Joint Applicants' Statement No. 3-R

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

JOINT APPLICATION OF MID-ATLANTIC INTERSTATE TRANSMISSION LLC ("MAIT"); METROPOLITAN EDISON COMPANY ("MET-ED") AND PENNSYLVANIA ELECTRIC COMPANY ("PENELEC") FOR: (1) A CERTIFICATE OF PUBLIC CONVENIENCE UNDER 66 PA.C.S. § 1102(A)(3) AUTHORIZING THE TRANSFER OF CERTAIN TRANSMISSION ASSETS FROM MET-ED AND PENELEC TO MAIT; (2) A CERTIFICATE OF PUBLIC CONVENIENCE CONFERRING UPON MAIT THE STATUS OF A PENNSYLVANIA PUBLIC UTILITY UNDER 66 PA.C.S. § 102; AND (3) APPROVAL OF CERTAIN AFFILIATE INTEREST AGREEMENTS UNDER 66 PA.C.S. § 2102

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Rebuttal Testimony
of
Steven R. Staub

<u>List of Topics Addressed</u>

Operating Control Of Mid-Atlantic Interstate Transmission, LLC, Cost Of Long-Term Debt, Structure Of The Proposed Transaction, Dividend Shares, Proposed Conditions For Approval

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REBUTTAL TESTIMONY
OF
STEVEN R. STAUB

I. INTRODUCTION

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

A. My name is Steven R. Staub. I am employed by FirstEnergy Service Company ("FESC") as Vice President and Treasurer. My business address is 76 South Main Street, Akron, OH 44308.

Q. Have you previously presented testimony in this proceeding?

A. Yes, on June 19, 2015, my Direct Testimony, Joint Applicants' Statement No. 3 and the accompanying Exhibits SRS-1 through SRS-3, were filed in this matter. On October 27, 2015, my Supplemental Direct Testimony, Joint Applicants' Statement No. 3S, was served upon the parties and the Administrative Law Judges.

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my Rebuttal Testimony is to respond to portions of the Direct Testimony of Richard S. Hahn, who submitted testimony on behalf of the Office of Consumer Advocate ("OCA") (OCA Statement No. 1), regarding: (1) Mr. Hahn's alleged concerns about the operating control of Mid-Atlantic Interstate Transmission, LLC ("MAIT") following the completion of the transaction for which approval is sought in the Joint Application filed on June 19, 2015 (the "Transaction") (OCA St. 1, p. 16, lines 15-20); (2) Mr. Hahn's contention that MAIT will not experience a lower cost of long-term debt than Metropolitan Edison Company ("Met-Ed") and Pennsylvania Electric Company

("Penelec") (together the "Companies") following the Transaction (OCA St. 1, p. 30, line 9 through p. 31, line 18); and (3) Mr. Hahn's assertions that the Companies will be "adversely affected" by the "structure of the proposed transaction" (OCA St. 1, p. 19, lines 6-25) and "harms to Pennsylvania ratepayers that will result from the Transaction" (OCA St. 1, p. 31, line 20 through p. 32, line 25).

II. RESPONSES TO MR. HAHN

A. Operational Control Of MAIT

Q. Please summarize Mr. Hahn's comments regarding operational control of MAIT when the Transaction is completed.

A. Mr. Hahn notes that, under the terms of the Transaction, FirstEnergy Transmission, LLC ("FET") will contribute "5% of the initial capitalization of MAIT" and will receive the Class A membership interest in MAIT.[1]

Mr. Hahn follows his observation about FET's initial contribution by commenting that he "find[s] this situation to be unusual" because, according to Mr. Hahn, "in a typical LLC formation, members are granted control rights based on the level of their contributions." (OCA St. 1, p. 16, lines 17-18).

Q. Please address Mr. Hahn's comment regarding the manner in which control is assigned between Class A and Class B membership interests in MAIT.

[1] The structure of the Transaction Mr. Hahn alludes to was explained in greater detail in the Joint Application and the Joint Applicants' Direct Testimony. Specifically, the Companies and their affiliate, Jersey Central Power & Light Company ("JCP&L"), will contribute their transmission assets to MAIT in exchange for Class B membership interests in MAIT. As owner of the Class A membership interest, FET will appoint the Board of Managers of MAIT, which will control day-to-day operation and management of MAIT. The Class B membership interests will have consent rights with respect to major corporate matters, such as mergers, acquisitions, and the filing of a bankruptcy petition.

A. Initially, I want to emphasize that the Class A and Class B membership interests assure that FET, the Companies and JCP&L have economic interests in the assets and earnings of MAIT that correspond to the value of the investments they are making in MAIT. FET is being issued Class A membership interests because, through its authority to appoint the Board of Managers, it will have the responsibility for the day-to-day business operation of MAIT.[2] The Transaction was designed so that the Companies and JCP&L would be equity investors in MAIT, while FET would have an interest in MAIT that, under applicable generally accepted accounting principles, FET would be the entity that consolidates MAIT on its balance sheet.[3] Thus, issuing Class A shares to FET assures that the substantial amounts of long-term debt that will be issued in the future for significant planned transmission investment in the Companies' and JCP&L's service territories will not appear on the balance sheets of Met-Ed, Penelec or JCP&L. Keeping that debt off the balance sheets of the Companies and JCP&L is one of the important reasons for undertaking the Transaction.

Additionally, and unmentioned by Mr. Hahn, during the period that the Energizing the Future ("EtF") program[4] is being completed in the Companies' service territories, additional investment by FET will eventually result in FET having the largest membership interest in MAIT.

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[2] As I explained in my Direct Testimony (Joint Applicants' St. 3, p. 9, lines 16-18), MAIT will be a member of PJM Interconnection L.L.C. ("PJM") and, therefore, PJM will have functional control of MAIT's transmission assets to assure that non-discriminatory transmission service is provide in accordance with the terms of PJM's Open Access Transmission Tariff ("OATT") approved by the Federal Energy Regulatory Commission ("FERC").

[3] The accounting principles that apply to consolidation for financial reporting purposes were explained in Mr. Taylor's Direct Testimony (Joint Applicants' St. 4, p. 14, lines 4-6).

[4] The EtF program is described in the Direct Testimony of Mr. Mackauer (Joint Applicants' St. 2).

B. Lower Cost Of Long-Term Debt

Q. Mr. Hahn disagrees that it is reasonable to expect that MAIT will have a lower cost of long-term debt (OCA St. 1, p. 29, line 29 through p. 30, line 22). What is the alleged basis for his contention?

A. Mr. Hahn claims to have reviewed data that purport to show "there is no assurance or even a likely expectation that MAIT is expected to have a better credit rating than the Operating Companies" (OCA St. 1, p. 30, lines 14-15). The data Mr. Hahn reviewed is presented in Table 6 in his Direct Testimony, which he describes as a "summary of the latest credit ratings for the FirstEnergy companies."

The data in Mr. Hahn's Table 6 show that Trans-Allegheny Interstate Line Company ("TrAILCo"), a separate transmission company owned by FET, has, in fact, been given stronger credit ratings by Moody's (A3) than any of the other FirstEnergy companies shown in that table. Therefore, Mr. Hahn's own data do not support his conclusion. Nonetheless, he tries to minimize the significance of TrAILCo's credit ratings by contending that "[w]hile TRAILCo does have a higher credit rating from Moody's, the S&P LT [Long Term] issuer ratings are the same for all FirstEnergy Companies at BBB-" (OCA St. 1, p. 30, lines 12-13). However, that is only half the story; Mr. Hahn left out additional, important facts that demonstrate his reliance on the Standard & Poor's ("S&P") credit ratings is misplaced.

As I explained in my Direct Testimony (Joint Applicants' St. 3, p. 12, lines 9-17), while Moody's derives a separate credit rating for each company under the same holding company umbrella, S&P employs a "group approach" that assigns the same long-term issuer rating to all members of a corporate holding company system, which cannot exceed the credit rating of the parent. In the case of FirstEnergy, that rating is BBB-. However, S&P also provides a pure "stand-alone" credit profile for each member of a holding company group. The S&P stand-alone credit profile for TrAILCo is AA, which is at least three notches above that of the Companies. Consequently, Mr. Hahn's contention that TrAILCo's credit ratings are no better than those of other companies in Table 6 is simply wrong.

Q. Have you presented any other evidence that demonstrates that there is a reasonable expectation that MAIT will have a lower cost of debt than the Companies?

A. Yes, I did. Joint Applicants' Exhibit SRS-2, which accompanied my Direct Testimony, shows the average spreads of corporate bond yields over U.S. Treasury yields for three different credit ratings assigned by S&P for the period from January 2013 through February 2015. The data show that higher credit ratings generally translate into a lower cost of capital, which is a direct benefit to customers of regulated utilities. The four data points shown as red squares (labeled 1, 2, 3 & 4) reflect the actual spread of the yields on bonds issued by the Companies, JCP&L and TrAILCo relative to the average spread of all corporate bonds issued with the specific credit ratings shown on the chart. The data show that the spread for Met-Ed and JCP&L, which are rated Baa2 by Moody's, is nearly identical to the basis point spread for S&P's BBB rated bonds. Penelec had a larger spread. Significantly, TrAILCo's debt at the time of issuance priced 30 basis points lower than the average spread for all BBB (S&P) bonds.[5] These data also demonstrate that it is reasonable to expect MAIT to have a lower cost of debt than the Companies.

The effects of credit quality on price are also shown by six additional data points on Joint Applicants' Exhibit SRS-2. The three data points shown as green circles (labeled 5, 6 and 7) reflect the actual spread of the yields on bonds issued by ITC Midwest LLC, ITC Great Plains LLC and Michigan Electric Transmission Company, LLC, all transmission-only utilities and wholly-owned subsidiaries of ITC Holdings Corp, the nation's largest independent electric transmission company. The three data points shown as orange triangles (labeled 8, 9 & 10) reflect the actual spread of the yields on bonds issued by American Transmission Company, a privately owned transmission-only company. As can be seen, all six issuances have a Moody's credit rating of A1, and are priced significantly lower than the spread for Moody's Baa2 and A3 bonds shown on the exhibit.

In summary, there is solid evidence that it is reasonable to expect MAIT to have lower debt costs than the Companies, and that evidence has not been refuted by Mr. Hahn, who selected incomplete data, drew incorrect conclusions from that data and ignored other significant evidence -- which I discussed above -- that contradicts his position.

Q. Mr. Hahn also tries to refute the evidence presented by the Joint Applicants by referring to a June 10, 2013 downgrade by Moody's of the senior unsecured debt of American Transmission Systems, Inc. ("ATSI"), a separate transmission company

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[5] These data also confirm that, contrary to Mr. Hahn's contention, TrAILCo's credit rating is better represented by Moody's rating (A3) and the stand-alone credit profile assigned by S&P (AA) than the group rating of BBB- for all FirstEnergy companies.

that is also a subsidiary of FET, from Baa1 to Baa2 and of TrAILCo from A3 to Baa1 (OCA St. 1, p. 32, line 30 through p. 33, line 7). Please respond.

A. At the outset, TrAILCo's senior unsecured debt rating by Moody's is currently A3, as shown by the data in Mr. Hahn's own Table 6. Consequently, his reference to TrAILCo is not relevant. Furthermore, the facts recounted by Mr. Hahn do not contradict the Joint Applicants' position. TrAILCo's pre-downgrade rating (A3) was higher than the rating of any FirstEnergy company shown on Mr. Hahn's Table 6 and, as I previously indicated, TrAILCo's rating has now returned to that higher (A3) rating. ATSI's pre-downgrade rating of Baa1 was higher than all but two of the FirstEnergy companies shown in Mr. Hahn's Table 6 (and one of the two companies with a higher rating is TrAILCo). Moreover, the downgrades were not the result of anything intrinsic to the nature or structure of TrAILCo and ATSI as separate transmission companies. Rather, as Mr. Hahn's description makes clear, the downgrade was caused by an extrinsic event unrelated to their status as a separate transmission company, namely, the collateralization of ATSI's and TrAILCo's future cash flows, which was required to address liquidity issues unrelated to their transmission businesses. In short, the downgrades do not diminish the weight of the evidence that shows separate transmission companies have lower long-term debt costs – evidence that also supports a reasonable expectation that MAIT's debt costs will be lower than that of the Companies.

Q. Mr. Hahn also asserts that, if MAIT does experience a lower cost of long-term debt, the resulting savings will be "more than offset by a higher ROE and/or a higher equity ratio" (OCA St. 1, p. 31, lines 1-2). Please respond.

A. Mr. Hahn's contentions regarding both the equity ratio and return on equity that the FERC would grant MAIT for calculating its Network Integration Transmission Service ("NITS") rate are incorrect for the reasons set forth in Mr. Fullem's Rebuttal Testimony (Joint Applicants' St. 1-R). As explained by Mr. Fullem, there is no basis for Mr. Hahn's contention that increases in MAIT's equity ratio or return on equity will offset the savings that will be produced by the lower cost of long-term debt MAIT will experience as a separate transmission company.

C. Alleged "Harms To Pennsylvania Ratepayers"

Q. What are the "harms to Pennsylvania ratepayers" alleged by Mr. Hahn?

A. The principal "harm" alleged by Mr. Hahn is that the Companies would be "adversely affected" because of the "structure of the proposed transaction" (OCA St. 1, pp. 19-20) and because the "dividend shares of the Operating Companies will decrease" in the future (OCA St. 1, p. 21, lines 12-24).[6] Neither of Mr. Hahn's contentions is correct.

Q. What is the alleged basis for Mr. Hahn's claim that the Companies will be "adversely affected" by the "structure of the proposed transaction"?

A. Mr. Hahn contends that the Companies will be "adversely affected" because "the Operating Companies will have fewer assets supporting the same debt, equity, and total capitalization after the proposed transaction than before" (OCA St. 1, p. 19, lines 12-14). That statement is entirely incorrect. After the Transaction, the Companies will have the

[6] Mr. Hahn also offers the downgrading of ATSI's and TrAILCo's credit ratings by Moody's as evidence that the creation of a separate transmission company could "harm" the Companies (OCA St. 1, p. 32, line 30 through p. 33, line 7). However, those downgrades (one of which has already been reversed), do not detract from the benefits of establishing a separate transmission company for the reasons I addressed previously in Section II.B., above.

same "debt, equity and total capitalization" as before the Transaction. In addition, after the Transaction, the Companies will have the same amount of assets on their balance sheets as before the Transaction. The only difference is that the asset account on their balance sheets will reflect their investment in MAIT, which will be equal to the value of the transmission assets they contribute to MAIT in exchange for membership shares in MAIT. Therefore, exactly the same amount of assets will support the exact same capitalization (i.e., sum of debt and equity) as before the Transaction.

Q. If neither the Companies' assets nor their capitalization will change as a result of the Transaction, why does Mr. Hahn allege that the "structure" of the Transaction will "adversely affect" the Companies?

A. Mr. Hahn sets up an artificial distinction between the asset he refers to as "net plant" (direct ownership of transmission assets by the Companies) and the asset of equal value representing the Companies' ownership in a limited liability company, namely, MAIT, which owns and operates the very same transmission assets. Mr. Hahn then proposes that the asset represented by the Companies' investment in MAIT be completely disregarded and, on that basis, contends that the "ratio of net plant to total capitalization" is lower for each of the Companies after the Transaction than before. Mr. Hahn claims that the artificially depressed "ratio" of "net plant to total capitalization" that results from his arithmetic exercise is somehow indicative of "degraded financial health" and "could result in lower credit ratings for the Operating Companies" because "ownership of MAIT shares by the Operating Companies will be viewed as less secure than ownership of assets" (OCA St. 1, p. 19, lines 20-25).

Q. Has Mr. Hahn offered any evidence that the ownership of "shares" in MAIT "will be viewed as less secure" than the Companies' directly owning the transmission assets that are being contributed to MAIT?

A. No, he has not produced any analyst reports, credit reports or other documentation from relevant authoritative sources that suggest his hypothesis is used to assess credit quality under circumstances like those presented here. Additionally, Mr. Hahn disregards the fact that, as investors in MAIT, the Companies will receive an income stream equivalent to the one they would obtain if they continued to own their contributed assets, while being relieved of the obligation to furnish transmission service and the obligation to finance investment in new transmission assets expected to approximate $2.5 billion to $3.0 billion.

Mr. Hahn also contends that the Companies will have "lower earnings" in the future if their transmission function is transferred to MAIT (OCA St. 1, p. 22, lines 4-7). However, he fails to acknowledge that such "earnings" would come with a price. The Companies cannot benefit from "earnings" on increased investment in transmission assets *without actually making that investment*. However, the Companies already have a statutory duty to furnish safe, reliable and reasonable *distribution* service, which imposes substantial obligations to use their available credit capacity to fund necessary distribution investments. He has not considered how the added stress of financing the expected magnitude of transmission investments will affect the credit profile of the Companies in light of their obligations as distribution utilities. Credit capacity is not unlimited and, when stressed by the demands to finance distribution *and* transmission investments, can result in increased debt costs for both functions.

Q. Please address Mr. Hahn's contention that the Companies will be adversely affected because their "dividend shares" will decrease if additional equity investments in MAIT are made by FET (OCA St. 1, p. 21, lines 12-24).

A. Mr. Hahn performed an arithmetic exercise purporting to show that dividends paid to the Companies, expressed as a percentage of total dividends paid by MAIT, will decline if FET makes additional equity investments in MAIT that are not matched by the Companies. That is hardly surprising. Under those circumstances, the Companies will get a smaller slice of a larger pie, but the economic value of the dividend yield on their investment in MAIT will not be adversely affected. Let me illustrate with a simple example.

Assume two individuals – A and B – agree to open a joint savings account on January 1, 2016 that pays 3% interest and further agree that each will be entitled to interest on the principal in proportion to the amounts they contribute to the bank account. They open the account with deposits of $1,000 each. On December 31, 2016, the total accrued interest is $60 ($2,000 x 3%) and both A and B withdraw 50% of the accrued interest, or $30 apiece. However, on January 1, 2017, B deposits an additional $1,000 in the joint account. The total in the account is now $3,000. By December 31, 2017, the total accrued interest is $90. However, because B had deposited $2,000 of the $3,000 in the account, he is entitled to 66.66% of the accrued interest, or $60. As a consequence, the percentage of accrued interest to which A is entitled declines to 33.33%, but the dollar amount of the interest to which he is entitled is the same ($30). A's percentage share has declined, but the economic value of his agreement with B stays the same – he still receives $30, which is 3% of his $1,000 deposit. Under the circumstances posited by Mr.

Hahn, the Companies would be represented by A, and FET would be represented by B. The illustrative examples that Mr. Hahn hypothesized in his testimony do not alter the fundamental economic value of the Transaction for the Companies. Under the terms of the Transaction, the Companies get the same "financial support" from MAIT's earnings whether or not FET makes additional investment in MAIT. Mr. Hahn's contention to the contrary is simply wrong.

Q. In addition to the two principal "harms" alleged by Mr. Hahn, which you discussed above, he also contends that the Companies and their distribution customers could be adversely affected because: (1) the Transaction could create the possibility for misallocation of transmission and distribution costs (OCA St. 1, p. 32, lines 15-19); (2) the implementation of a "formula" rate will "increase the cost of transmission service" and produce "more frequent transmission rate increases" (OCA St. 1, p. 32, lines 23-25) and (3) MAIT will pay dividends to the Companies less frequently than PJM distributes transmission revenue to the Companies for furnishing transmission service (OCA St. 1, p. 31, line 26 through p. 32, line 4). Please respond.

A. Mr. Hahn's first two contentions – the possibility for post-Transaction misallocation of costs between the transmission and distribution functions and the potential for higher transmission rates and more frequent increases if a formula rate is implemented by MAIT – are addressed by Mr. Fullem, who explains why there is no basis for either of Mr. Hahn's claims. Mr. Hahn's third contention is also meritless, as I will explain.

It has not been finally determined how frequently MAIT will pay dividends to the Companies, JCP&L and FET. However, the Companies will not be adversely affected even if that interval is longer than the "weekly payments" PJM makes to the Companies, which represent the rate revenue PJM receives from transmission customers for the transmission service the Companies furnish under PJM's OATT. Although PJM makes "weekly payments," the Companies, as the transmission facility providers, incur costs continuously to furnish the transmission service that generates the rate revenue PJM distributes to them. Consequently, the Companies incur expenses to furnish transmission service in advance of receiving revenues from PJM. In short, they have a cash working capital requirement, which imposes a cost – a cost Mr. Hahn simply ignores.

Following the Transaction, the Companies will not incur the same level of continuously accruing expenses to furnish transmission service in advance of receiving transmission rate revenue. Thus, they may not receive "weekly payments," but they also will not incur the working capital requirement that accompanies the obligation to provide transmission service. Mr. Hahn looks at only half of the equation – the benefit of "weekly payments" – while disregarding the other half of that equation – the costs that are imposed to provide the transmission service to generate the rate revenue reflected by those payments. His analysis is incomplete and, therefore, wrong. There is no adverse effect to the Companies as he alleges.

Q. Mr. Hahn has proposed various conditions that he asserts the Commission should impose if it were to approve the Transaction (OCA St. 1, p. 33, line 18 through p. 34, line 30.) One of Mr. Hahn's proposed conditions provides: "A cap of 55% on the MAIT equity ratio to be used for ratemaking purposes after 2 years". Do you agree with Mr. Hahn that such as condition should be attached to the Commission's approval of the Transaction?

A. No, this is simply not the forum to decide such matters, which will be addressed in future FERC proceedings where the FERC will decide what represents a reasonable capital structure for the transmission-owning entity. The OCA, along with other parties, will have a full and fair opportunity to review MAIT's future formula rate filing and to present their position on what they believe is a reasonable capital structure.

Q. Mr. Hahn also proposes as a condition of this Commission's approval that "[a]ny Operating Companies' investment in MAIT should require Commission approval". Do you agree?

A. No, I do not. I've already stated in my Direct Testimony that all future investments in MAIT will be financed with debt capital issued by MAIT and equity infusions from FET. In fact, Mr. Hahn acknowledges in his Direct Testimony (OCA St. 1, p. 22, lines 2-4) that further contributions to MAIT by the Companies after their initial contributions are unlikely to occur. The basis for Mr. Hahn's proposed condition is his belief that a further equity contribution by the Companies to MAIT would require Commission approval because it is "a transaction between affiliates" (OCA St. 1, p. 22, lines 1-2). I have been advised by counsel that a further equity contribution by the Companies to MAIT, if one were made, would not be an affiliated interest agreement subject to the affiliated interest provisions of Chapter 21 of the Public Utility Code.

III. CONCLUSION

Q. Does this conclude your Rebuttal Testimony?

A. Yes, it does, at this time.

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