, and electric matters.

Q. Mr. Smith, please summarize your educational background.

A. I received a Bachelor of Science degree in Business Administration (Accounting Major) with distinction from the University of Michigan - Dearborn, in April 1979. I passed all parts of the Certified Public Accountant ("C.P.A.") examination in my first sitting in 1979, received my CPA license in 1981, and received a certified financial planning certificate in 1983. I also have a Master of Science in Taxation from Walsh College, 1981, and a law degree (J.D.) cum laude from Wayne State University, 1986. In addition, I have attended a variety of continuing education courses in conjunction with maintaining my accountancy license. I am a licensed

C.P.A. and attorney in the State of Michigan. I am also a Certified Financial Planner™ professional and a Certified Rate of Return Analyst ("CRRA"). Since 1981, I have been a member of the Michigan Association of Certified Public Accountants. I am also a member of the Michigan Bar Association. I have also been a member of the American Bar Association ("ABA"), and the ABA sections on Public Utility Law and Taxation and the Society of Utility and Regulatory Financial Analysts ("SURFA").

Q. Please summarize your professional experience.

A. Subsequent to graduation from the University of Michigan, and after a short period of installing a computerized accounting system for a Southfield, Michigan realty management firm, I accepted a position as an auditor with the predecessor CPA firm to Larkin & Associates in July 1979. Before becoming involved in utility regulation where the majority of my time for the past 36 years has been spent, I performed audit, accounting, and tax work for a wide variety of businesses that were clients of the firm.

During my service in the regulatory section of our firm, I have been involved in rate cases and other regulatory matters concerning electric, gas, telephone, water, and sewer utility companies. My present work consists primarily of analyzing rate case and regulatory filings of public utility companies before various regulatory commissions, and, where appropriate, preparing testimony and schedules relating to the issues for presentation before these regulatory agencies.

I have performed work in the field of utility regulation on behalf of industry, state attorneys general, consumer groups, municipalities, and public service commission staffs concerning regulatory matters before regulatory agencies in Alabama, Alaska, Arizona, Arkansas, California, Connecticut, Delaware, Florida, Georgia, Hawaii, Indiana, Illinois, Kansas, Kentucky, Louisiana, Maine, Maryland, Michigan, Minnesota, Mississippi, Missouri, New Jersey, New Mexico, New York, Nevada, North Carolina, North Dakota, Ohio, Oregon, Pennsylvania, Puerto Rico, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, Washington, Washington D.C., West Virginia and Canada as well as the Federal Energy Regulatory Commission and various state and federal courts of law.

Q. Have you prepared an attachment summarizing your educational background and regulatory experience?

A. Yes. Attachment RCS-1 provides details concerning my experience and qualifications.

Q. On whose behalf are you appearing?

A. Larkin & Associates, PLLC, was retained by the Pennsylvania Office of Consumer Advocate ("OCA") to review the rate requests of the FirstEnergy electric distribution utilities ("FE", "FirstEnergy", or "Companies"). Accordingly, I am appearing on behalf of the OCA.

Q. Have you previously filed testimony before the Pennsylvania Public Utility Commission?

A. Yes. I have testified before the Pennsylvania Public Utility Commission ("PaPUC" or "Commission") previously on a number of occasions

Q. How will your testimony be organized?

A. I will present an Overall Financial Summary that addresses the revenue increases requested by FE for its electric utilities. I then address each of the utilities that are the subject of the Company's revenue requirement filings in these proceedings. I then present an explanation of the organization and content of my exhibits for each system, which are attached to my testimony. That discussion is then followed by sections on Rate Base and Net Operating Income adjustments, where I explain each adjustment for each FE electric utility.

Q. For which FE utilities are you addressing FE's revenue requirements?

A. I am addressing the revenue requirements requested by FE for Metropolitan Edison Company ("Met-Ed" or "ME"), Pennsylvania Electric Company ("Penelec" or "PN"), Pennsylvania Power Company ("Penn Power" or "PP"), and West Penn Power Company ("West Penn" or "WP"), (collectively "Companies" or "Utilities").

Q. Have you prepared any exhibits to accompany your testimony?

A. Yes. Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1 present Accounting Schedules that quantify each of the recommendations discussed in my testimony for

Met-Ed, Penelec, Penn Power, and West Penn, respectively. The adjusted base rate revenue requirements for each of the Companies on those Exhibits also incorporate the cost of capital recommendation of OCA witness David Parcell and the new depreciation rates recommended by OCA witness James Garren

Exhibit LA-2 presents selected non-confidential material that is referenced in my testimony and schedules.

Exhibit LA-3 presents selected confidential material that is referenced in my testimony and schedules.

II. SCOPE AND PURPOSE OF TESTIMONY

Q. What base rate revenue increases have the Companies requested?

A. FE has presented four revenue requirement calculations where the Company applies a rate of return to rate base and compares the required operating income with its adjusted operating income and uses the difference to derive a revenue deficiency or sufficiency. FE's Exhibit CVF-3 contains the revenue requirement results for these utilities:

On April 28, 2016, Met-Ed filed with the Commission Tariff Electric – Pa. P.U.C. No. 52 (Tariff No. 52) which reflects an increase in annual distribution revenues of $134.180 million, or a 38.0% increase in its electric base rate revenues. Met-Ed's current distribution base rates were established pursuant to the Settlement Agreement entered February 3, 2015 at Docket No. R-2014-2428745, which was the last base rate proceeding for the Company. That proceeding resulted in an increase in Met-Ed's distribution base rates.

Penelec filed with the Commission Tariff Electric – Pa. P.U.C. No. 81 (Tariff No. 81) which reflects an increase in annual distribution revenues of $152.817 million, a 40.1% increase in its electric base rate revenues. Penelec's current distribution base rates were established pursuant to the Settlement Agreement entered February 3, 2015 at Docket No. R-2014-2428743, which was the last base rate proceeding for the Company. That proceeding resulted in an increase in Penelec's distribution base rates.

Penn Power filed with the Commission Tariff Electric – Pa. P.U.C. No. 36 (Tariff No. 36) which reflects an increase in annual distribution revenues of $37.399 million, or a 39.7% increase in its electric base rate revenues. Penn Power's current distribution base rates were established pursuant to the Settlement Agreement entered February 3, 2015 in the proceeding at Docket No. R-2014-2428744. That proceeding resulted in an increase in Penn Power's distribution base rates.

West Penn filed Tariff Nos. 38 and 40 which set forth proposed rates designed to produce, in aggregate, an increase in the Company's annual distribution revenue of $94.484 million, or a 25.5% increase in its electric base rate revenues. West Penn's current distribution base rates were established pursuant to the Settlement Agreement entered February 3, 2015 in the proceeding at Docket No. R-2014-2428742. That proceeding resulted in an increase in West Penn's distribution base rates.

Q. What is the purpose and scope of your testimony?

A. Larkin & Associates, PLLC was engaged by the OCA to conduct a review and analysis and to present testimony regarding certain rate base, operating income and revenue requirement aspects of the filing.

The purpose of my testimony is to present to the Commission the appropriate test period rate base, overall rate of return and utility operating income, as well as the appropriate overall revenue requirement and rate increase for each of the Companies in this proceeding.

Q. What capital structure and return on equity have you used?

A. In the determination of the OCA's recommended overall revenue requirement and revenue increase, I have used the capital structure and cost rates recommended by OCA witness David Parcell, which include a 9.15 percent rate of return on common equity.[1] I applied the resulting overall rate of return to my recommended adjusted rate base for each Company in these proceedings.

Q. What information did you review in developing your testimony?

A. In developing this testimony, I have reviewed and analyzed the Companies' filings, supporting testimonies, exhibits, filing requirements and workpapers; the Companies' responses to data requests by the OCA and other parties; prior Commission orders; and other relevant financial documents and data. I also applied the depreciation rates recommended by OCA witness James Garren.

[1] I will refer to this as the "return on equity" or "ROE".

III. SUMMARY OF FINDINGS AND CONCLUSIONS

Q. Please summarize your findings and conclusions in this case.

A. I have reached the following findings and conclusions with respect to the Companies' revenue requirements using OCA witness Parcell's recommended cost of capital, and without consideration of the quality of service:

As shown on Exhibit LA-ME-1[2], Schedule A, page 1, Met-Ed's proposed distribution revenue increase of $134.180 million should be reduced by $70.996 million. The distribution revenue increase for Met-Ed should be no greater than $63.184 million.

As shown on Exhibit LA-PN-1[3], Schedule A, page 1, Penelec's proposed distribution revenue increase of $152.817 million should be reduced by $98.843 million. The distribution revenue increase for Penelec should be no greater than $53.974 million.

As shown on Exhibit LA-PP-1[4], Schedule A, page 1, Penn Power's proposed distribution revenue increase of $37.399 million should be reduced by $22.018 million. The distribution revenue increase for Penn Power should be no greater than $15.381 million.

As shown on Exhibit LA-WP-1[5], Schedule A, page 1, West Penn's proposed distribution revenue increase of $94.484 million should be reduced by $61.771 million. The distribution revenue increase for West Penn should be no greater than $32.713 million.

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[2] This Exhibit is attached to my testimony.

[3] This Exhibit is attached to my testimony.

[4] This Exhibit is attached to my testimony.

[5] This Exhibit is attached to my testimony.

IV. ORGANIZATION OF ACCOUNTING SCHEDULES

Q. How are the OCA's accounting schedules organized?

A. The OCA's revenue requirement and accounting schedules for each utility are presented in Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1. These Exhibits present Accounting Schedules that quantify each of the recommendations in my testimony for Med-Ed, Penelec, Penn Power, and West Penn, respectively. Each of those Exhibits is organized into summary schedules and adjustment schedules. The summary schedules consist of four sets of Schedules A, A-1, B, B.1, C, C.1 and D. Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1 also contain rate base adjustment Schedules B-1 through B-4, and net operating income adjustment Schedules C-1 through C-13. The description of these schedules in the section immediately below applies to the Companies' summary schedules as well as the individual sets of summary schedules. Exhibits LA-ME-1, LA-PN-1, and LA-PP-1 also include Schedules E and E-1, which show the calculation of consolidated tax savings and the application of Act 40 Revenue Use Differential amounts for those Companies.[6]

Q. What is shown on Schedule A of Exhibit LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1?

A. On Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1, Schedule A, page 1, presents the overall financial summary, giving effect to all the adjustments I am

[6] The Act 40 Revenue Use Differential adjustments do not apply to West Penn.

recommending in my testimony. This schedule presents the change in the Companies' gross revenue requirement needed for the Companies to have the opportunity to earn the rate of return I have used on the adjusted rate base. The rate base and operating income amounts are taken from Schedules B and C, respectively. The overall rate of return on rate base with an ROE of 9.15 percent, as recommended by OCA witness Parcell, is provided on Schedule D of Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1, along with the derivation of the overall weighted average cost of capital for each Company.

Column A of Schedule A replicates the Companies' proposed calculations of the revenue deficiency. Column B of Schedule A presents the OCA's determination of the base rate revenue deficiency. Column C shows the differences between the Companies' request and the OCA's recommendation.

As described above, the operating income deficiency shown on line 5 of Schedule A is obtained by subtracting the adjusted operating income on line 4 (operating income as adjusted) from the required operating income on line 3. Line 7 represents the gross revenue requirement, which is obtained by multiplying the income deficiency by the Gross Revenue Conversion Factor ("GRCF"). Line 9 presents the amount of revenue increase after rounding differences.

Q. What is shown on Schedule A, page 2 of Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1?

A. Schedule A, page 2, presents a reconciliation of the revenue requirement and shows the approximate impact of each adjustment.

Q. What is shown on Schedule A-1 of Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1?

A. Schedule A-1 shows the derivation of the GRCF. The GRCF is used to convert the net operating income deficiency into a revenue deficiency amount.

Q. How does the GRCF recommended by OCA compare with the GRCF contained in the Companies' filing?

A. As shown on Schedule A-1, of Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1, the GRCF I have used for each utility corresponds to the GRCF used for that utility in the FE filings.

Q. What is shown on Schedule B of Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1?

A. Schedule B presents the Companies' proposed adjusted test year rate base and OCA's proposed adjusted test year rate base. The Company-proposed rate base amounts presented on Schedule B are taken from each Company's filing for the fully projected future test year ("FPFTY") ending December 31, 2017. OCA's recommended adjustments to rate base are summarized on Schedule B.1.

Schedules B-1 through B-4 provide further support and calculations for the rate base adjustments I am recommending.

Q. What is shown on Schedule C of Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1?

A. The starting point on Schedule C is the Companies' adjusted test year net operating income, as provided on each Company's Exhibit RAD-2. OCA's adjustments to the Companies' adjusted test year revenues and expenses are summarized on Schedule C.1. Each of the adjustments is discussed in my testimony.

Schedules C-1 through C-13 provide further support and calculations for the net operating income adjustments I am recommending.

Q. What is shown on Schedule D of Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1?

A. Schedule D summarizes the capital structure and cost of capital that was proposed by the Companies and the capital structure and cost of capital that I have used to compute the revenue requirement deficiency for each of the Companies. The OCA's recommended capital structure, cost rate, and ROE are sponsored by OCA witness David Parcell.

Q. Have you prepared a list of which of the OCA's proposed adjustments to rate base and net operating income pertaining to each Company?

A. Yes. Schedule A, page 2 on Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1 summarizes the OCA's proposed adjustments to rate base and net operating income for each Company.

V. RATE BASE

Q. Have you prepared a schedule that summarizes OCA's proposed adjustments to rate base?

A. Yes. As noted above, in Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1 the adjusted rate base is shown on Schedule B and the adjustments to each Company's proposed rate base are summarized on Schedule B.1.

B-1, Average Rate Base for the Fully Projected Future Test Year (All Four FE Utilities)

Q. Please explain the adjustment for the average rate base for the Fully Projected Future Test Year.

A. This adjustment for each Company is shown on Schedule B-1 of the respective exhibits, LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1.

Focusing on the Met-Ed adjustment, which is shown on Exhibit LA-ME-1, Schedule B-1, for purposes of explanation, the original cost at the beginning and end of the FPFTY are shown in columns A[7] and B. The rate base elements requested by Met-Ed are shown in column C. The corresponding average FPFTY balances for each rate base component are shown in column D.[8] The differences between Met-Ed's proposed rate base and the average FPFTY rate base, by rate base component, are shown in column E. For Met-Ed, the use of average FPFTY rate base balances results in an increase to FPFTY rate base of $11.0 million.

[7] The amounts shown for the beginning of the FPFTY were taken from Exhibit RAD-3.

[8] These average FPFTY balances are based on an average of the amounts shown in columns A and B.

The calculations for Penelec, Penn Power, and West Penn are similar and are shown on Schedule B-1 of Exhibits LA-PN-1, LA-PP-1, and LA-WP-1, respectively.

Q. Does Act 11 allow utilities use of a fully projected future test year?

A. Yes. Act 11 allows Pennsylvania utilities to utilize a FPFTY as the basis for determining their revenue requirement in a base rate case.

Q. How did FirstEnergy apply Act 11 in its current rate case?

A. For determining rate base, FirstEnergy applied Act 11 by projecting capital additions, revenues and operating expenses through the end of the FPFTY, and used estimated future amounts as of December 31, 2017, the <u>end</u> of the FPFTY, rather than using an <u>average</u> FPFTY concept for rate base components such as net plant in service. For operating expenses such as pay increases, FirstEnergy has used expenses, which are beyond the FPFTY. FirstEnergy has done this by including annualized increases occurring within and beyond the FPFTY, including pay increases projected for March 1, 2018 and May 1, 2018.

Q. Do you agree with FE's use of December 31, 2017 values for the fully projected future test year rate base?

A. No. Act 11 allows for the use of a fully projected future test year as the basis for determining revenue requirement. Thus the rate base should be based on the average for the FPFTY, rather than upon values as of a single date at the end of the FPFTY. The use of an average FPFTY approximately matches the collection of the revenue

requirement during the first year of new rates, i.e. with the FPFTY beginning on January 1, 2017 and continuing through December 31, 2017. FirstEnergy's new base rates established in these consolidated cases are anticipated to become effective on January 27, 2017. Consequently, the 2017 FPFTY is an approximation of the first year of new rates.

Q. In measuring FE's FPFTY rate base, what has FE proposed for the determination of jurisdictional rate base for its electric distribution utilities?

A. For each of the four electric distribution utilities, FE proposes that a year-end December 31, 2017 rate base be used for the purpose of determining its revenue requirement in the current rate case. However, the use of a year-end rate base to measure fully projected future test year results in a mis-match, since FE utilities would not have that level of rate base throughout the fully projected test year period. If a utility's jurisdictional rate base has changed during the test year measurement period, it could cause a significant distortion to the measurement of the utility's earnings if year-end values are used for major rate base components, such as net plant in service.

Q. Has a year-end rate base been used in previous FE utility base rate cases?

A. Yes, but those base rate cases pre-dated Act 11 and were based on a future test year that ended before rates went into effect, not a fully projected future test year. On the other hand, the purpose of the FPFTY is to calculate the utility's revenue requirement that will be in effect, on average, for the rate year, i.e., for the first full

year of the new rates. Thus, the FPFTY should use an average test year to determine the utility's revenue requirement for that 12-month forecasted calendar year rate effective period.

Q. Was the proper rate base determination when using a FPFTY an issue in FirstEnergy's last base rate cases?

A. Yes. In FirstEnergy's last base rate cases (Case Nos. Docket Nos. R-2014-2428742, R-2014-2428743, R-2014-2428744, and R-2014-2428745) FirstEnergy proposed an end-of-period rate base and OCA disagreed with that approach and recommended using an average FPFTY rate base.

Q. How was the issue of the proper determination of rate base when using a FPFTY resolved?

A. That particular issue was not specifically resolved. In those FirstEnergy base rate cases, the parties reached a "black box" settlement on the amount of revenue deficiency for each Company.

Q. To your knowledge, has the Commission ruled on how to determine utility rate base (i.e., on whether to use a year-end or average approach) when a FPFTY is being used in any utility rate cases since Pennsylvania utilities began using fully projected future test years pursuant to the authorization provided in Act 11?

A. No. I am advised by counsel that there are no Commission decisions yet on this issue.

Q. Can you provide a simple example of how a year-end rate base would compare to the use of actual cost information for the calendar year, on average?

A. Yes. The following illustration assumes that the utility had jurisdictional rate base investment of $6.5 billion on January 1 and $6.74 billion on December 31 of the FPFTY (which is a calendar year in this illustrative example), that the investment had been added ratably during the calendar year, and that the amount of actual net operating income for the year was approximately $540 million:

Simplified Comparison of Year-End and Average Calendar Rate Base - Illustrative Example
(Thousands of Dollars)

Line No.	Description	December 31 (Calendar Year-End) Rate Base (A)	Average Rate Base for Applicable Calendar Year (B)	Difference (C)
1	Jurisdictional Rate Base	$ 6,740,000	$ 6,620,000	$ 120,000
2	Required Return	8.12%	8.12%	
3	Operating Income Required	$ 547,288	$ 537,544	$ 9,744
4	Net Operating Income Available	$ 540,000	$ 540,000	
5	Operating Income Deficiency (Excess)	$ 7,288	$ (2,456)	$ 9,744
6	Gross Revenue Conversion Factor	1.6596	1.6596	
7	Revenue Deficiency (Sufficiency)	$ 12,095	$ (4,076)	$ 16,171

As shown in the example, the difference between using a year-end rate base (shows a revenue increase of $12.095 million) and the average rate base for the applicable calendar year that constitutes the FPFTY (shows a revenue decrease of $4.076 million) can have a significant impact on the results. Where the utility's rate base is changing significantly, the distortion in the measurement of results for the applicable period being used for the FPFTY can become quite large.

Q. Does proper matching dictate that an average rate base for the fully projected future test year be used?

A. Yes. For purposes of determining the utility's revenue requirement for the rate year that constitutes the FPFTY, an average rate base concept should be used. This is necessary for proper matching of the measurement information.

Q. Should an average test year rate base concept for the FPFTY period be employed in the current proceeding to determine the revenue requirement for each of the four FE electric distribution utilities?

A. Yes.

Q. Are you familiar with the use of a forecasted future test year in other jurisdictions?

A. Yes. I am familiar with the use of forecasted future test years in a number of other jurisdictions, including from my review of specific utility filings in jurisdictions, such as California and Hawaii, among others. It is common in states where a fully projected future test year is used to employ an average test year concept for purposes of measuring rate base and to determine the utility's revenue requirement.

Q. Has the rate base for each of the FE utilities changed substantially from the beginning to the end of the FPFTY in the current case?

A. No. The change in each of the FE utility's rate base from the beginning to the end of the FPFTY, i.e., the difference between average FPFTY rate base, as I am

recommending, versus the end-of-period FPFTY rate base that FE proposes, is not a major driver of the Companies' revenue increase requests in the current rate cases. In fact, for one of the four FE utilities (Met-Ed), the use of an average FPFTY rate base, other things being equal, results in an upward adjustment to rate base in the current rate case.

Q. What adjustment does the use of an average rate base for the FPFTY produce for the FE utilities?

A. As shown on Exhibit LA-ME-1, Schedule B-1 for Met-Ed, this adjustment increases rate base by $11.0 million.

As shown on Exhibit LA-PN-1, Schedule B-1 for Penelec, this adjustment decreases rate base by $8.472 million.

As shown on Exhibit LA-PP-1, Schedule B-1 for Penn Power, this adjustment decreases rate base by $14.0 million.

As shown on Exhibit LA-WP-1, Schedule B-1 for West Penn, this adjustment decreases rate base by $34.574 million.

<u>B-2, Deferred Extraordinary Storm Costs and Storm Reserves (All Four FE Utilities)</u>

Q. What have the FirstEnergy Companies proposed for inclusion of deferred extraordinary storm costs in rate base?

A. FirstEnergy proposes adjustments to include extraordinary storm damage cost deferrals in rate base. These are reflected on each Company's Exhibit RAD-1, Adjustment No. 7 (page 8) where the Companies have included their proposed rate

base amounts for (1) deferred extraordinary storm costs and (2) the storm reserve balances. The Companies have netted the storm reserve balances against their unamortized rate base request balances for extraordinary and merger deferred storm costs. For Met-Ed, Penelec, and West Penn, the starting point, i.e., the Total Deferral for extraordinary storm cost amounts reflects the same extraordinary and merger storm cost deferrals ("deferred storm costs") that FirstEnergy proposed in its 2014 Pennsylvania rate cases.[9]

Q. How were ratemaking issues related to storm costs addressed in the settlement that was reached by the parties and approved by the Commission in the 2014 FirstEnergy rate cases?

A. Ratemaking issues of "storm riders" and "reserve accounts" came to the forefront in Pennsylvania after the severe storms in 2011 and 2012. In its 2014 rate cases, FirstEnergy requested a reconcilable storm rider, a Companies' proposal which was opposed by the OCA. The settlement in the 2014 FirstEnergy rate cases provided for the establishment of a storm reserve account on each Company's balance sheet. The storm reserve amount represents a five-year average of historical expense related to

[9] See, for example, paragraph A(4) of the Met-Ed Joint Petition for Settlement in the 2014 base rate case. We note that the Winter Storm Nika storm cost deferral amount in the 2014 rate case was $13.327 million, approximately $39,000 higher than the proposed amount in the current 2016 rate case. The amounts have been partially amortized since the 2014 rate cases.

storm damage[10] excluding expense related to damage from extraordinary storm events, i.e., the deferred storm costs, which each Company had permission to defer. The deferred storm costs were a separate amortization not related to the storm reserve accounts.

Q. Did the settlements in the 2014 FirstEnergy rate case authorize rate base inclusion of deferred storm costs?

A. No. The settlements in the 2014 FirstEnergy rate cases only provided that the Company's claim for deferred storm damage expenses shall be amortized over a five-year period, beginning on the date the settlement rates became effective. No rate base inclusion was authorized.

Q. Please explain what a storm reserve balance is.

A. A storm reserve balance is an amount recorded as of a certain date in a storm reserve balance sheet account that is being used to account for the recovery of storm costs, but not the costs of extraordinary storms. For example, the settlement in the 2014 rate case for Met-Ed at pages 7-8, paragraph 5, provided as follows:

> A Storm Reserve Account will be established and maintained on the Company's balance sheet beginning on the date the Settlement Rates become effective. The Company's total revenue requirement includes $13 million to be recovered for

[10] As with all claimed expenses in base rate cases, it is appropriate during these current base rate cases to review each Company's actual storm damage expenses against the accrued amounts in their storm reserves and then, if appropriate, make a recommendation going forward whether the annual accrual amount was too high, too low. As such, existing balances or deficits in the storm reserve accounts in these 2016 FirstEnergy rate cases would be addressed. The storm reserve accounts, however, have been in use since the 2014 base rate case rates went into effect on May 3, 2015. This is too short of a time to adequately evaluate whether the storm reserve account expense recovery levels are too high or too low. As such, I recommend that the recovery levels for each Company remain the same as established in the 2014 base rate case settlement.

purposes of funding this reserve, which represents a five-year average of historical storm damage expenses excluding expenses associated with extraordinary storms, which the Company received Commission approval to defer. Actual storm expenses excluding the expenses associated with extraordinary storms will be recorded in the Storm Reserve Account in order to eliminate any impact of such storm expenses on the Company's income statement. Expenses associated with extraordinary storms will be accounted for separately in accordance with the current practice of petitioning the Commission for approval to defer such expenses. Both revenues received and costs incurred by the Company in support of other regulated utilities, including other jurisdictional and non-jurisdictional affiliated companies, for assisting during storm events will be reflected in the reserve account.

Q. What deferred storm costs are included in the FirstEnergy proposed amounts for Met-Ed and Penelec in the 2016 base rate cases?

A. For Met-Ed, which specifies "Extraordinary" along with merger approval storm damage deferrals, the Company's adjustment includes deferred storm costs for Hurricane Sandy and Winter Storm Nika. Pursuant to a provision in the case involving the FirstEnergy merger with Allegheny (Case No. 10-0713-E-PC) the Met-Ed deferred storm cost amount requested for rate base inclusion also includes the distribution non-capital storm expenses that exceeded 125% of storm costs included in base rates between February 25, 2011 and September 30, 2012, which included storm costs for Hurricane Irene, an October 2011 snowstorm, and Tropical Storm Lee. This is similar to a FirstEnergy-proposed rate base addition in the 2014 case, which was opposed by the OCA. In the current case, Met-Ed has proposed to include $44.584 million of extraordinary and merger case storm damage deferred

cost amounts in rate base.[11] Met-Ed has also reflected a credit-balance storm damage reserve amount of $9.865 million as a rate base offset, for a net rate base increase for storm costs of $34.719 million.

The FirstEnergy-Allegheny merger approval items pertaining to storm cost deferrals also applied to Penelec. For Penelec on Exhibit RAD-1, page 8, the Company proposes to include $8.544 million for merger storm damage cost deferrals, less $637,000 for its storm reserve balance, for a net rate base increase of $7.907 million.

Q. What deferred storm costs is FE proposing to include in the current rate base for West Penn?

A. For West Penn, FE is proposing to include in rate base $10.327 million for the deferred extraordinary storm costs from the February 2010 Winter Storm (which FE also proposed in the 2014 rate case and which OCA opposed). West Penn has netted its storm reserve balance of $779,000 against those extraordinary deferred storm costs, for a net rate base amount of $9.548 million.

Q. Please discuss the FE-proposed deferred storm cost amount for Penn Power in the current 2016 rate case and how it compares to the Company's request in the 2014 rate case.

A. There was no Company proposed adjustment to include deferred storm costs in rate base for Penn Power in the 2014 case. In the current rate case, however, as shown

[11] Met-Ed's response to I&E RE-15 stated that the $44.584 million amount in its filing should be $43.353 million.

on Exhibit RAD-1, page 8, the Company proposes to increase Penn Power's rate base by a storm reserve balance amount of $1.425 million. The $1.425 million amount also appears in Penn Power's response to I&E RE-18.

Q. Do you agree with FirstEnergy that deferred storm costs should be included in rate base?

A. No. As I will discuss in more detail below, I do not agree with FirstEnergy that deferred extraordinary storm costs should be included in rate base. The OCA opposed rate base inclusion of deferred storm costs in the 2014 FirstEnergy rate cases and continues to oppose rate base inclusion of such costs in the current FirstEnergy rate cases.

Q. Why should the deferred storm costs be excluded from rate base in the current FirstEnergy rate cases?

A. Inclusion in rate base would allow the Companies to earn a return on the unamortized storm expense, thus increasing profits for shareholders. The recovery of extraordinary storm costs is provided through an appropriate amortization, but a return on these operating expenses is not allowed. I am advised by counsel that the Commission's practice for extraordinary storm cost deferral has typically been to allow deferral and to require the utility to immediately begin expensing the deferred amounts in accordance with a reasonable amortization schedule without interest. No amounts of deferred storm cost should be included in rate base, because this is an

operating expense not an investment. The result is that there is no rate base return on extraordinary storm cost.

Q. Regarding the FE storm reserve balances, what reasons has FirstEnergy stated for including the storm reserve balances in rate base?

A. FirstEnergy has attempted to reflect storm reserve balances in rate base. Language from the settlement that was reached in the 2014 FirstEnergy rate cases (at paragraph 5 for MetEd – the language is similar for the other FirstEnergy Companies) indicates that: "A Storm Reserve Account will be established and maintained on the Company's balance sheet beginning on the date the Settlement Rates become effective." Companies' witness D'Angelo's Direct Testimony for Met-Ed at page 12 indicates that because the storm reserve account was to be established on the Company's balance sheet, "accordingly, the storm reserve account balance has been included in rate base." (His testimony for the other Companies on this issue is similar or identical.)

Q. Should any storm reserve balance, whether positive or negative, be included in rate base?

A. No. The Commission has consistently held that reserve balances should not be included in rate base in cases such as Pa. PUC v. Penn. Power Co., 55 Pa. PUC 552 (1982) and Pa. PUC v. UGI Corp., 56 Pa. PUC 575 (1982).

Q. For their proposed rate base amounts for deferred storm costs, have the Companies netted the storm reserve balance amounts against what they show as the unamortized storm cost deferral amounts?

A. Yes. On each Company's Exhibit RAD-1, in Adjustment No. 7, the rate base adjustments proposed by the Companies (with the exception of Penn Power) are the result of netting the deferred storm costs, as described above, against the storm reserve balance amounts. The Companies' response to I&E RE-19 indicates that the amortization amounts (total storm deferral costs which are being amortized over five years per the settlement) are reflected on Exhibit RAD-2, page 1, line 13 (Amortization and Accretion). As previously mentioned, the Penn Power rate base adjustment proposed by FirstEnergy is for the storm reserve balance amount of $1.425 million.

Q. Is it reasonable to net the reserve balances for normal storm expense against the amortizations of deferred storm costs?

A. No, not for accounting purposes. For accounting purposes, FirstEnergy should continue to separately account for (1) the amortization of deferred storm costs and (2) for the revenues and costs associated with the non-extraordinary storms that are being accounted for in the storm reserve account for each FirstEnergy company.

As described elsewhere in this section of my testimony, for ratemaking purposes, the net amounts that the FirstEnergy Companies have attempted to include in rate base for deferred storm costs and for the storm reserved balances have been removed from rate base for the reasons I have stated.

Q. Please explain your adjustment to remove deferred storm costs from rate base.

A. As shown in Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1 on Schedule B-2 for each of the FirstEnergy Companies, the amounts proposed by FirstEnergy for inclusion in rate base of deferred storm costs are being removed. My adjustments reduce the net amount of deferred storm costs in rate base for each Company to zero. The adjustment is shown in two parts, first to recognize that I have adjusted the FPFTY rate base amounts to an average of the beginning and ending balances (versus FirstEnergy's proposal to use end of FPFTY amounts, i.e., projected December 31, 2017 amounts for the rate base balances). Second, to remove the remaining average FPFTY amounts from rate base.

The end result of the my recommended adjustments is to remove all FirstEnergy-proposed deferred storm costs from rate base in the current 2016 rate cases. Recovery of such costs through amortization is allowed; however, including unamortized amounts of expenses in rate base is not. Hence, the Companies' proposed rate base amounts should be removed.

Q. What adjustment does this produce for each of the FE utilities?

A. As shown on Exhibit LA-ME-1, Schedule B-2, rate base for Met-Ed is reduced by $44.319 million.

As shown on Exhibit LA-PN-1, Schedule B-2, rate base for Penelec is reduced by $9.633 million.

As shown on Exhibit LA-PP-1, Schedule B-2, rate base for Penn Power is reduced by $1.428 million.

As shown on Exhibit LA-WP-1, Schedule B-2, rate base for West Penn is reduced by $11.496 million.

<u>B-3, Accumulated Depreciation - Impact of New Depreciation Rates (All Four FE Utilities)</u>

Q. Please explain your adjustment to the depreciation reserve related to the impact of new depreciation rates.

A. OCA witness Garren is recommending new depreciation rates that are different from the ones proposed by FirstEnergy. This adjustment relates to an adjustment to Depreciation Expense, which is discussed in detail in a subsequent section of my testimony. The new depreciation rates would affect the Accumulated Depreciation balance at the end of the FPFTY. The impact on average Accumulated Depreciation for the FPFTY resulting from the OCA's recommended depreciation rates has been estimated by taking one-half of the Depreciation Expense adjustment amounts shown on Schedule C-1 for each Company.

Q. What impact does this adjustment have on rate base?

A. As shown on Exhibit LA-ME-1, Schedule B-3, for Met-Ed accumulated depreciation on average for the FPFTY is reduced by $8.795 million. This increases rate base by that same amount.

As shown on Exhibit LA-PN-1, Schedule B-3, for Penelec this similar adjustment calculation process results in a $10.296 million decrease in average

FPFTY accumulated depreciation. This results in a net increase to Penelec's rate base for that same amount.

As shown on Exhibit LA-PP-1, Schedule B-3, for Penn Power this similar adjustment calculation process results in a $2.951 million decrease in average FPFTY accumulated depreciation. This results in a net increase to Penelec's rate base by that amount.

As shown on Exhibit LA-WP-1, Schedule B-3, for West Penn this similar adjustment results in a $7.208 million decrease in average FPFTY accumulated depreciation. This increases West Penn's rate base by that amount.

B-4, Cash Working Capital (All Four FE Utilities)

Q. What is cash working capital?

A. Cash working capital ("CWC") is the cash needed by the Company to cover its day-to-day operations. If the Company's cash expenditures, on an aggregate basis, precede the cash recovery of expenses, investors must provide cash working capital. In that situation a positive cash working capital requirement exists. In this case, the cash working capital requirement is an addition to rate base as investors are essentially supplying these funds.

Q. Please summarize the standard procedure utilized to calculate a utility's cash working capital requirement.

A. The normal procedure for calculating a utility's cash working capital requirement is to first calculate the lag with which revenue is received from customers. Second, the lag with which the utility pays for the various types of cash expenses such as wages,

benefits, etc., is then determined. Third, a net lag for each type of cash expense is calculated by subtracting the expense payment lag from the revenue lag. Fourth, the net lag is multiplied by the average daily amount of each type of cash expense to calculate the cash working capital requirement for that item. Finally, the individual items are summed to determine the total cash working capital requirement.

Q. Did the FirstEnergy utilities follow that procedure?

A. Yes. My review of Company Exhibit JLA-1 for each Company indicates that the Companies calculated their cash working capital requirements in the manner described above.

Q. How was the proper treatment of non-cash expenses addressed in a previous Commission order for Met-Ed and Penelec?

A. The Commission's January 11, 2007 order in Cases R-00061366 and R-00061367 et al. discussed the treatment of non-cash items such as depreciation, amortization, deferred income taxes, and uncollectibles at pages 72-76. As stated at page 74 of that Order:

> The OCA contended that the Commission has held that no consideration should be given to non-cash items in the cash working capital computation citing *Pa. PUC. V. Phila. Suburban Water Co.*, 58 Pa. PUC 668, 674 (1984) ("we consider uncollectible accounts expense to be a non-cash expense and, as such, no return allowance will be granted"); *Pa. PUC v. Mechanicsburg Water Co.*, 80 Pa. PUC 212, 226 (1993) (elimination of non-cash items, such as amortization and written-off uncollectibles, from the cash working capital calculation); *Pa. PUC v. Roaring Creek Water Co.*, 81 Pa. PUC 285, 292 (1994); and *Pa. PUC v. Columbia Gas of Pa, Inc.*, 74 Pa. PUC 282, 300 (1990) ("any expense which does

> not require the utility to utilize cash funds does not require a CWC allowance"). The OCA concluded that the Commission should reject the Companies' inclusion of non-cash items in its claim for cash working capital.

b. ALJs' Recommendation

> The ALJs agreed with the OCA's position. The ALJs found that the prior Commission decisions cited by the OCA consistently reject including non-cash items in cash working capital. The ALJs state that, while MEPN point out some state utility commissions have adopted their position that non-cash items should be included in cash working capital, the decisions of other state utility commissions are not controlling in this proceeding. The ALJs maintain that prior Commission decisions are controlling. They concluded that MEPN have cited no Commission decisions in support of their position that non-cash items should be included within the calculation of cash working capital nor have they proven that the Commission should deviate from its prior decisions. Therefore, the ALJs adopted the position of the OCA and excluded the non-cash items from cash working capital. (R.D. at 85).

At page 76 of that order, the Commission stated that:

> Our review of the record evidence leads us to conclude that the ALJs recommendation relative to the treatment of "non-cash" items within the cash working capital analysis is reasonable and consistent with Commission precedent. We find that the OCA's position that depreciation, amortization, deferred income taxes and uncollectibles are not cash expenses for which a payment must be made at a specified date is correct. Therefore, these expenses are not properly included in the lead-lag study analysis to determine cash working capital. We are not persuaded by the Companies' arguments to deviate from our prior decisions on this issue and will continue to follow Commission precedent. Accordingly, the Exceptions of MEPN on this matter are denied.

Q. Should the Commission's practice of excluding non-cash items from cash working capital continue to apply in the current FirstEnergy rate cases as well?

A. Yes. The prior Commission's decisions cited above consistently reject including non-cash items in cash working capital for a very good reason: any expense which does not require a utility to utilize cash funds does not require a CWC allowance. This reason continues to apply in the current FirstEnergy rate cases.

Q. How has the payment-lag for interest on long-term debt been reflected for CWC in the current FirstEnergy rate cases?

A. The payment-lag for long-term debt has been reflected as a cash expense with a payment lag of 91.3 days, reflecting that interest on long-term debt is typically paid semi-annually.

Q. How was the CWC treatment for other O&M items, including interest on customer deposits and pole rental expenses addressed in previous Met-Ed and Penelec rate cases?

A. The Commission's January 27, 2007 Order in Cases R-00061366 and R-00061367 et al. discussed the treatment of these items for CWC at pages 81 – 83. The OCA's recommended CWC treatment for these items was adopted.

Q. Has that treatment also been applied by the Companies to these other O&M items in the current case?

A. Yes. The treatment for the interest on customer deposits and pole rental expenses for CWC has been applied by the Companies in the current case.

Q. How did the Companies treat the non-cash expenses included in their revenue requirement?

A. As discussed in the direct testimony of Companies witness Adams, and reflected on each Company's Exhibit JLA-1, non-cash items such as depreciation, amortization, deferred federal income taxes, and investment tax credit, were not included in the cash working capital amount requested by FE for rate base inclusion.

Q. Have you identified any problems with the Companies' lead lag studies?

A. Yes. I have identified a number of corrections which are required to more accurately determine cash working capital. Accordingly, I have presented a revised cash working capital analysis for each Company.

Q. Would you summarize the revisions that you have made to the Companies' cash working capital requests?

A. Yes. I have made the following revisions to the lead-lag studies utilized by the Companies:

- I corrected certain errors in Penelec's lead/lag study, which relate to (1) revenue lag days, (2) interest on long-term debt, and (3) interest on customer deposits. The Company has agreed that these errors should be corrected.[12]
- I have removed the lobbying cost portion of the Companies' requested CWC for inclusion of EEI dues prepayments.

[12] See the responses to OCA-XI-3, OCA-XI-4, and OCA-XI-5.

- I have removed an item for unamortized pension contributions that the Companies have attempted to include in the prepayments component of CWC in the current rate cases (see additional discussion below).
- Finally, I have adjusted the expenses included in the lead-lag study to reflect my adjustments to the Companies' cash operating expenses.

Q. Did the Companies include EEI lobbying costs in their CWC request for prepayments?

A. Yes. The Companies' prepaid EEI dues assessment amounts that were used for their claimed prepayments component of CWC failed to exclude the portion of EEI dues associated with lobbying. The EEI dues lobbying portion should be excluded from CWC so that the Companies do not receive a rate base return on their lobbying expenses. This exclusion of lobbying cost from the EEI prepayment is reflected on Schedule B-4 for each Company.

Q. Have the Companies attempted to include any other items in its proposed CWC component of rate base?

A. Yes. The Companies have attempted to include large amounts in CWC for Unamortized Cash Pension Contributions, which was presented for the first time in their 2014 rate cases, and which was opposed in those cases by the OCA. This is shown on Schedule B-4, page 1, line 27, of Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1. The amounts requested for rate base inclusion, via CWC, for this item in the current cases are:

- $56.224 million for Met-Ed;
- $82.609 million for Penelec;
- $6.629 million for Penn Power; and
- $38.903 million for West Penn.

Q. Have the Companies explained why they are requesting this item?

A. Yes. The Companies' response to OCA-XI-2 states that:

> The Companies have made large cash contributions to the pension trust fund over the last ten years. For ratemaking purposes, the Companies recover those cash outlays over ten years. Throughout those ten years, the Companies bore the carrying costs associated with the prior period expenditures that they made but have not recovered in base rates. That unrecovered amount constitutes the Unamortized Cash Pension Contributions that form the basis for the Companies' claim, as shown on page 7 of Exhibit JLA-1.

Q. Were Unamortized Cash Pension Contributions included in the Met-Ed or Penelec claim for CWC in Docket Nos. R-00061366 and R-00061367?

A. It appears they were not. I have reviewed the Order in that proceeding as well as the Met-Ed and Penelec CWC filings and the OCA's testimony on CWC in those dockets and find no inclusion in CWC of any line item for Unamortized Cash Pension Contributions.

Q. What amount of prepayments was requested by Met-Ed and Penelec in Docket Nos. R-00061366 and R-00061367?

A. According to Met-Ed Exhibit MJS-1, pages 1 and 14 of 14[13] in Docket No. R-00061366, the total prepayments balance claimed by Met-Ed in that case was $916,000. Moreover, the items included are Prepaid PaPUC Assessments, Prepaid Property & Liability Insurance and Prepaid EEI dues. There is no inclusion of any Unamortized Cash Pension Contributions.

Similarly, according to Penelec Exhibit MJS-1, pages 1 and 14 of 14[14] in Docket No. R-00061367, the total prepayments balance claimed by Penelec in that case was $932,000. Moreover, the items included are PaPUC Assessments, Prepaid Property & Liability Insurance and Prepaid EEI dues. There is no inclusion of any Unamortized Cash Pension Contributions.

Q. The Companies' response to OCA-XI-1 states in part that: "No testimony was served by any of the parties in those cases challenging the inclusion of prepayments in the calculation of cash working capital. Therefore, the Commission adopted this treatment at Docket Nos. R-00061366 and R-00061367 in its Order dated January 11, 2007." How would any party challenge the inclusion of Unamortized Cash Pension Contributions in a prepayments component of CWC in Docket Nos. R-00061366 and R-00061367 if no Unamortized Cash Pension Contributions were included?

A. This is something that the Companies have not explained.

[13] Copies of these pages are included in Exhibit LA-2, attached to my testimony.

[14] Copies of these pages are also included in Exhibit LA-2, attached to my testimony.

Q. Did the Commission authorize the inclusion of Unamortized Cash Pension Contributions in CWC in Docket Nos. R-00061366 and R-00061367?

A. No, it did not. The item was apparently not included in the Met-Ed or Penelec claims made in those cases, and was therefore not addressed. No reasonable inference can be made that inclusion in rate base of Unamortized Cash Pension Contributions in CWC was authorized in Docket Nos. R-00061366 and R-00061367. Indeed, it appears from a review of the record in that docket that this item was **not** included in rate base for either Met-Ed or Penelec.

Q. How do the components of the prepayments that Met-Ed and Penelec requested in Docket Nos. R-00061366 and R-00061367 compare with the prepayments that they are requesting in the current rate cases?

A. The components of the prepayments that Met-Ed and Penelec requested in Docket Nos. R-00061366 and R-00061367 are comparable with the prepayments that they are requesting in the current rate cases, only without the inclusion of Unamortized Cash Pension Contributions.

The prepayments in the current rate cases without that item include Prepaid PaPUC Assessments, Prepaid Property & Liability Insurance and Prepaid EEI dues. Those components are comparable to the prepayments that Met-Ed and Penelec in Docket Nos. R-00061366 and R-00061367.

There was no Unamortized Cash Pension Contributions in the prepayments that were requested by Met-Ed and Penelec in Docket Nos. R-00061366 and R-00061367. Thus, any inference that the Companies have attempted to make that the

Commission adopted a CWC allowance in Docket Nos. R-00061366 and R-00061367 that included a component for Unamortized Cash Pension Contributions is contrary to the facts.

Q. Were there statements in the Companies' testimony in their 2014 rate cases indicating that their attempted inclusion of Unamortized Cash Pension Contributions was a new item that has not previously been authorized for rate base inclusion in any prior rate case by the Commission?

A. Yes. For example, in Docket Nos. R-2014-2428742, R-2014-2428743, R-2014-2428744, and R-2014-2428745, the testimony of Ms. Larkin at Companies' Statement 6, page 14, lines 4-7, singles out their attempted inclusion of Unamortized Cash Pension Contributions as an exception to the methodology that Met-Ed and Penelec employed in their 2006 base rate cases in Docket Nos. R-00061366 and R-00061367.

Q. Was the methodology that Met-Ed and Penelec employed in their 2006 base rate cases for CWC in Docket Nos. R-00061366 and R-00061367 accepted by the Commission?

A. Only in part. In considerable part, such as the attempt by Met-Ed and Penelec in those cases to include non-cash items, to include a return on equity component, to fail to reflect the lag on the payment of interest expense on long-term debt, as illustrative examples, all of which are discussed above, the Companies' methodology was not accepted.

Q. Do you agree with the Companies' proposed inclusion of Unamortized Cash Pension Contributions in CWC?

A. No. I have removed the amounts for Unamortized Cash Pension Contributions, as shown on Schedule B-4, page 1, line 27, of Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1.

Q. Please explain why those amounts should be removed.

A. These amounts should be removed for several reasons. First, these amounts are not part of the lead-lag study.

Second, there is no authorization that I could find in any Commission Order, including the one in the Met-Ed or Penelec 2006 base rate cases, for including this item in CWC.

Third, this item was not included in the Met-Ed or Penelec requested or in the Commission authorized CWC in their 2006 rate cases in Docket Nos. R-00061366 and R-00061367.

Fourth, to the extent that the Companies' requested inclusion of Unamortized Cash Pension Contributions in the current rate cases may be based in some respect on the Companies' proposed use of a ten-year average of pension funding contributions to determine a normalized pension <u>expense</u> in the 2006 Met-Ed and Penelec rate cases, which was accepted by the Commission, or the similar request being made by the Companies in the current rate cases, that is not sufficient rationale for creating a new rate base item. A normalized O&M expense allowance, such as

rate case expense or pensions, is not converted into a rate base investment. The use of a multi-year period for an amortization or normalization for such items does not result in the creation of new rate base balances that should earn a return. In Docket Nos. R-00061366 and R-00061367, the references to pension funding in the prior Met-Ed and Penelec rate case was for the purpose of deriving a normalized amount of an operating expense, and, a review of the record in those cases reveals that this did not encompass the creation of any new rate base inclusion in CWC for unamortized pension funding amounts.

Fifth, there has been no showing by the Companies that pension expense for Penn Power or West Penn has historically been similarly based on a ten-year average of pension funding contributions. Consequently, there is no apparent historical justification for imposing a new CWC component for Unamortized Cash Pension Contributions on Penn Power or West Penn ratepayers.

Sixth, there is a general lack of support or convincing rationale for including these large amounts in rate base for a new component of CWC that has apparently never been authorized for rate base inclusion in the past for any of these four utilities.

Q. What adjustment have you reflected to remove these amounts from CWC?

A. As shown on Schedule B-4, page 1, line 27, of Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1, I have removed the amounts the Companies' have requested for rate base inclusion, via CWC, for this item, as follows:

- $56.224 million for Met-Ed;
- $82.609 million for Penelec;

- $6.629 million for Penn Power; and
- $38.903 million for West Penn.

Q. What overall adjustments to cash working capital do you recommend for each utility?

A. As shown on Schedule B-4 of Exhibit LA-ME-1, I have determined Met-Ed's cash working capital requirement to be $77.193 million. This is $57.675 million less than Met-Ed's claim.

As shown on Schedule B-4 of Exhibit LA-PN-1, I have determined Penelec's cash working capital requirement to be $76.433 million. This is $101.545 million less than Penelec's filed claim.

As shown on Schedule B-4 of Exhibit LA-PP-1, I have determined Penn Power's cash working capital requirement to be $21.879 million. This is $7.027 million less than Penn Power's filed claim.

As shown on Schedule B-4 of Exhibit LA-WP-1, I have determined West Penn's cash working capital requirement to be $83.061 million. This is $40.165 million less than West Penn's filed claim.

VI. ADJUSTMENTS TO OPERATING INCOME

Q. Please describe how you have summarized your proposed adjustments to operating income.

A. On Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1, Schedule C summarizes my recommended net operating income. The Companies' overall proposed adjusted net operating income is shown in column A of Schedule C. My adjustments are

shown in column B, and the adjusted results are shown in column C. Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1, Schedule C.1 presents my recommended adjustments to test year revenues and expenses. The impact on state and federal income taxes associated with each of the recommended adjustments to operating income is also reflected on Schedule C.1. The recommended adjustments to operating income are discussed below in the same order as they appear on Schedule C.1.

C-1, Depreciation Expense at Proposed Rates Using Average Plant Balances (All Four FE Utilities)

Q. What Depreciation Expense amounts have the FirstEnergy Companies requested?

A. The FirstEnergy Companies have requested the following amounts of Depreciation Expense, which are based on applying their proposed new depreciation rates to end-of-FPFTY Plant (i.e., to December 31, 2017 Plant balances) plus a 2011-2015 five-year average of cost of removal:

	FirstEnergy Companies Proposed Depreciation Expense (000's)				
Line No.	Description	Med-Ed	Penelec	Penn Power	West Penn
1	Jurisdictional Depreciation Expense Accrual at Equal Life Group Rates	$ 71,310	$ 79,388	$ 21,809	$ 69,719
2	Jurisdictional Cost of Removal/Salvage Expense at a Five-Year Average	$ 14,420	$ 14,812	$ 2,578	$ 8,736
3	Total Proposed Depreciation Expense	$ 85,730	$ 94,200	$ 24,387	$ 78,455

Q. Do you agree with the Companies' proposal to use a five-year historic average for cost of removal?

A. Yes. I am in agreement with the Companies' proposal to use a five-year historic average for cost of removal.

Q. Do you agree with the Companies' proposed Depreciation Expense for the FPFTY?

A. No. There are two adjustments to be made to the Companies' proposed Depreciation Expense for the FPFTY for each Company. The first adjustment is to use the average FPFTY plant balances, rather than the December 31, 2017 end-of-FPFTY plant balances to derive the FPFTY Depreciation Expense. The second adjustment is to apply the new depreciation rates recommended by OCA witness James Garren to the average FPFTY plant balances to derive the allowed amounts of FPFTY Depreciation Expense.

Q. In applying the depreciation rates to the FPFTY average plant, how did you treat Transmission Plant that the FirstEnergy Companies show on Met-Ed Exhibit RAD-46, Attachment B as being Transferred?

A. On Exhibit LA-ME-1, Schedule C-1, in deriving the average FPFTY plant balances to which the depreciation rates are being applied, I treated the same items of Transmission Plant as being transferred as are shown on Met-Ed Exhibit RAD-46, Attachment B as being Transferred. Specifically, the December 31, 2016 (i.e., beginning of FPFTY) Plant amounts from Met-Ed Exhibit RAD-47 were used. Those amounts agree with the December 31, 2016 (i.e., beginning of FPFTY) Plant amounts that were used in developing the recommended rate base for Met-Ed.

A similar procedure was applied to each of the other FirstEnergy Companies, as shown on Schedule C-1, page 2 of 3, of Exhibits LA-PN-1, LA-PP-1, and LA-WP-1.

Q. What Depreciation Expense do you recommend?

A. As shown on Schedule C-1 of Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1, for each Company, I recommend using the depreciation rates recommended by OCA witness James Garren and applying those new depreciation rates to the average 2017 FPFTY plant to derive the amount of Depreciation Expense for each Company.

This results in the recommended Depreciation Expense for each Company summarized in the following table (the corresponding FirstEnergy requested amount and the differences are also shown):

	OCA Total Adjustments to Depreciation Expense (Thousands of Dollars)				
Line No.	Description	Med-Ed	Penelec	Penn Power	West Penn
1	Company Proposed FPFTY Depreciation Expense Based on 12/31/2017 Plant	$ 85,730	$ 93,791	$ 24,387	$ 78,455
2	OCA Adjustment to Reflect Depreciation Expense at Company Proposed Rates Using 2017 Average Plant Balances	$ (2,511)	$ (3,348)	$ (749)	$ (3,274)
3	OCA Adjustment to Reflect Depreciation Expense at OCA Proposed Rates Using 2017 Average Plant Balances	$ (15,079)	$ (17,245)	$ (5,152)	$ (11,142)
4	OCA Total Adjustments to Depreciation Expense	$ (17,590)	$ (20,593)	$ (5,901)	$ (14,416)
5	OCA Adjusted FPFTY Depreciation Expense	$ 68,140	$ 73,198	$ 18,486	$ 64,039

Q. Please explain what is shown on Schedule C-1, page 1 of 3, of Exhibits LA-ME-1.

A. Schedule C-1, page 1 of 3, of Exhibit LA-ME-1 shows the recommended adjustment to Depreciation Expense for Met-Ed.

Q. Does the Schedule C-1 in Exhibits LA-PN-1, LA-PP-1, and LA-WP-1 show similar information, in a similar format for the other FirstEnergy Companies?

A. Yes. Schedule C-1 in Exhibits LA-PN-1, LA-PP-1, and LA-WP-1 shows similar information, in a similar format for the other FirstEnergy Companies, Penelec, Penn Power, and West Penn, respectively.

Q. Please explain the adjustment to Depreciation Expense for each Company.

A. The adjustment to FPFTY Depreciation Expense is in two parts. Part 1, which is detailed on Schedule C-1, page 2 of 3, uses the new depreciation rates proposed by FirstEnergy and calculates the difference in Depreciation Expense that results from applying those Company-proposed depreciation rates (1) to FPFTY year-end plant (as requested by FirstEnergy) and (2) to average FPFTY plant. The OCA recommends using average FPFTY plant balances to correspond with the first year of new rates concept.

Part 2, which is detailed on Schedule C-1, page 3 of 3, for each Company (1) applies the new depreciation rates proposed by FirstEnergy to average FPFTY plant, (2) applies the new depreciation rates recommended by OCA witness Garren to average FPFTY plant, and computes the differences.

Q. Please explain what is shown on Schedule C-1, page 2 of 3, of Exhibit LA-ME-1.

A. Schedule C-1, page 2 of 3, of Exhibit LA-ME-1 shows (1) the application of the new depreciation rates proposed by FirstEnergy for Met-Ed to the December 31, 2017 end-of FPFTY plant as proposed by FirstEnergy and (2) the application of the new

depreciation rates proposed by FirstEnergy for Met-Ed to the average FPFTY plant. As described above in the rate base section of my testimony, the OCA recommends using average FPFTY plant balances to correspond with the first year of new rates concept. The difference, which nets to a $2.511 million decrease for Met-Ed, is the first part of OCA's recommended adjustment to Depreciation Expense.

Q. Please explain what is shown on Schedule C-1, page 3 of 3, of Exhibit LA-ME-1.

A. Schedule C-1, page 3 of 3, of Exhibit LA-ME-1 shows (1) the application of the new depreciation rates proposed by FirstEnergy for Met-Ed to the average FPFTY plant and (2) the application of the new depreciation rates proposed by OCA witness James Garren to the average FPFTY plant. As described above in the rate base section of my testimony, the OCA recommends using average FPFTY plant balances to correspond with the first year of new rates concept. The difference, which nets to a $15.079 million decrease for Met-Ed, is the second part of OCA's recommended adjustment to Depreciation Expense for Met-Ed.

Q. Returning to Exhibit LA-ME-1, Schedule C-1, page 1 of 3, what is shown there?

A. As noted above, Exhibit LA-ME-1, Schedule C-1, page 1 of 3, summarizes the results of the two-step adjustment of Met-Ed Depreciation Expense. As shown there, the OCA's recommended Depreciation Expense for Met-Ed of $68.140 million is $17.590 million less than the amount proposed by Met-Ed.

Q. Please explain your recommended adjustment to Penelec's FPFTY Depreciation Expense.

A. As shown on Exhibit LA-PN-1, Schedule C-1, page 1 of 4[15], the results of the two-step adjustment of Penelec Depreciation Expense reduce the Company's proposed Depreciation Expense of $93.791 million by $20.593 million, to the recommended Depreciation Expense of $73.198 million. Exhibit LA-PN-1, Schedule C-1, pages 3 and 4 present the details of the Depreciation Expense adjustment calculation.

Q. Please explain your adjustment to Penn Power's FPFTY Depreciation Expense.

A. As shown on Exhibit LA-PP-1, Schedule C-1, page 1 of 3, the results of the two-step adjustment of Penn Power's requested Depreciation Expense reduces the Company's proposed Depreciation Expense of $24.387 million by $5.901 million, to the recommended Depreciation Expense of $18.486 million. Exhibit LA-PN-1, Schedule C-1, pages 2 and 3 present the details of the Depreciation Expense adjustment calculation.

Q. Please explain your adjustment to West Penn's FPFTY Depreciation Expense.

A. As shown on Exhibit LA-WP-1, Schedule C-1, page 1 of 3, the results of the two-step adjustment of West Penn's Depreciation Expense reduce the Company's proposed Depreciation Expense of $78.455 million by $14.416 million, to the recommended Depreciation Expense of $64.039 million. Exhibit LA-WP-1,

[15] On Exhibit LA-PN-1, Schedule C-1 is comprised of four pages, with page 2 reflecting the removal of New York jurisdictional plant in service totaling $15.784 million per Penelec Exhibit RAD-3.

Schedule C-1, pages 2 and 3 present the details of the Depreciation Expense adjustment calculation.

Q. For each of the FirstEnergy Companies, is there a related adjustment to the amount of Accumulated Depreciation in rate base?

A. Yes. As the result of applying the depreciation rates recommended by OCA witness Garren versus the new depreciation rates requested by FirstEnergy, there is a related impact on the average amount of Accumulated Depreciation in the FPFTY rate base. Schedule B-3 of Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1 show the impacts for each of the FirstEnergy Companies. For each Company, the amount of FPFTY Accumulated Depreciation is reduced and the rate base is correspondingly increased by the amounts shown on the respective Schedule B-3.

<u>C-2, Miscellaneous Expenses (All Four FE Utilities)</u>

Q. Please explain your adjustment to remove certain Miscellaneous Expenses.

A. The Companies have included in FPFTY cost of service in their respective filings, certain budgeted miscellaneous expenses that are discretionary and not necessary for the provision of electric service. Specifically, examples of these questionable miscellaneous expenses include the following descriptions:

a. Expenses budgeted for employee gifts, awards, luncheon, dinners and picnics, including golf outings, baseball games, and basketball games.

b. Expenses budgeted for athletic events and tickets for such events, including (1) corporate plan hockey tickets; (2) golf outings; (3) golf tournament sponsorships; (4) club and suite ticket fees; and (5) playoff ticket sponsorship.

c. Athletic and employee associations, examples of which include (1) FirstEnergy Men's Club; (2) FirstEnergy Women's Club; (3) JC&PL Retirees Club; (4) Marion Area Men's Club; and (5) Perry Employee Association.[16]

The Companies have not justified the expenditures associated with these organizations and/or events, nor have the Companies' demonstrated that such costs are needed for the provision of safe and reliable electric service. Given the discretionary nature of these expenditures, it would be unreasonable to include them in rates without some type of review for cost/benefit and appropriateness. Therefore, as shown on Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1, Schedule C-2, I have reduced Miscellaneous Expense by $12,969 for Met-Ed; $111,051 for Penelec; $1,226 for Penn Power; and $34,642 for West Penn.

C-3, Incentive Compensation Expense (All Four FE Utilities)

Q. What incentive compensation expenses have the FirstEnergy Companies requested be included in operating expenses?

A. According to Exhibit RAD-27, Attachment A, the Companies are requesting the following amounts of incentive compensation expense be included in FPFTY operating expenses:

Company	Full-Time Bargaining Employees ($000's)	Full-Time Non-Bargaining Employees ($000's)	Total Incentive Compensation Expense ($000's)
Met-Ed	$ 2,193	$ 1,739	$ 3,932
Penelec	$ 2,376	$ 2,341	$ 4,717
Penn Power	$ 610	$ 436	$ 1,046
West Penn	$ 1,887	$ 2,125	$ 4,012
Total	$ 7,066	$ 6,641	$ 13,707

Source: Exhibit RAD-27, Attachment A

[16] For each of the four Companies, see the responses to OCA I-76, OCA-I-77, and OCA-I-80.

As indicated in the table above, the Companies' projected FPFTY incentive compensation is broken out between bargaining and non-bargaining employees. My recommended adjustment to incentive compensation expense relates only to the amounts associated with the Companies' non-bargaining employees.

Q. Please discuss the incentive compensation program.

A. A copy of the FirstEnergy Companies' 2016 Short-Term Incentive Program ("STIP," "STIP Plan," or "Plan") was provided in response to OCA-I-41. The STIP is the plan that the projected incentive compensation expense being requested by the Companies in the FPFTY is based upon.[17] The stated purpose of the Plan is a follows:

> The Short-Term Incentive Program (STIP) provides incentive awards to employees whose contributions support the successful achievement of Corporate Financial and Operational Key Performance Indicators (KPIs).

Q. Please describe the Key Performance Indicators that are associated with the STIP.

A. According to the STIP Plan, the corporate performance goals consist of FirstEnergy system Key Performance Indicators ("KPIs"). These KPIs include (1) operating earnings per share (operating EPS) and (2) safety as measured by the corporate or business unit specific Occupational Safety & Health Administration ("OSHA") incident rate.

[17] See the response to I&E-RE-24.

Q. Does the Operating EPS KPI relate to the Companies' financial performance?

A. Yes. The response to OCA-I-34(a) indicates that Operating EPS is the KPI that relates to the Companies' financial performance. The Companies provide the following explanation of Operating EPS:

> Operating Earnings and Operating EPS are not calculated in accordance with GAAP. These measures start with GAAP net income and GAAP earnings per share and adjust for the impact, or per share impact, of "special items", such as mark-to-market adjustments, regulatory charges, trust securities impairment, the impact of non-core asset sales/impairments, merger accounting-commodity contracts, plant deactivation costs, restructuring costs, litigation resolution, retail repositioning charges and loss on debt redemptions. The purpose of Operating Earnings and Operating EPS are to present a more accurate picture of the long-term recurring earnings potential of the Company. All Business Unit financial KPIs will be measured in alignment with the Operating EPS as reported to the financial community.
>
> Also, for 2015, the Operating EPS range for STIP purposes was equal to the Operating EPS guidance reported to the financial community. This ensures consistency both internally and externally of our financial results.

Q. Does the STIP have other KPIs in addition to the system KPIs discussed above?

A. Yes. In addition to the aforementioned system KPIs, the STIP also has operational goals which consist of business unit, departmental or individual KPIs. The STIP Plan indicates that there is an emphasis on operational KPI results driving the Companies' financial success. In addition, each KPI has a threshold, target, and stretch level of achievement which are subject to approval from a member of the Leadership Council and/or the Board of Directors.

Q. How do the Companies determine the STIP awards?

A. As discussed in the STIP Plan, the STIP awards are calculated based upon the annual achievement of the KPIs and are then modified as needed based on the available STIP pool of funds. Specifically, any STIP award payouts are contingent upon the Companies achieving the Operating EPS threshold level and a STIP pool of funds is established based on the Operating EPS achieved. In the event that the level of STIP awards earned exceeds the available STIP pool of funds, the operational KPIs are then reduced as needed.

Q. How are the operational KPIs reduced?

A. According to the STIP Plan, the operational KPIs are reduced in the following three steps as necessary:

> Step 1: For operational KPIs meeting the threshold but less than target, reduce the payout amount until the total STIP payout does not exceed the pool of funds available, maximum 25% reduction. If the total reduction is not sufficient to equal the available pool of funds, then Step 2 will be applied.
>
> Step 2: For operational KPIs at or above target, reduce the payout amount until the total STIP payout does not exceed the pool of funds available, maximum 10% reduction. If the total reduction is not sufficient to equal the available pool of funds, then Step 3 will be applied.
>
> Step 3: Apply a uniform proration to the operational KPIs earned under the STIP to an amount equal to the available pool of funds.

Q. Is the Operating EPS KPI reduced in the event the STIP award exceeds the available pool of funds?

A. No. According to the STIP Plan, no reductions are applied to Operating EPS or any single component of the safety related KPIs. In other words, the KPI related to the

Companies' financial performance is not reduced to meet the available STIP pool of funds.

Q. How are the STIP awards calculated?

A. As discussed in the STIP Plan, the calculation of the STIP awards are based on the annual achievement of the KPIs, then modified as needed to correspond to the available STIP pool of funds. Specifically, the STIP payouts are calculated by multiplying the total percentage achievement of the corporate, financial, safety and operational KPIs by the applicable incentive target opportunity.

Q. How is the incentive target opportunity determined?

A. The incentive target opportunity is calculated by multiplying an employee's base salary as of December 31 by their STIP target percentage. The threshold is then determined as 50% of the target opportunity and the stretch level is determined as 150% of the target opportunity.

Q. What portion of the STIP payouts relate to the achievement of financial goals?

A. The table below, which reflects the proportion of the KPI weightings according to the STIP Plan, indicates that the portion of the STIP payouts related to the achievement of financial goals is 30 percent.

Award	Weight
Corporate Financial Award Potential	30%
Safety Award Potential	10%
Operational Award Potential	60%
Total Award Opportunity	100%
Source: OCA-I-41	

Q. Are the KPI weightings always in accordance with the KPI weightings indicated in the table above?

A. Not necessarily. There is a passage in the STIP Plan that states: "Financial, Safety, and Operational KPI weightings for each Business Unit may differ from those stated above in order to ensure the required focus for the particular Business Unit."

Q. What adjustment are you proposing to make to incentive compensation expense?

A. I am proposing to adjust the incentive compensation allowed in rates to exclude the compensation amounts paid to non-bargaining employees that are directly associated with meeting the Companies' financial performance goals (i.e., Operating EPS). As noted above, approximately 30 percent of the STIP payments are attributable to meeting the Companies' financial goals. The remaining 70 percent of the STIP payouts are related to meeting non-financial goals (safety and operational) which I have treated as an allowable expense for ratemaking.

Q. Please explain why you are proposing to eliminate the portion of incentive compensation expense that is directly attributable to meeting financial goals.

A. The portion of the incentive compensation expense that is directly attributable to meeting financial performance goals is not properly recoverable from ratepayers for several reasons. First, if the financial goals are set properly, achieving the necessary performance should be self-supporting. That is, measures that achieve additional

cost savings, improve sales, or otherwise improve the financial results of the Companies should provide the income necessary to fund the awards. Second, the payouts for financial goal achievement can be distinguished from incentive compensation that is measured for improving the quality of service, efficiency, or safety goals. Finally, the incentive to improve financial performance is not necessarily consistent with ratepayers' interests.

Q. What adjustment to incentive compensation expense are you recommending?

A. As shown on Schedule C-3 on Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1, I recommend that FPFTY operating expense be reduced by the following amounts for each Company to remove the 30 percent of incentive compensation expense for non-bargaining employees that relates to financial performance goals:

- $522,000 for Met-Ed;
- $702,000 for Penelec;
- $131,000 for Penn Power; and
- $638,000 for West Penn

<u>C-4, Stock-Based Compensation Expense (All Four FE Utilities)</u>

Q. How much expense has each of the Companies proposed to include in operating expenses for stock-based compensation?

A. Each of the four Companies have included stock-based compensation in the FPFTY that is either directly charged or allocated to each Company from the Service Company. The table below summarizes the stock-based compensation directly

charged to the Companies as well as that allocated by the Service Company:

Description	Met-Ed	Penelec	Penn Power	West Penn	Total
Direct Charged Stock-Based Compensation	$ 270,407	$ 298,353	$ 19,938	$ 295,749	$ 884,447
Allocated by the Service Company	$1,910,615	$2,205,008	$ 494,581	$2,593,608	$7,203,812
Total Stock-Based Compensation	$2,181,022	$2,503,361	$ 514,519	$2,889,357	$8,088,259
Source: OCA-I-31 and OCA-I-32					

Q. What stock-based compensation programs does FirstEnergy provide?

A. According to the 2015 FirstEnergy Executive Compensation and Benefits Overview, which was provided as a confidential attachment in the response to OCA-I-43, FirstEnergy's long-term incentive program ("LTIP") provides two stock-based compensation programs including **[BEGIN CONFIDENTIAL]** [redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[18] According to the response to OCA-XI-13, the Cash-Based Performance-Adjusted RSU Award replaced the Performance Shares Program ("PSP") starting in 2015.

[redacted]

[redacted]

[END CONFIDENTIAL]

Q. Who is eligible for the stock-based compensation in FirstEnergy's LTIP?

A. According to the Executive Compensation and Benefits Overview provided in OCA-I-43, **[BEGIN CONFIDENTIAL]** [redacted] **[END CONFIDENTIAL]**

Q. Are the amounts provided by the Companies as being included in the FPFTY cost of service broken out between Cash-Based Performance-Adjusted RSU's and Stock-Based Performance-Adjusted RSU's?

A. No. According to the responses to OCA-I-31 and OCA-I-32, the stock-based compensation included in the FPFTY is broken out between (1) performance shares, (2) RSU's, and (3) a Restricted Stock Units Dividend Account. As previously noted, effective in 2015, the Cash-Based Performance-Adjusted RSU's replaced the

performance shares. I am recommending that an adjustment be made to remove stock-based compensation expense from the FPFTY.

Q. What adjustment are you proposing to make to the stock-based compensation expense?

A. I am proposing to exclude 100 percent of LTIP compensation expenses. This expense is to reward executives for the achievement of FE goals that are in total to increase shareholder value. The expense is based on financial performance, including the FirstEnergy stock performance. Ratepayers should not be required to pay executive or director compensation that is based on the performance of the Company's (or its parent company's) stock price, or which has the primary purpose of benefitting the parent company's stockholders and aligning the interests of the executives who participate in the stock-based compensation plans with those of such stockholders.

Q. What adjustment to LTIP compensation expense are you recommending?

A. As shown on Schedule C-4 on Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1, I recommend that FPFTY operating expense be reduced by the following amounts for each Company to remove the direct charged and Service Company allocated stock-based compensation expense:

- $2.181 million for Met-Ed;
- $2.503 million for Penelec;
- $515,000 for Penn Power; and
- $2.889 million for West Penn

C-5, Supplemental Executive Retirement Plan ("SERP") Expense (All Four FE Utilities)

Q. How much expense have the FirstEnergy Companies requested for Supplemental Executive Retirement Plan (SERP) Expense?

A. As shown on Schedule C-5 of Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1, the Companies have proposed including the following amounts of SERP expense:

- $158,000 for Met-Ed;
- $147,000 for Penelec;
- $98,000 for Penn Power; and
- $130,000 for West Penn.

Q. Please explain your adjustment for SERP

A. This adjustment removes 100 percent of the expense for the SERP. The SERP provides supplemental retirement benefits for select executives. Generally, SERPs are implemented for executives to provide retirement benefits that exceed amounts limited in qualified plans by Internal Revenue Service ("IRS") limitations. Companies usually maintain that providing such supplemental retirement benefits to executives is necessary in order to ensure attraction and retention of qualified employees. Typically, SERPs provide for retirement benefits in excess of the limits placed by IRS regulations on pension plan calculations for salaries in excess of specified amounts.

Q. Why should the SERP expense be removed?

A. The SERP benefits a select group of high-level executives. The provision of additional compensation to FirstEnergy's highest paid employees to remedy a perceived deficiency in retirement benefits relative to the Companies' other employees is not a reasonable expense that should be recovered in rates. Without the SERP, the Companies' officers still enjoy the same retirement benefits available to other Company employees, and the attempt to make these executives 'whole' in the sense of allowing greater retirement benefits does not meet the test of reasonableness. If FirstEnergy wishes to provide additional retirement benefits for its top executives that are above the level permitted by IRS regulations applicable to all other employees, it may do so at the expense of its shareholders. However, it is not reasonable to place this additional burden on ratepayers.

<u>C-6, Payroll Expense (All Four FE Utilities)</u>

Q. Please explain the adjustment to FPFTY Payroll Expense.

A. This adjustment is shown on Schedule C-6 of Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1. It reflects payroll expense for the FPFTY and removes payroll expense that is estimated to occur beyond the end of the FPFTY. As noted previously, the 2017 FPFTY approximately corresponds with the first year of new rates. It is appropriate to reflect the amounts of payroll expense to be incurred in the FPFTY. The payroll projected to occur beyond the end of the FPFTY, such as for March 2018 pay increases, will not be incurred during the first year of new rates. Consequently, including it is a mismatch with the FPFTY. Expense projected to be incurred beyond the end of the FPFTY is therefore being eliminated.

Q. What specific payroll expenses have you adjusted?

A. Consistent with the concept and principle of including expenses in the FPFTY that will be incurred during the first year of new rates, and excluding expenses that will not be incurred during the 2017 FPFTY, I have removed pay increases that are not anticipated to become effective through December 31, 2017. I have also prorated pay increases that are becoming effective during 2017 to include the portion that would be incurred during the 2017 FPFTY and to eliminate the portion that would be incurred beyond the end of the FPFTY.

Q. What adjustment does this produce for each utility?

A. As shown on Schedule C-6 of Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1 respectively:

- Met-Ed's requested payroll expense is reduced by $1.117 million.
- Penelec's requested payroll expense is reduced by $1.455 million.
- Penn Power's requested payroll expense is reduced by $322,000.
- West Penn's requested payroll expense is reduced by $1.245 million.

<u>C-7, Payroll Tax Expense (All Four FE Utilities)</u>

Q. Please explain your adjustment to Payroll Tax Expense.

A. My recommended adjustment to each Company's payroll tax expense is made in conjunction with the recommended adjustment to payroll expense, incentive compensation, and stock-based compensation expenses discussed in the previous

sections. The adjustment to payroll tax expense is shown on Schedule C-7 of Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1. Applying the effective payroll tax rates to my recommended adjustments to those payroll expenses, I have reduced payroll tax expense by $114,000 for Met-Ed, $169,000 for Penelec, $27,000 for Penn Power, and $154,000 for West Penn, respectively.

C-8, Employee Benefits (All Four FE Utilities)

Q. Please explain your adjustment to Employee Benefits Expense.

A. My recommended adjustments to Companies' employee benefits expense other than Pensions and OPEBs[19] is made in conjunction with my recommended adjustments to payroll expense and are reflected on Schedule C-8 of Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1. Based upon my recommendations to (1) remove from the 2017 FPFTY the wage increases for the Companies' bargaining employees that are effective beyond the FPFTY, and (2) to prorate the wage increases for the Companies' non-bargaining employees as well as Service Company employees in which a portion of such wage increases will become effective within the FPFTY, I have reduced employee benefits expense by $106,000 for Met-Ed, $154,000 for Penelec, $42,000 for Penn Power and $121,000 for West Penn, respectively.

C-9, Pension Expense (All Four FE Utilities)

Q. How have the FirstEnergy Companies proposed to derive their requested allowance for pension expense in the current rate cases?

[19] Separate adjustments for Pensions and OPEBs are discussed below in conjunction with adjustments C-9 and C-10, respectively.

A. The Companies have proposed to base pension expense on a ten-year average of cash funding contributions.

Q. What is their basis for using a ten-year average?

A. This request appears to be based on the allowance for pension costs in the 2006 Met-Ed and Penelec rate cases, Docket Nos. R-00061366 and R-00061367.

Q. Do you agree with the Companies' proposed pension expense?

A. No. For several reasons, which I will explain in this section of my testimony, I do not. For the reasons explained herein, I am recommending that the utilities' pension cost in these rate cases be based on SFAS 87 accruals.

Q. Was the use of a ten-year average of contributions the Companies' initially recommended basis for pension cost recognition in the 2006 base rate cases?

A. No, it was not. Based on a review of testimony from Docket Nos. R-00061366 and R-00061367, it appears that the initial recommendations of Met-Ed and Penelec in those cases for pension expense was to use only the service cost component of Statement of Financial Accounting Standards No. 87 ("SFAS 87"). Such treatment was opposed, and the Companies proposed using a ten-year average of contributions for pension cost recognition in rebuttal. This proposal was also opposed.

Q. Does the Order in Docket Nos. R-00061366 and R-00061367 concerning the treatment of pension costs apply to the other two utilities, i.e., to Penn Power or West Penn?

A. I am advised by OCA counsel that it does not. Since the Order in Docket Nos. R-00061366 and R-00061367 concerning the treatment of pension costs was in the context of Met-Ed and Penelec rate cases, it does not apply to the other two utilities, i.e., to Penn Power or West Penn.

Q. Should the use of a ten-year average of pension funding contributions have any wider application, beyond the Met-Ed and Penelec rate cases that were addressed in Docket Nos. R-00061366 and R-00061367?

A. No. That recognition of Met-Ed and Penelec pension expense in those cases appears to be the result of a fall-back position of Met-Ed and Penelec that was not even presented with the utilities' initial application and direct testimony. Moreover, it does not appear to be the result of a comprehensive analysis of pension costs. Nor does it appear to be a regulatory practice that should be applied on a wider basis beyond its narrow use in establishing the revenue requirements in those particular prior Met-Ed and Penelec rate cases that were addressed in Docket Nos. R-00061366 and R-00061367. It appears that a ten-year average was not used for those utilities prior to those cases. Its use in those cases should be confined to only those cases. A ten-year average should not be expanded to other utilities or even used in subsequent rate cases of Met-Ed or Penelec. There are good reasons why it should not be used

in subsequent rate cases, such as the current rate case, for those two utilities (Met-Ed or Penelec) or for others.

Q. Based on your experience, is the use of a ten-year average of funding contributions for pensions as the basis for ratemaking recognition of utility pension expense common in utility ratemaking?

A. No, it is not common. In fact, I would characterize it as an extreme aberration. Recognition of pension costs for ratemaking for most utilities is based on some variant of SFAS 87 cost. In the few states I am aware of where cash funding contributions are used, and a multi-year average is used, the period for multi-year averaging is typically much shorter than ten years. For example, when cash funding contributions have been used as the basis for pension expense recognition in Washington State in cases in which I have direct knowledge, a four-year period was used. A ten-year period reaches too far into the past and does not reflect current or going forward conditions.

Q. Are there other concerns with using a lengthy backward looking historical period of cash funding contributions as the basis for ratemaking recognition of utility pension cost?

A. Yes. It is inconsistent with generally accepted accounting principles ("GAAP"), and could result in overstating the utility's pension costs for an extended period. Additionally, as I will describe in additional detail below, utility management has considerable discretion in how defined benefit pensions are funded. Thus, historical

funding amounts can reflect the impact of management decisions on when and how much to fund, subject to minimum required funding and maximum tax-deductible funding. Using a ten-year average of historical funding contributions is also inconsistent with how the FE utilities budget for pension cost. To understand these concerns, a review of defined benefit pension plans, and the related accounting and funding should be helpful. I will discuss those aspects and then explain the recommended adjustment.

Q. What is a defined benefit pension plan?

A. There are two general types of pension plans: (1) defined benefit pension plans and (2) defined contribution plans. In a defined benefit pension plan employees accrue benefits during their years of service and receive specified benefits in the form of an annuity or lump sum, after they retire, and the employer bears the risk of investment market fluctuations and assuring that there are sufficient funds available to pay the pensioners at the specified level. In contrast, in defined contribution pension plans, such as 401(k) savings plans or money purchase pension plans, employees and employers make contributions at a predefined level and employees bear the risk of investment market fluctuations in the value of their investments.

Q. Are the FE utilities requesting pension cost for their defined benefit pension plans?

A. Yes. The pension cost issue in the current cases relates to the cost of providing retirement benefits in a defined benefit pension plan.

Q. What is SFAS 87?

A. SFAS 87 is an accounting standard promulgated by the Financial Accounting Standards Board ("FASB") in December 1985 relating to employer's accounting for pensions. It has been codified in the Accounting Standards Codification ("ASC") as ASC 715. For purposes of this testimony, I will generally refer to this as FAS 87 rather than ASC 715, consistent with how the Companies have presented their discussion.

Q. What is net periodic pension cost ("NPPC")?

A. As it pertains to a defined benefit pension plan, NPPC is the amount recognized in an employer's financial statement as the cost of the pension plan for the period. Put another way, the NPPC is the annual accounting expense or income a company must recognize in their income statement, and direct adjustments to the plan sponsor's balance sheet, if applicable.

Q. What are the components of net periodic pension cost under FAS 87?

A. Under FAS 87, the NPPC is the sum of the following components:

- **Service cost**, which is the value of the benefits earned, or accrued, during the current year based on the applicable benefit formula for each participant.
- **Interest cost**, which represents the interest on the pension plan liability (i.e., Projected Benefit Obligation, or "PBO") for the year. This amount increases pension cost and reflects the passage of time or the time value of money on the PBO.
- **Expected return on assets for the year**, which reduces pension cost and is based on applying an expected rate of return to pension trust assets. Differences

between the actual return on assets and the expected return on assets represent an actuarial gain or loss that will be recognized in future pension cost.

- **<u>Amortizations of unrecognized costs and gains</u>**, which can include amortizations related to changes in liability due to plan changes, changes in actuarial assumptions used to value plan liabilities, differences between expected and actual asset returns, and/or experienced gains or losses to be recognized over time and subject to amortization. The amortization period is not to exceed the average future lifetime of plan participants. Prior Service Cost amortization is generally the cost of retroactive benefits granted in a plan amendment. Retroactively increasing benefits increases the PBO and prior service cost at the date of amendment and vice-versa. The increased (or decreased) cost is amortized as a component of net periodic pension cost. Amortization can be done on straight line basis that amortizes cost over the average remaining service life of the active employees. Actuarial gains and losses occur due to changes in actuarial assumptions. Gains decrease and losses increase the pension cost. There are two components of gains/losses: (1) the current period difference which is the difference between actual and expected return (expected rate of return on plan assets times the market related value of plan assets) and (2) the amortization of the unrecognized gain/loss for previous periods. In amortizing unrecognized gains or losses, a 10% corridor is allowed to be used in which only those gains or losses in excess of the greater of 10% of the PBO or the market-related value of assets are subject to amortization.

Q. When FAS 87 was initially adopted for financial reporting purposes, was there also a transitional component of the NPPC?

A. Yes. When FAS 87 was promulgated by the FASB in December 1985, it also included a component of NPPC for Amortization of Transition Benefit Asset (decrease) or Obligation/Liability (increase) to pension cost. The Transition Benefit (or Obligation) amount was based on the funded status of the defined benefit pension plan when FAS 87 was initially adopted for financial reporting purposes. The employer recorded the amortization of the Transition Benefit Obligation ("TBO") over average remaining service of plan employees, or over a 15-year period if the service period was less than 15 years. Most companies, and it is believed that all of the FE utilities participating in the current case, are now beyond the TBO

amortization periods, so TBO amortization would generally no longer be a component of a utility's NPPC.

Q. Please describe the events or circumstances that can result in a company recording a pension asset.

A. As noted above, in December 1985, the FASB issued FAS 87. FAS 87 provided guidance as to how companies would recognize costs associated with defined benefit pension plans for financial statement reporting purposes, effective for fiscal years beginning after December 15, 1986. Prior to the issuance of FAS 87, the amount of pension costs recorded by a company for financial statement purposes was generally equal to the level of contributions actually made into the pension trust fund.[20] As a result of FAS 87, the FASB determined that pension costs reported for financial statements purposes would not automatically be equal to the pension trust fund contribution, breaking the historical linkage between financial reporting of net periodic pension costs (expense and capital)[21] and pension funding contributions.

If the pension funding contributions exceeded the pension costs recorded for financial statement purposes,[22] FAS 87 required the difference to be recorded in a balance sheet account as a pension asset. If the contribution to the pension fund was

[20] The pension fund is **separate** from the utility's financial statements. The monies in the pension fund are held by the pension trustee. The utility's contributions (i.e., monies deposited) to the pension fund are invested by the pension trustee to ensure that the fund balances are sufficient to pay future pension obligations to the utility's employees.

[21] The full amount of NPPC determined by the Company's actuary is initially recorded in expense Account No. 926, Employee Pensions and Benefits. The portion of NPPC that is capitalized to plant or billed to others is recorded in a contra-expense to Account No. 926, Employee Benefits Transfer. This latter account recognizes that a pro-rata portion of employee benefits are attributable to the labor costs that are charged to capitalized construction projects and eventually to utility plant in service.

[22] Pension costs recorded for financial statement purposes pursuant to FAS 87 are also referred to as Net Periodic Pension Cost or NPPC.

less than the recorded pension cost, the company would record a pension obligation or liability. In a period when a company had pension income (i.e., a negative NPPC), and made no pension trust funding contributions, this type of situation could also lead to the company recording a pension asset. In sum, FAS 87 required companies to record either a pension asset or pension liability for the difference between accrual basis pension costs that are recorded for financial statement purposes and the amount of any contributions to the pension fund. As indicated previously, this accounting is commonly referred to as accrual accounting for NPPC.

Q. Does FAS 87 dictate a particular ratemaking treatment?

A. No. FAS 87 provides accounting guidance with respect to the financial accounting disclosure of pension costs, related assets, and liabilities. FAS 87 neither prescribes nor imposes any regulatory guidance or authoritative ratemaking treatment for the NPPC or for the prepaid pension asset or pension liability. FAS 87 sets forth the required framework for all publicly traded companies to quantify and record net periodic pension costs. Neither the actual FAS 87 NPPC accruals nor actual pension contributions should be interpreted as costs recovered from, or benefits provided to ratepayers, particularly without any evidence to substantiate such claims.

Q. What is the usual source for the amounts recorded by a company on its books for its NPPC for a defined benefit pension plan?

A. It is typically an actuarial report. Each year, with assistance from its actuarial consultants, the employer providing the defined benefit pension plan would record a

journal entry in its accounting records in order to accrue the NPPC pursuant to FAS 87. The actuarial consultants may also provide assistance in quantifying the range in pension contributions that are required or permitted under existing regulations.[23]

Q. How have the minimum funding levels for a defined benefit pension plan generally been determined?

A. Prior to 2008, the minimum required funding requirements were specified in ERISA.[24] ERISA is a federal law that established minimum standards for pension plans in private industry and provides for extensive rules on the federal income tax effects of transactions associated with employee benefit plans. ERISA was enacted to protect the interests of employee benefit plan participants and their beneficiaries by:

- Requiring the disclosure of financial and other information concerning the plan to beneficiaries;
- Establishing standards of conduct for plan fiduciaries;
- Providing for appropriate remedies and access to the federal courts.

Q. Does ERISA require that pensions be provided in a defined benefit plan?

A. No. ERISA does not require employers to establish pension plans. Likewise, as a general rule, ERISA does not require that pension plans provide a minimum level of benefits. Instead, ERISA regulates the operation of a pension plan once it has been established. Under ERISA, pension plans must provide for vesting of employees' pension benefits after a specified minimum number of years. ERISA requires that the

[23] This information may include minimum required funding contributions and the maximum tax-deductible contributions.

[24] Pub.L. 93–406, 88 Stat. 829, enacted September 2, 1974, codified in part at 29 U.S.C. ch. 18.

employers who sponsor plans satisfy certain minimum funding requirements. ERISA also regulates the manner in which a pension plan may pay benefits. For example, a defined benefit plan must pay a married participant's pension as a "joint-and-survivor annuity" that provides continuing benefits to the surviving spouse unless both the participant and the spouse waive the survivor coverage.

Q. How has ERISA helped assume that defined benefit pension plans would have sufficient assets from which to pay benefits?

A. Among other things, ERISA established the Pension Benefit Guaranty Corporation ("PBGC") to provide coverage in the event that a terminated defined benefit pension plan does not have sufficient assets to provide the benefits earned by participants. Later amendments to ERISA require an employer who withdraws from participation in a multi-employer pension plan with insufficient assets to pay all participants' vested benefits to contribute the pro rata share of the plan's unfunded vested benefits liability.

Under ERISA, minimum funding requirements were also established for defined benefit plans.[25] Under ERISA, a defined benefit pension plan maintained a "funding standard account," which was charged annually for the cost of benefits earned during the year and credited for employer contributions. Increases in the plan's liabilities due to benefit improvements, changes in actuarial assumptions, and any other reasons were amortized and charged to the account. Decreases in the plan's liabilities were amortized and credited to the account. Every year, the

[25] By their nature, defined contribution plans are always fully funded, even if the employee has not yet become vested in the employer contributions.

employer was required to contribute the amount necessary to keep the funding standard account from falling below zero at year-end. Minimum annual funding requirements are therefore sometimes referred to as the ERISA funding requirement or the ERISA minimum.

Q. Are the minimum funding requirements for a defined benefit pension plan now also impacted by another act?

A. Yes. The Pension Protection Act of 2006 ("PPA") included additional funding requirements to improve the benefit security provided by defined benefit pension plans. The PPA redefined minimum required cash funding requirements for defined benefit pension plans for 2008 and beyond.

Q. Please describe the general funding requirements for a defined benefit pension plan under the PPA.

A. In 2008, when the PPA funding rules went into effect, single-employer defined benefit pension plans no longer maintain funding standard accounts. The funding requirement under PPA is basically that a plan must stay fully funded (that is, its assets must equal or exceed its liabilities). If a plan is fully funded, the minimum required contribution is the cost of benefits earned during the year. If a plan is not fully funded, the contribution also includes the amount necessary to amortize over seven years the difference between its liabilities and its assets. Stricter rules apply to severely underfunded plans (called "at-risk status").

The PPA has different funding requirements for multi-employer pension plans, which preserve most of the pre-PPA funding rules including the funding standard account. Under the PPA, increases and decreases in the plan's liabilities will be amortized, but the amortization period for benefit improvements adopted after 2007 will be shortened. As with single-employer plans, multi-employer pension plans that are significantly underfunded are subject to restrictions. The restrictions, which may limit the plan's ability to improve benefits or require the plan to reduce employees' benefits, vary depending whether a pension plan's funding status is termed "endangered," "seriously endangered," or "critical." The restrictions accompanying each deficient funding status are progressively more severe as funding status worsens.

In general, the PPA requires a sponsor of a defined benefit pension plan to contribute into the plan annually an amount equal to: (1) the benefits being earned for the year, plus (2) a seven-year amortization of the amount the plan is underfunded. The seven-year amortization base is established each year based on the difference between the funded status of the plan and the value of the previous seven-year amortization bases that still exist. Once the plan becomes fully funded, all amortization bases are eliminated and the required contribution simply becomes the benefits being earned for the year. This is sometimes referred to as the "normal cost." If the plan becomes overfunded by more than the benefits being earned for the year, no new funding contribution is required for that year. Contributions are typically to be made on a quarterly basis. More frequent funding (e.g., monthly) is

not prohibited. A final contribution for the year is generally allowed to be made up to eight and one-half months after the end of the plan year.

Q. Please explain the concept of the maximum tax deductible contribution for funding of a defined benefit pension plan.

A. The Internal Revenue Code contains provisions limiting the maximum tax deduction for contributions made to fund various types of retirement benefits, including defined benefit pension plans.

Q. Can you provide an explanation of how the maximum tax deductible contribution for a defined benefit pension plan is generally determined?

A. Generally, an actuary will provide the plan sponsor with information on both (1) the minimum funding obligation (representing the lowest amount needed to meet the minimum funding obligation, as discussed above) and (2) the maximum tax-deductible funding contribution. The latter generally involves actuarial calculations, which can be quite complex, to derive a "full funding limitation."

Basically, two provisions determine the maximum amount an employer can contribute and take as a deduction to a qualified pension plan in any one taxable year.

The first of these rules permits a deduction for a contribution that will provide, for all employees participating in the plan, the unfunded cost of their past and current service credits distributed as a level amount or as a level percentage of compensation over the remaining future service of each such employee. If this rule

is followed, and if the remaining unfunded cost for any three individuals is more than 50 percent of the total unfunded cost, the unfunded cost attributable to such individuals must be distributed over a period of at least five taxable years. Contributions under individual policy pension plans are typically claimed under this rule.

The second rule, while occasionally used with individual policy plans, is used primarily in group pension and trust fund plans. This rule permits the employer to deduct the normal cost of the plan plus the amount necessary to amortize any past service or other supplementary pension or annuity credits in equal annual installments over a 10-year period. However, the maximum tax-deductible limit cannot exceed the amount needed to bring the plan to its full-funding limit. The full-funding limit is defined as the lesser of 100 percent of the plan's actuarial accrued liability (including normal cost) or 150 percent of the plan's current liability, reduced by the lesser of the market value of plan assets on their actuarial value. If the plan's actuarial cost method does not generate an accrued liability, the value that would be generated by the entry age normal method is used. The plan's funding standard account credit balance is subtracted from the asset value before determining the full-funding limitation.

Q. Do other income tax considerations also apply?

A. Yes. If amounts contributed in any taxable year are in excess of the amounts allowed as a deduction for that year, the excess may be carried forward and deducted in succeeding taxable years, in orders of time, to the extent that the amount carried

forward to any such succeeding taxable year does not exceed the deductible limit for such succeeding taxable year. However, a 10 percent excise tax is imposed on nondeductible contributions by an employer to a qualified plan. For purposes of the excise tax, nondeductible contributions are defined as the sum of (1) the amount of the employer's contribution that exceeds the amount deductible under Internal Revenue Code section 404 and (2) any excess amount contributed in the preceding tax year that has not been returned to the employer or applied as a deductible contribution in the current year.

Additionally, obtaining benefit from taking an income tax deduction for pension funding contributions can also be impacted by other deductions and whether the company has taxable income against which to take a deduction.

Q. Does utility management generally have a wide range of discretion as to how much to contribute to funding a defined benefit pension plan in a given year?

A. Yes. Utility management's discretion as to how much funding to contribute into the defined benefit pension plan trust for a given year is generally confined by (1) the minimum funding obligation (representing the lowest amount needed to meet the minimum funding obligation, as discussed above) and (2) the maximum tax-deductible funding contribution (which can represent the maximum amount to be considered for the pension funding contribution). Contributions above the minimum funding obligation and up to the maximum tax deductible amount for the year are sometimes referred to as discretionary contributions. For larger pension

plans, this range of potential discretionary contributions can amount to hundreds of millions of dollars.

Q. Can management's decisions on how much to contribute into a defined benefit pension plan also impact the amount of net periodic pension cost in a year?

A. Yes, it can. Generally, the most directly impacted component of NPPC is the expected return on assets for the year. As I discussed above, the expected return on plan assets is derived by applying an expected rate of return to pension trust assets. The expected return on plan assets reduces the net periodic pension cost.

Q. What do you recommend as the basis for ratemaking recognition of the cost for the Companies' defined benefit pension plans in the current rate cases?

A. I recommend that the SFAS 87 accrual method be used for the ratemaking recognition of the cost for the Companies' defined benefit pension plans in the current rate cases.

Q. Is using the SFAS 87 accrual amounts for Pensions consistent with how the FirstEnergy utilities budget for Pensions?

A. Yes. The FirstEnergy utilities' budgets for Pensions reflect the SFAS 87 accrual method. FirstEnergy also uses the accrual accounting for its actual Pension costs.

Q. What adjustments are produced by using SFAS 87 accrual accounting for Pensions in the current rate case?

A. As shown on Schedule C-9 of Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1, respectively:

- Pension expense for MetEd is decreased by $10.436 million;
- Pension expense for Penelec is decreased by $11.922 million;
- Pension expense for Penn Power is decreased by $1.783 million; and
- Pension expense for West Penn is decreased by $7.216 million.

Q. Why is the FAS 87 accounting preferable to using a 10-year average of contributions for pension expense?

A. As noted above, the recognition of Met-Ed and Penelec pension expense on a 10-year average basis from Docket Nos. R-00061366 and R-00061367 was the result of a fall-back position of Met-Ed and Penelec that was not even presented with the utilities' initial application and direct testimony. Moreover, it does not appear to be the result of a comprehensive analysis of pension costs. Nor does it appear to be a regulatory practice that should be applied on a wider basis beyond its narrow use in establishing the revenue requirements in those particular prior Met-Ed and Penelec rate cases that were addressed in Docket Nos. R-00061366 and R-00061367. It appears that a ten-year average was not used for those utilities prior to those cases. Its use in those cases should be confined to only those cases. A ten-year average should not be expanded to other utilities or even used in subsequent rate cases of Met-Ed or Penelec. Among the reasons why it should not be used in subsequent rate cases, such as the current rate case, for those two utilities (Met-Ed or Penelec) or for others, is that the use of a ten-year average of funding contributions for pensions as the basis for ratemaking recognition of utility pension expense common in utility

ratemaking is not common. In fact, I would characterize it as an extreme aberration. Recognition of pension costs for ratemaking for most utilities is based on some variant of SFAS 87 cost. In the few states I am aware of where cash funding contributions are used, and a multi-year average is used, the period for multi-year averaging is typically much shorter than ten years. For example, when cash funding contributions have been used as the basis for pension expense recognition in Washington State in cases in which I have direct knowledge, a four-year period was used. In Tennessee, a three-year period is used. A ten-year period reaches too far into the past and does not reflect current or going forward conditions.

Moreover, the use of a lengthy backward looking historical period of cash funding contributions as the basis for ratemaking recognition of utility pension cost has other problems including being inconsistent with generally accepted accounting principles ("GAAP"). It could result in overstating the utility's pension costs for an extended period. Additionally, as I have described, utility management has considerable discretion in how defined benefit pensions are funded. Thus, historical funding amounts can reflect the impact of management decisions on when and how much to fund, subject to minimum required funding and maximum tax-deductible funding. Using a ten-year average of historical funding contributions is also inconsistent with how the FE utilities budget for pension cost. In contrast, use of FAS 87 amounts are consistent with how FE budgets for pension costs and with FE's use of accrual accounting for pension costs. The use of the FAS 87 amounts for pension expense is the preferable method and should be applied in the current FE rate cases.

C-10, Post Retirement Benefits Other Than Pensions ("OPEB") (All Four FE Utilities)

Q. What have the FirstEnergy Companies proposed for Post Retirement Benefits Other Than Pensions in the current case?

A. The FirstEnergy Companies propose to use only the service cost component of Statement of Financial Accounting Standards No. 106 ("SFAS 106") for their requested expense for Post Retirement Benefits Other Than Pensions (also referred to as "Other Post Employment Benefits" or "OPEBs").

Q. Is that consistent with how the Companies budget for OPEBs?

A. No. The Companies' budgets for OPEBs appear to include the full FAS 106 cost.

Q. What components are included in the SFAS 106 cost for OPEBs?

A. Under Accounting Standards Codification ASC 715 (SFAS 106) for accounting for other post retirement employee benefits OPEB, companies with defined benefit plans must accrue for financial accounting purposes an expense for retirees' health benefits during the years those employees are working. The components of Net Periodic Post Retirement Benefit Cost ("NPPBC") under SFAS 106 are generally understood to include the following:

1. Service cost - the cost of benefits accruing in the current period;
2. Interest cost - interest on the Accumulated Postretirement Benefit Obligation;
3. Expected return on plan assets - anticipated earnings on plan assets;
4. Amortization of net transition amount - net transition amount is the difference between APBO and plan assets when FAS 106 was first adopted; and
5. Net amortization and deferrals.

a) Amortization of gains and losses - a gain or loss is the change in APBO resulting from a change in assumptions or experience.

b) Prior service cost (plan amendment) - the change in the APBO due to a plan amendment.

The NPPBC is thus the result of these components:

NPPBC = service cost + interest cost - expected return on plan assets +/- amortizations

Q. How were OPEB expenses addressed in the 2006 Met-Ed and Penelec rate cases?

A. It appears that the OPEB expense was based on only the service cost component in the 2006 Met-Ed and Penelec rate cases in Docket Nos. R-00061366 and R-00061367.

Q. Does focusing only on the service cost component result in proper accounting for OPEB costs?

A. No, it does not. Any company that reported only the service cost component for its OPEBs on its financial statements would be in violation of GAAP.

Q. Is focusing only the service cost component of OPEBs also contrary to how the FirstEnergy utilities budget for OPEBs?

A. Yes. The FirstEnergy utilities' budgets for OPEBs reflect the SFAS 106 accrual method. FirstEnergy also uses the accrual accounting for its actual OPEB costs.

Q. Could using only the service cost component of OPEB cost over-recover the cost versus the budgeted amounts?

A. Yes, it could, and this over-recovery versus budgeted amounts also appears to be the scenario reflected in the Companies' filings, where they are making a pro forma adjustment to increase their budgeted amounts for OPEB, which are based on SFAS 106 accruals. They are thus requesting more than their budgeted expense.

Q. Of what regulatory guidance concerning OPEB costs for ratemaking purposes have you been made aware?

A. OCA has advised me that the Pennsylvania regulations include 52 Pa. Code § 69.351 which provides as follows a policy statement concerning OPEBs and FAS 106:

> § 69.351. Implementation of Statement of Financial Accounting Standards for Rule No. 106 (SFAS 106)—statement of policy.
>
> (a) Effective with financial statements for fiscal years beginning after December 15, 1992, SFAS 106 provides the generally accepted accounting principles to be used by large companies in accounting for post-retirement benefits other than pensions (OPEBs). Up to now, companies which provided OPEBs for their employers used the pay-as-you-go (cash) basis. Each year a company would record on its books the actual cash paid for OPEBs.
>
> (b) SFAS 106 operates on the premise that post-retirement benefits are a form of deferred compensation whereby an employer promises to exchange future benefits for current service. SFAS 106 requires companies to switch to the accrual method of accounting for OPEBs. As guidance to utilities wishing to implement SFAS 106, the Commission provides the following guidelines regarding the rulemaking treatment of OPEBs:
>
> (1) Each jurisdictional utility which has satisfied the appropriate customer notice requirements, presented sufficient documentation to support its SFAS 106 cost estimates and presented sufficient cost containment measures, may seek formal Commission approval to record on its books a regulatory asset pursuant to SFAS 71 equal to the difference between its current rate recognition of OPEB costs and its accrued liability for the expenses under SFAS 106 subject to

recovery in future rate proceedings to the extent that the costs are prudently incurred and demonstrated to be reasonable.

(2) The funding of a dedicated trust for the deferred amounts is not required at this time. A utility should maintain separate balance sheet accounts for both the accrued liability and the regulatory asset along with sufficient records to allow a detailed analysis of the accounts.

(3) The Commission intends to move jurisdictional utilities to SFAS 106 accrual accounting for ratemaking purposes within approximately 5 years and to allow the recovery in base rates of deferred amounts in approximately 20 years, to the extent that OPEB costs are prudently incurred and examined for reasonableness in a base rate proceeding prior to rate recognition.

(4) If the Commission, after examination, grants current rate recognition of OPEB costs exceeding the pay-as-you-go amount, the excess amount should be placed in a dedicated trust fund.

(5) The Commission will monitor the development of changes in OPEB costs as a result of both government policy changes and company cost containment efforts.

Q. When was SFAS 106 adopted as part of GAAP?

A. SFAS 106 was adopted as part of GAAP in December 1990. As noted in § 69.351, the Implementation of Statement of Financial Accounting Standards for Rule No. 106 statement of policy, quoted above: "Effective with financial statements for fiscal years beginning after December 15, 1992, SFAS 106 provides the generally accepted accounting principles to be used by large companies in accounting for post-retirement benefits other than pensions (OPEBs)."

Q. Should the FirstEnergy utilities be moved to full SFAS 106 accrual accounting in the current rate cases?

A. Yes. In accordance with the statement of policy in § 69.351, SFAS 106 accrual accounting should be used in the current rate cases. This is also consistent with how the FirstEnergy utilities budget for OPEB costs and with the guidance provided in this statement of policy.

Q. What adjustments are produced by using SFAS 106 accrual accounting for OPEBs in the current rate case?

A. As shown on Schedule C-10 of Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1, respectively:

- OPEB expense for Met-Ed is decreased by $2.682 million;
- OPEB expense for Penelec is increased by $145,000;
- OPEB expense for Penn Power is decreased by $892,000; and
- OPEB expense for West Penn is decreased by $2.328 million.

<u>C-11, Affiliate Aircraft Expense (All Four FE Utilities)</u>

Q. Please explain your adjustment for affiliate aircraft expense.

A. Affiliate aircraft expense that was identified in the Companies' responses to OCA-XI-11 is being removed from FPFTY operating expenses. FirstEnergy has failed to demonstrate that affiliate aircraft expenses are necessary for the provision of public utility service. Additionally, these costs are charges from an affiliate, which bear increased regulatory scrutiny. Moreover, FirstEnergy has not demonstrated that the affiliated aviation department is cost effective. Having corporate aircraft for use by executives and directors, including spousal travel, could suggest that the corporate

aircraft is an additional executive and director perquisite. As such, the cost should be borne by shareholders, not Pennsylvania ratepayers.

As shown on Exhibit LA-ME-1, Schedule C-11, Met-Ed's operating expense is reduced by $80,000.

As shown on Exhibit LA-PN-1, Schedule C-11, Penelec's operating expense is reduced by $92,000.

As shown on Exhibit LA-PP-1, Schedule C-11, Penn Power's operating expense is reduced by $21,000.

As shown on Exhibit LA-WP-1, Schedule C-11, West Penn's operating expense is reduced by $81,000.

C-12, Rate Case Expense (All Four FE Utilities)

Q. Please explain the Companies' claim for Rate Case Expense in the FPFTY ending December 31, 2017.

A. As shown on each Company's Exhibit RAD-23, Met-Ed, Penelec, Penn Power and West Penn have budgeted the following amounts for its claimed rate case expense:

Rate Case Expense - $000's					
Description	**Met-Ed**	**Penelec**	**Penn Power**	**West Penn**	**Total**
Legal Fees	$ 290	$ 301	$ 85	$ 374	$ 1,050
Expert Witnesses	$ 44	$ 46	$ 13	$ 57	$ 160
Other	$ 214	$ 222	$ 63	$ 276	$ 775
Total Rate Case Expense	$ 548	$ 570	$ 162	$ 706	$ 1,984
Source: Exhibit RAD-23					

Q. Over what period are the Companies proposing to recover the claimed amounts for rate case expense reflected in the table above?

A. As shown on each Company's Exhibit RAD-2, Adjustment No. 8, Met-Ed, Penelec, Penn Power and West Penn are proposing to recover the claimed amounts for rate case expense over a two-year period.

Q. What justification do the Companies give for proposing to normalize claimed rate case expense over a two-year period?

A. In each of the responses to OCA-I-62(d), the Companies' stated the following:

> The two-year normalization reflects the anticipated interval between the current base rate case and the next subsequent base rate case, which is consistent with prior decisions of the Commission, including its Final Order in Pa. P.U.C. v. PPL Electric Utilities Corporation, Docket No. R-20102-2290597 (Final Order entered December 28, 2012), pp. 47-48. Given the Company's anticipated level of capital expenditures, it would be reasonable to expect that another base rate case could be deferred beyond two years.

Q. Do you agree with the Companies' proposed two-year recovery period for rate case expense?

A. No, I do not. Prior to the Companies' last base rate cases in Docket Nos. R-2014-2728745 (Met-Ed), R-2014-2428743 (Penelec), R-2014-2428744 (Penn Power) and R-2014-2428742 (West Penn), which were filed two years ago, the intervals between each Company's previously filed base rate cases were substantially longer and more sporadic. Specifically, the response to OCA-1-62 indicates that prior to the aforementioned 2014 base rate cases, the previous two Met-Ed base rate cases were filed in 1992 and 2006. For Penelec, the previous two base rate cases (prior to 2014) were filed in 1986 and 2006. For Penn Power, prior to 2014, its previous base rate case was filed in 1987. Finally, for West Penn, prior to 2014, its previous base rate

cases were filed in 1992 and 1994. Additionally, it is my understanding that the Companies have received authorization for a DSIC to address cost of recovery of infrastructure spending. One of the reasons commonly cited for infrastructure riders is to extend the time between rate cases.

Q. Was the issue of a reasonable and realistic normalization period for rate case expense addressed in Met-Ed's and Penelec's 2006 base rate cases in Docket Nos. R-00061366 and R-00061367?

A. Yes. In those prior proceedings, Met-Ed and Penelec had proposed a three-year recovery period for rate case expense. The Commission's Final Order dated January 11, 2007 stated in part that:

> . . . rate caps prevented a rate case filing in the last decade; however, a review of the filing frequency before the implementation of the rate caps reveals that the Companies had unusually long intervals between rate case filings. For example, ME's most recent rate cases were filed in 1984 and 1992 and PN's most recent rate case was filed in 1984. Although the Competition Act established the rate caps, nothing prevented the Companies from filing rate cases on a regular basis prior to 1996. Although it is convenient to use the rate caps as a justification for an expedited recovery period, **a three year recovery period is unwarranted given ME's and PN's history of long stay outs between rate case filings.**
>
> **Second, the Companies assertion that there is a "greater likelihood" of more frequent filings now that the rate caps have expired is merely a statement of future intentions, which is highly speculative. The Commission relies on filing history because that history is the most reliable barometer of when future rate cases will be filed. The filing history of MEPN does not support a three year filing cycle.** The Companies' request to ignore those facts and instead rely on unpredictable future intentions must be rejected.

> Finally, the Companies' reliance on the PPL case is wholly irrelevant because **normalization periods are specific to each company and are based on the historic frequency of base rate case filings.**
>
> (Emphasis supplied)

As noted above, the Commission's Final Order in the above referenced prior dockets was dated January 11, 2007, or over seven years from August 4, 2014, i.e., from the filing date of the Companies' rate case filings in the 2014 proceedings. In addition, prior to the 2014 proceedings, Penn Power's last rate case filing was in Docket No. R-870732, filed August 5, 1987 and with the Final Order issued May 3, 1988. Moreover, West Penn's last rate case filing prior to the 2014 proceedings was in Docket No. R-00942986 with the Final Order issued December 29, 1994. Based on this history, a two-year normalization period for recovery of rate case expense in the current proceedings is unwarranted and should be rejected.

Q. What normalization period do you recommend for the recovery of the Companies' claimed rate case expense in the current proceedings?

A. I recommend that each Company's claimed rate case expense be normalized over a period of five years, which is more representative of the historical long periods between rate cases for these utilities. While it is true that each Company's last base rate case was filed in 2014, there is no indication that a trend whereby the Companies will be filing base rate cases every two years has been established going forward. As noted above, Met-Ed and Penelec's preceding base rate case was eight years prior to the 2014 cases. Penn Power's preceding base rate case was 27 years prior to the 2014 case and West Penn's preceding base rate case was filed 20 years

prior to the 2014 case. Based on that prior history, the Companies' have not demonstrated that filing a base rate case every two years is a certainty. Using a five-year normalization period, I have reduced the Companies' claimed annual amount for rate case expense by:

- $164,000 for Met-Ed, as shown on Exhibit LA-ME-1, Schedule C-12;
- $171,000 for Penelec, as shown on Exhibit LA-PN-1, Schedule C-12;
- $49,000 for Penn Power, as shown on Exhibit LA-PP-1, Schedule C-12; and
- $212,000 for West Penn, as shown on Exhibit LA-WP-1, Schedule C-12, respectively.

<u>C-13, Interest Synchronization (All Four FE Utilities)</u>

Q. Please explain OCA Adjustment C-13 for interest synchronization.

A. The interest synchronization adjustment applies the weighted cost of debt to the adjusted rate base to calculate the amount of interest deduction to be reflected in the calculation of test year income tax expense. After adjustments, the OCA's proposed rate base differs from the rate base used in the Companies' filing. This results in a different amount of synchronized interest expense included in the income tax calculation. The calculation of the interest synchronization adjustment is shown on Schedule C-13 of Exhibits LA-ME-1, LA-PN-1, LA-PP-1, and LA-WP-1. This adjustment increases the combined state and federal income tax expense for each Company by the amounts shown on Schedule C-13. Each Company's combined net operating income is reduced by the amount of the net increase to income tax expense.

VII. ACT 40 APPLICATION OF REVENUE USE DIFFERENTIAL AMOUNTS (MET-ED, PENELEC, PENN POWER)

Q. What do you address in this section of your testimony?

A. This section of my testimony addresses Act 40, which changes the way that federal income tax expense is calculated for ratemaking purposes for many Pennsylvania utilities that participate in a consolidated federal income tax return.

Q. How is your testimony in this section organized?

A. I first discuss Act 40. Second, I discuss the calculation of the Revenue Use differential amount. Third, I address the application of the Revenue Use differential amount that applies to infrastructure. Fourth, I address the Revenue Use differential amount that is for "general corporate purposes." Fifth and finally, I address post-2017 FPFTY accumulations of Act 40 "Revenue Use" differential amounts.

1. Act 40 Requirements

Q. What does Act 40 state regarding the computation of income tax expense for the reduction of rates and the Revenue Use of the differential?

A. Act 40 added Section 1301.1 to the Public Utility Code, which states as follows:

> § 1301.1. Computation of income tax expense for ratemaking purposes.
>
> (A) Computation.- - If an expense or investment is allowed to be included in a public utility's rates for ratemaking purposes, the related income tax deductions and credits shall also be included in the computation of current or deferred income tax expense to reduce rates. If an expense or investment is not allowed to be included in a public utility's rates, the related income tax deductions and credits, including tax losses of the public utility's parent or affiliated companies, shall not be included in the computation of income tax expense to reduce rates. The deferred income taxes used to determine the rate base of a public utility for ratemaking purposes shall be based

solely on the tax deductions and credits received by the public utility and shall not include any deductions or credits generated by the expenses or investments of a public utility's parent or any affiliated entity. The income tax expense shall be computed using the applicable statutory income tax rates.

(b) Revenue use.--if a differential accrues to a public utility resulting from applying the ratemaking methods employed by the commission prior to the effective date of subsection (a) for ratemaking purposes, the differential shall be used as follows:

(1) fifty percent to support reliability or infrastructure related to the rate-base eligible capital investment as determined by the commission; and

(2) fifty percent for general corporate purposes.

(c) Application.--the following shall apply:

(1) Subsection (b) shall no longer apply after December 31, 2025.

(2) This section shall apply to all cases where the final order is entered after the effective date of this section.

Q. When is Act 40 applicable?

A. Act 40 is to become effective sixty days after becoming law. Act 40 became law on June 12, 2016 and thus becomes effective by August 11, 2016. Act 40 applies to "all cases where the final order is entered after the effective date of this section."

Q. Does Act 40 apply to the current FE rate cases?

A. Yes. The suspension period in the Companies' base rate cases ends on January 27, 2017. Additionally, given the procedural schedule that is in place for these base rate cases, the final order in this consolidated proceeding would be entered after the effective date of Section 1301.1. So, Act 40 applies in the current FE rate cases.

Q. Should a consolidated tax savings adjustment ("CTA") be made in the current rate cases as a reduction to federal income tax expense?

A. No. Due to the FirstEnergy utilities' participation in the FirstEnergy System consolidated federal income tax return, Act 40 requires that a CTA be calculated, but specifies that it is to be reflected as a "Revenue Use" differential. Act 40 specifies that 50% of the Revenue Use differential is for the support of reliability and infrastructure related to the rate base eligible capital investment determined by the Commission and the other 50% is for "general corporate purposes."

Q. Has FirstEnergy served supplemental testimony related to Act 40?

A. Yes. The Companies served the Supplemental Testimony of Richard A. D'Angelo (Companies Statement No. 2-S) on July 7, 2016 to address Act 40. Mr. D'Angelo's Supplemental Testimony was accompanied by Exhibit RAD-68 (which contains CONFIDENTIAL Company information) to present a computation of a consolidated tax adjustment for each of the Companies. Mr. D'Angelo states at page 3 of his Supplemental Testimony that this represents the "ratemaking methods employed by the Commission prior to the effective date of [Section 1301.1(a)]" that is identified as being the basis for calculating the "differential" referenced in Section 1301.1(b).

Q. Have you reviewed the computation of a consolidated tax adjustment for each of the Companies that FirstEnergy has presented in Exhibit RAD-68?

A. Yes. FirstEnergy also provided calculations of the CTA that would apply in its response to OCA-I-125. FirstEnergy states that: "Act 40 of 2016 does require the

Commission to determine whether a differential exists between the ratemaking methods utilized prior to the effective date of Act 40 and those that result from the application of Act 40." The Companies have therefore provided their calculation of a consolidated tax savings adjustment employing the modified effective tax rate method and historic three-year average federal income tax information.

Q. Do you agree with the computation of a consolidated tax adjustment for each of the Companies that FirstEnergy has presented in Exhibit RAD-68?

A. Generally, yes.

<u>2. The Revenue Use Differential</u>

Q. Section B of Act 40 speaks of the "Revenue Use" of a differential between the pre-Act 40 ratemaking method and the post-Act 40 ratemaking method. Did you determine that a differential exists?

A. Yes. I have replicated the Companies' calculation on Schedule E of Exhibits LA-ME-1, LA-PN-1, and LA-PP-1. As shown there, I have derived the same amount of federal income tax expense savings that is shown on FirstEnergy Exhibit RAD-68 for each of the Companies. On Schedule E, I have applied the gross revenue conversion factor for each of the Companies to convert that amount of federal income tax savings into a revenue requirement or "revenue use" differential amount. As shown on Schedule E of Exhibits LA-ME-1, LA-PN-1, and LA-PP-1, I show the "Revenue Use" differential to be as follows:

- $29.756 million for Met-Ed
- $12.051 million for Penelec, and

- $8.907 million for Penn Power.

The "Revenue Use" differential amounts are derived by applying the GRCF to the federal income tax savings amounts that resulted from the modified effective tax rate method. The amounts are shown on Schedule E and summarized below:

Line No.	Description	FirstEnergy Company Met-Ed	Penelec	Penn Power	Total
1	Jurisdictional Reduction to Federal Income Tax Expense for Consolidated Tax Savings	$ (16,384,389)	$ (6,635,898)	$ (4,904,519)	$ (27,924,806)
2	Gross Revenue Conversion Factor	1.81613	1.81609	1.81600	
3	Revenue Use Differential Impact per Act 40	$ (29,756,131)	$ (12,051,408)	$ (8,906,621)	$ (50,714,160)

Notes and Source	
Line 1:	OCA-VII-2
Line 2:	Schedule A-1
Line 3:	Line 1 x Line 2

As shown in the above table, other things being equal, the FirstEnergy Companies' revenue requirement in the current rate cases is approximately $50.7 million higher due to computing federal income tax on a stand-alone basis, rather than using the ratemaking methods utilized prior to the effective date of Act 40. This differential of approximately $50.7 million under Act 40 is ratepayer supplied money that is addressed in Act 40 as the "Revenue Use" differential. I also note that this is ratepayer supplied money for an expense that the operating Companies will not incur, as taxes are not paid by the operating Companies or the parent company due to filing a consolidated tax return through the parent company.

3. The "Revenue Use" Differential Applicable to Infrastructure

Q. Has FirstEnergy calculated amounts for the 50% of the differential that applies to supporting infrastructure?

A. Yes. At page 6 of Mr. D'Angelo's Supplemental Testimony, FirstEnergy provides the following amounts that he states correspond to 50% of the differential that corresponds to Section 1301.1(b)(1):

- $8.192 million for Met-Ed;
- $3.318 million for Penelec;
- $2.452 million for Penn Power; and
- $0 for West Penn (the Modified Effective Tax Rate Method produces no CTA for West Penn.)

Q. Do you agree with FE's calculation of the 50% "Revenue Use" differential amount that is applicable to infrastructure?

A. In part. I agree that 50% should be applied. However, FE applied the 50% to the CTA amount, i.e., to the equivalent of a federal income tax expense adjustment. That is a federal income tax differential, not a "Revenue Use" differential. To derive the "Revenue Use" differential, the federal income tax expense differential has to be multiplied for each Company's gross revenue conversion factor. In a utility rate case, such as the current ones, applying the GRCF to income tax expense adjustments is how the associated Revenue Requirement impact, i.e., the related Revenue Use amount, is derived.

Q. How does FirstEnergy propose to apply the "Revenue Use" amounts for the 50% of the differential that must be used to support reliability or infrastructure related to the rate-base eligible capital investment as determined by the Commission?

A. As described in the Companies' response to OCA-VII-1(c)(4):

> The Companies plan to file amendments to their Long Term Infrastructure Improvement Plans ("LTIIP") after the current base rate cases are concluded to account for the 50% differential devoted to reliability and infrastructure in accordance with Act 39. [sic] The LTIIP amendments will contain the planned reliability and/or infrastructure improvements each Company plans to undertake in response to Act 39. [sic]

In his Supplemental Testimony at page 7, Mr. D'Angelo states similarly that:

> After the current base rate cases are concluded, the Companies will file amendments to their Long Term Infrastructure Improvement Plans ("LTIIP")[26] to increase their investment in "eligible property" (as defined in Section 1351 of the Public Utility Code) in years 2018 through the end of the term of the LTIIP by fifty percent of each Company's "differential." The LTIIP amendments will set forth the planned reliability and other LTIIP "eligible property" infrastructure improvements that the Companies plan to undertake to conform to Section 1301.1(b)(1). Once the LTIIP amendments are approved by the Commission, the Companies will implement the reliability and infrastructure projects reflected in those amendments. The portion of the "differential" that will be used for reliability and infrastructure projects in the manner previously explained will be reflected initially in the Distribution System Improvement Charges ("DSIC") of the Companies, pursuant to the terms of the DSIC Riders approved by the Commission in its final orders entered June 9, 2016 at the same docket numbers as its order approving their LTIIPs. In a subsequent base rate case, the DSIC investments, including those funded by the incremental internally-generated funds produced by the Act 40 "differential," will be rolled into base rates and the DSIC will be set to zero on the effective date of those base rates.

Q. Should rate base grow for ratepayer supplied funds?

A. No. Rate base should grow only to the extent such growth is funded by investor supplied funds. To the extent that infrastructure-related rate base investment in a

[26] The Companies' LTIIPs were approved by the Commission in a Final Order entered February 11, 2016 at Docket Nos. P-2015-2508942, P-2015-2508936, P-2015-2508948, and P-2015-2508931.

DSIC or base rate case is being funded by ratepayer supplied funds, the investor return requirement does not grow.

Q. What is FirstEnergy's reason for not reflecting the application of the 50% differential for infrastructure in its current rate case?

A. Page 8 of Mr. D'Angelo's Supplemental Testimony provides the following reason:

> The fifty percent "differential" computed on Exhibit RAD-1 68 will not begin to accrue until after the base rates established in this proceeding go into effect near the end of January 2017. Therefore, at most, approximately 11/12ths of fifty percent of the "differential" calculated on Exhibit RAD-68 would be realized in 2017 – and that amount would have to grow from zero to 11/12ths over the course of eleven months. Thus, a full annual amount will not be realized until 2018. Because fifty percent of the "differential" would not be available as incremental internally generated funds for use in 2017, the investment of fifty percent of the "differential" in reliability and infrastructure projects will occur thereafter.

Q. Do you agree with this FirstEnergy proposal?

A. No. The current rate case is using a fully projected future test year of 2017 as the basis for establishing the Companies' revenue requirements. New rates are anticipated to be effective by January 27, 2017, i.e., by the end of the suspension period. At least 11/12ths of the 2017 "Revenue Use" differential of 50% that is to be used to support reliability or infrastructure related to the rate-base eligible capital investment as determined by the Commission should be reflected in the current rate case.

Q. What adjustment for the 50% "Revenue Use" differential that is to be used to support reliability or infrastructure related to the rate-base eligible capital investment as determined by the Commission do you recommend should be reflected in the current rate case?

A. As shown on Schedule E, the Revenue Use amounts related to the CTA for Met-Ed, Penelec and Penn Power are split 50% to infrastructure and 50% for "general corporate purposes."[27] For the 50% infrastructure amounts, if the Companies' proposed approach to the FPFTY rate case were to be used (against my recommendation), then 11/12ths of the 50% infrastructure amount should be used to offset rate base in the current case. The offset to rate base reflects that the amounts of "Revenue Use" differential are being used to support infrastructure related to the rate-base eligible capital investment as determined by the Commission. As shown on Schedule E-1, page 1, of Exhibits LA-ME-1, LA-PN-1, and LA-PP-1, the rate base adjustments under this approach would be:

- $13.638 million for Met-Ed;
- $5.524 million for Penelec; and
- $4.082 million for Penn Power

If in contrast, my proposed average rate base approach to the FPFTY in the current cases is used (corresponding with a first year of new rates approach), then the rate base offset would be one-half of the 11/12ths. This reflects that the "Revenue Use" differential amounts for 2017 would be accumulating gradually during the year, with zero accumulation at January 1, 2017 and the full 11/12ths of the annual "Revenue Use" amount being accumulated by December 31, 2017. (Recall that the 11/12ths

[27] I discuss the application of the 50% "Revenue Use" differential for "general corporate purposes" below in Part 4 of this section of my testimony.

impact in 2017 is based on the assumption that the new rates established in this case would be effective before the end of January 2017.) As shown on Schedule E-1, page 1, of Exhibits LA-ME-1, LA-PN-1, and LA-PP-1, the rate base adjustments under this approach would be:

- $6.819 million for Met-Ed;
- $2.762 million for Penelec; and
- $2.041 million for Penn Power

By the rate base reduction, we are supporting infrastructure and reliability investment and reducing the burden of the 2017 rate-base eligible capital investment on ratepayers. The use of the increased revenue to FE that is being supplied by ratepayers is applied as non-investor-supplied funding for 2017 FPFTY rate base infrastructure. This appears to be consistent with the requirement of Act 40 for infrastructure use. It is also consistent with an objective that the additional ratepayer-supplied funds supports infrastructure investments in Pennsylvania to benefit those consumers and the Commonwealth and are not merely passed to the parent company, shareholders, or affiliated companies.

4. The "Revenue Use" Differential Applicable to "General Corporate Purposes"

Q. What is FirstEnergy's proposal for the other 50% of the differential, which Section 13.01.1(b)(2) states must be used for "general corporate purposes"?

A. Companies' witness D'Angelo does not appear to propose a specific treatment for the other 50% of the differential in his Supplemental Testimony, which Section 13.01.1(b)(2) states must be used for "general corporate purposes."

Q. Did you probe the part of the "Revenue Use" differential application in discovery to FE?

A. Yes. For example, OCA-VII-1(c)(6) asked FirstEnergy to: "Identify and explain each of the 'general corporate purposes' for which each of the FirstEnergy Companies would apply the 50% that HB 1436 indicates shall be applied 'for general corporate purposes.'" The Companies' response to OCA-VII-1(c)(6) states rather vaguely that: "There is no current specific 'plan' for how the 50% of the 'differential' that Act 39 [sic] provides for general corporate purposes will be spent, nor are the Companies required to establish a plan for such funds."

OCA-VII-1(c)(5) asked: "How will each of the FirstEnergy Companies account for the 50% that is being applied for general corporate purposes? Explain fully and show the related accounting entries that will be used by each Company." The Companies' response to OCA-VII-1(c)(5) indicates, regarding the 50% differential for general corporate purposes, that: "There are no specific accounting entries to account for how general corporate funds are utilized."

OCA-VII-1(c)(7) asked: "when the FirstEnergy Companies apply 50% of the amounts for 'general corporate purposes': (a) what impact will that have on each Company's 2017 operating expenses? (b) what impact will that have on each Company's 2018 rate base? Explain fully and show the estimated impacts." The Companies' response states that:

> (7) (a) There may be no impact on operating expenses. The revenue collected would be billed and accounted for similar to all other base rate revenue.
>
> (b) The Companies do not expect any portion of the 50% of the "differential" that can be used for general corporate purposes to have an impact on 2018 rate

> base. Therefore, rate base will not grow. However, the 50% of the differential that will be used for reliability and infrastructure will have an impact on 2018 rate base. Rate base will grow by the entire amount devoted to reliability and infrastructure improvements.

Q. Do you agree with FE's comment that "rate base will grow by the entire amount devoted to reliability and infrastructure improvements?

A. No. As noted previously, rate base should grow only to the extent such growth is funded by investor supplied funds. To the extent that infrastructure-related rate base investment in a DSIC or base rate case is being funded by ratepayer supplied funds, the investor return requirement does not grow.

Q. What do you conclude from the FirstEnergy responses concerning the 50% of the differential that Act 40 requires be used for "general corporate purposes"?

A. I conclude that the FirstEnergy Companies have stated that they have no specific plans for how that differential will be spent and have identified no specific ways in which that 50% of the differential would be used in any way to benefit Pennsylvania ratepayers. One might conclude from this that FirstEnergy therefore basically intends to use that money for the benefit of its stockholders, and not apply it in any manner to provide a quantifiable ratepayer benefit or in a manner that directly benefits service to Pennsylvania customers.

Q. What does "general corporate purposes" as used in Act 40 mean?

A. That is a question that the Commission will likely have to determine in the current FirstEnergy rate cases. Because these FirstEnergy Companies are all regulated

electric distribution utilities in Pennsylvania, their "general corporate purpose" is to provide regulated electric utility distribution service in the Commonwealth of Pennsylvania. While the term "general corporate purposes" is rather vague, consistent with that general corporate purpose of these regulated electric utilities, general corporate purposes would include uses for such "differential" revenues as supporting capital expenditures necessary to execute utility business plans, paying off debt, funding construction projects, paying dividends, paying for maintenance and operating expenses, investing in utility plant in Pennsylvania, and providing a source of working capital, etc. Many of these uses for "general corporate purposes" would have a quantifiable benefit to Pennsylvania ratepayers. As I read the entirety of Act 40, the "revenue use differential" addressed in the Act for "general corporate purposes" should mean public utility purposes and uses that result in having some identifiable and quantifiable benefit to Pennsylvania and FE's ratepayers, rather than just resulting in a windfall of approximately $50.7 million annually to FE's shareholders or affiliates.

Q. Is the time period specified in Act 40 relevant to when Pennsylvania ratepayers should experience a benefit from the 50% "Revenue Use" differential that is for "general corporate purposes"?

A. Yes. Act 40 specifies that the "Revenue Use" differential applies through 2025 (i.e., Subsection B shall no longer apply after December 31, 2025). This suggests a transitional provision that should provide some net quantifiable benefit to Pennsylvania utility consumers through 2025 to help offset the impact of the

significant rate increases (including approximately $50.7 million in rate hikes for three of the four FirstEnergy Companies in the current rate cases) caused by no longer making the traditional Pennsylvania consolidated tax savings adjustment for ratemaking purposes.

Q. What specific recommendation do you have in the current FirstEnergy Companies rate cases for applying the 50% of the "Revenue Use" differential that Act 40 requires be for "general corporate purposes"?

A. While a dollar-for-dollar reduction of operating and maintenance expense would be a "general corporate purpose," such as if the 50% of the "Revenue Use" differential were applied to 2017 FPFTY maintenance and reliability improvement expenses, for the purposes of the current rate cases, I have reflected the 50% differential for general corporate purposes as a source of non-investor-supplied funding for utility working capital.

With the cessation of the CTA, Met-Ed, Penelec, and Penn Power will have revenue requirements that are approximately $29.756 million, $12.051 million, and $8.907 million, respectively, higher than they would be with continuation of the CTA.[28] Their Pennsylvania ratepayers will be funding these higher revenue requirements through the rates paid for electric distribution service with no corresponding outlay for additional federal income tax expense being made by FE. Thus, the source of the additional funds to the utilities is higher payments from ratepayers related to the change in ratemaking practices. In other words, this is

[28] These amounts are quantified on Schedule E of Exhibits LA-ME-1, LA-PN-1, and LA-PP-1, respectively.

ratepayer-supplied capital that offsets needed contributions from investors. The utilities will have the use of these additional funds from ratepayers during the period through 2025 when the provisions of Section 1301.1(b) are applicable. The "Revenue Use" differential provided for in Act 40 should therefore be used in a manner that will provide some type of quantifiable benefit to ratepayers during that period. Reflecting the 50% differential for "general corporate purposes" as a source of non-investor-supplied working capital would therefore be one way of accomplishing the requirements of Act 40 in a manner that is consistent with the Act and which provides for some quantifiable benefit to the utilities' customers who are paying the higher revenue requirements. This use also recognizes that the increased funding from ratepayers reduces requirements from investors to support working capital of the impacted utilities. Consequently, as shown on Schedule E-1, page 2, of Exhibits LA-ME-1, LA-PN-1, and LA-PP-1, respectively, I have reflected the application of the 50% "Revenue Use" differential for "general corporate purposes" as a non-investor supplied source of funding for working capital that helps support the projected 2017 FPFTY rate base.

Q. Should the same amounts of that 50% revenue use differential for "general corporate purposes" be applied as the rate base offset if FirstEnergy's FPFTY year-end approach to rate base is used, or if the OCA's average FPFTY rate base approach is used?

A. No. If the FirstEnergy's year-end approach to FPFTY rate base were to be used, and if the new rates set in this proceeding are assumed to be in place by the end of

January 2017, I recommend that 11/12ths of the 50% "Revenue Use" differential for "general corporate purposes" be applied as the amount of non-investor-supplied funding for CWC in rate base. This would result in offsetting the Met-Ed, Penelec, and Penn Power rate bases by the following amounts (which are calculated on Schedule E-1, page 2, of Exhibits LA-ME-1, LA-PN-1, and LA-PP-1, respectively):

- $13.638 million for Met-Ed;
- $5.524 million for Penelec; and
- $4.082 million for Penn Power.

Q. What about if your recommended average test year rate base approach to the 2017 FPFTY is used?

A. If my recommended average test year rate base approach to the 2017 FPFTY is used, the rate base CWC support from ratepayers would be one-half of the above-identified amounts, to reflect that the amounts of the ratepayer-provided 50% "Revenue Use" differential for "general corporate purposes" was zero at January 1, 2017 (the beginning of the FPFTY) and reaches 11/12ths of the "Revenue Use" amounts at December 31, 2017 (the end of the FPFTY).[29] Accordingly, the non-investor-supplied funding to support the Met-Ed, Penelec, and Penn Power rate base CWC for the application of the 50% of the "general corporate purposes" Revenue Use differential should reflect the following amounts (which are calculated on Schedule E-1, page 2, of Exhibits LA-ME-1, LA-PN-1, and LA-PP-1), respectively:

- $6.819 million for Met-Ed;
- $2.762 million for Penelec; and

[29] Again, this assumes that the new rates for this case become effective by the end of January 2017 and are thus collected for 11 of the 12 months of the 2017 FPFTY.

- $2.041 million for Penn Power.

5. Post-2017 FPFTY Accumulations of Act 40 "Revenue Use" Differential Amounts

Q. Would there be additional accumulations by Met-Ed, Penelec, and Penn Power of the Act 40 "Revenue Use" differential amounts in the years after the 2017 FPFTY being used in the current FE rate cases?

A. Yes. The consolidated tax savings are an annual amount. It is expected that there would be additional accumulations by Met-Ed, Penelec, and Penn Power of the "Revenue Use" differential amounts in the subsequent years, 2018 through 2025. For example, additional "Revenue Use" differential amounts would be collected by these three utilities from their ratepayers, via the approximately $50.7 million annual base rate revenue increase directly attributable to not having applied the CTA to reduce rates in the current rate cases. An additional annual related hypothetical income tax expense (grossed up to a revenue amount) on a "stand-alone" basis is being included in the revenue requirement that would be funded by ratepayers each year that these rates are in effect. That is approximately $50.7 million annually for Met-Ed, Penelec, and Penn Power for an income tax expense that may never be fully paid by the FirstEnergy consolidated group that is participating in the consolidated federal income tax return.

Q. How should the additional "revenue use differential" amounts accumulated by Met-Ed, Penelec, and Penn Power in the years 2018 through 2025 be addressed?

A. The annual amounts of "Revenue Use" differential amounts accumulated by Met-Ed, Penelec, and Penn Power in the years 2018 through 2025 could be addressed by applying them to the utility's investment-based surcharges, such as the DSIC, that utilize infrastructure investment as the basis for the surcharge rate increases. Under Act 40, the "Revenue Use" differentials are to be used in the manner described until December 31, 2025. Additional accumulations of such "Revenue Use" differential amounts during 2018 through 2025 could therefore be recognized and applied in the context of infrastructure based surcharges such as the DSIC, or by some other means, determined by the Commission that would provide a benefit to the Commonwealth and to the impacted FE ratepayers.

VIII. REFLECTION OF ADIT IN UTILITY INFRASTRUCTURE SURCHARGE MECHANISMS (SUCH AS DSICS)

Q. Please briefly discuss how infrastructure investment surcharges have been used by Pennsylvania utilities.

A. In Pennsylvania, a DSIC is a "charge imposed by a utility to recover the reasonable and prudent costs incurred to repair, improve, or replace eligible property that is part of the utility's distribution system." 66 Pa.C.S. § 1351. When a utility invests in infrastructure, it obtains tax deductions for the capital spending when the plant is placed into service. Tax benefits such as accelerated tax depreciation and bonus tax depreciation can thus provide a significant source of non-investor-supplied financing for utility plant investments. The benefits of accelerated tax depreciation are typically realized over time. Deferred income tax expense is included in a utility's operating expenses and revenue requirement. The non-investor-supplied cost-free

financing related to deferred income taxes is accumulated in an Accumulated Deferred Income Tax ("ADIT") account, and is used as an offset to the utility's rate base in Pennsylvania and many other jurisdictions. Utility infrastructure surcharges typically have an element that is similar to rate base, and the infrastructure revenue requirement typically includes a component for a return on the new net investment in plant. The net investment in new plant is typically the result of investments in new plant less accumulated depreciation. A number of jurisdictions with infrastructure surcharges also reflect an offset for ADIT, similar to how ADIT related to plant investments is reflected as a rate base offset in utility base rate cases. If a utility's ADIT were used to offset the calculation of the investor-funded return requirement in a DSIC, then the DSIC would be lower.

Q. How has the Commission addressed whether ADIT should be reflected in determining a utility DSIC revenue requirement?

A. The Commission determined that ADIT tax benefits do not need to be included in the calculation of DSICs, a decision that was affirmed by the Commonwealth Court. McCloskey v. Pa. Pub. Util. Comm'n., 127 A.3d 860 (Pa. Commw. Ct. 2015).

Q. Does the recently enacted House Bill 1436 (Act 40) appear to require a different treatment?

A. Yes.

Q. How does Act 40 address how income tax impacts should be addressed in relation to the establishment of rates through an infrastructure surcharge?

A. Recently enacted House Bill 1436 states that "[i]f an expense or investment is allowed to be included in a public utility's rates for ratemaking purposes, the related income tax deductions and credits shall also be included in the computation of current or deferred income tax expense to reduce rates." H.B. 1436, 2015-2016 Reg. Sess. (Pa. 2016). A utility DSIC is a form of utility rates. That form of utility rates is commonly referred to as a surcharge. A utility DSIC would typically include costs related to investment in infrastructure. Act 40 provides that if an investment is allowed to be included in a utility's rates, the related income tax deductions and credits shall also be included in the computation of current and deferred income tax expense to reduce rates. Computing the deferred taxes and ADIT impacts of the infrastructure investment-related tax benefits appears to be required by Act 40 to reduce rates. Reflecting the infrastructure investment-related tax benefits to reduce rates would typically take the form of reducing the net plant investment amount by the directly related ADIT. Act 40 appears to modify the Commission's prior decision on this matter and requires a different treatment of ADIT than that previously approved by the Commission.

Q. What do you recommend?

A. I recommend that the DSIC tariff rider for each FE Company be amended to include the reflection of ADIT in the surcharge calculation and that the ADIT be reflected in all future FE utility DSIC rates.

IX. OTHER MATTERS

Q. Have the Companies proposed adjustments to reduce base operating revenues?

A. Yes. As shown on each Company's Exhibit RAD-2, Adjustment No. 1, several adjustments have been proposed to base operating revenues. Among these is an adjustment to normalize sales and revenues related to (1) the Companies' Energy Efficiency and Conservation Phase III Plan and (2) to reflect the impact of behind-the-meter generation. The impact of these proposed adjustments decreases the Companies' base operating revenues by the following amounts:

- $7.274 million for Met-Ed;
- $10.738 million for Penelec;
- $1.398 million for Penn Power; and
- $5.315 million for West Penn

Q. Do you have any recommendations with respect to the Companies' proposed adjustment to normalize sales and revenues related to the Energy Efficiency and Conservation Phase III Plan or behind-the-meter generation?

A. Not at this time. The Companies have provided responses to my data requests on these issues, but I have not yet received the related supporting documentation. As such, I have not completed my analysis by the filing date of my Direct Testimony in this proceeding. However, once I receive the supporting documentation and complete my analysis, it may be necessary to file Supplemental Testimony at a later date to address this issue.

Q. Does this conclude your direct testimony?

A. Yes, it does.

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission	:	
	:	
v.	:	
	:	
Metropolitan Edison Company	:	Docket No. R-2016-2357349 ET AL
Pennsylvania Electric Company	:	
Pennsylvania Power Company	:	
West Penn Power Company	:	

VERIFICATION

I, Ralph C. Smith hereby state that the facts above set forth in my Direct Testimony, OCA Statement No. 1 is true and correct and that I expect to be able to prove the same at a hearing held in this matter. I understand that the statements herein are made subject to the penalties of 18 Pa.C.S. § 4904 (relating to unsworn falsification to authorities).

Signature: Ralph C. Smith

Ralph C. Smith

Consultant Address: Larkin & Associates, PLLC
15728 Farmington Road
Livonia, MI 48154

DATED: July 22, 2016

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