

**BEFORE THE  
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

**Docket No. R-2024-3046523**

**Duquesne Light Company**

**Statement No. 12**

**Direct Testimony of James Milligan**

**Subjects: Capital Structure, Cost of Long-Term Debt, Credit Ratings, Liability  
Driven Investment Strategy for Pension Assets**

**Dated: March 20, 2024**

1 **Q. Please state your full name and business address.**

2 A. James H. Milligan, 411 Seventh Avenue MD 7-3, Pittsburgh PA 15219.

3

4 **Q. On whose behalf are you testifying?**

5 A. Duquesne Light Company (“Duquesne Light” or “Company”).

6

7 **Q. What is your position at Duquesne Light?**

8 A. I am the Treasurer.

9

10 **Q. What are your current responsibilities?**

11 A. I am responsible for cash management, corporate insurance, workers’ compensation,  
12 capital markets transactions, pension administration, and bank, bondholder, and rating  
13 agency relationship management.

14

15 **Q. Please describe your professional experience and educational background.**

16 A. I received a Bachelor of Science in Marketing and Economics from Indiana University of  
17 Pennsylvania and a Master of Business Administration from the University of Pittsburgh.  
18 I am also a Certified Treasury Professional. I have been employed at Duquesne Light since  
19 February 2008 and in my current role since 2018. Prior to joining Duquesne Light, I served  
20 in various finance positions at Strategic Energy LLC and FirstEnergy Corp.

21

22 **Q. Have you previously testified before the Commission or other regulatory agencies?**

1 A. Yes, I testified in Duquesne Light's 2013 distribution rate case Docket No. R-2013-  
2 2372129, Duquesne Light's 2018 distribution rate case Docket No. 2018-3000124 and  
3 Duquesne Light's 2021 distribution rate case Dockey No. R-2021-3024750.

4  
5 **Q. What is the purpose of your testimony?**

6 A. I will explain the Company's current and future capital structure, cost of long-term debt,  
7 current credit ratings and the importance of maintaining Duquesne Light's credit ratings.  
8 Finally, I will discuss the Company's Liability Driven Investment ("LDI") strategy for the  
9 Company's pension assets.

10

11 **Q. Are you sponsoring any data filing requirements (DFRs) as part of your testimony?**

12 A. Yes, I am sponsoring Duquesne Light's capitalization and cost of capital schedules. Please  
13 see Exhibit JHM-1 to see a list of data filing requirements that I am sponsoring.

14

15 **Company's Current and Future Capital Structure**

16 **Q. Please review Duquesne Light's current and future capital structure.**

17 A. As of December 31, 2023, the capital structure was approximately 45.67% debt and  
18 54.33% equity. During 2023, the Company retained 49% of its net income, or \$90 million,  
19 and accessed short-term and long-term borrowing to support the Company's funding needs.  
20 During 2024, the Company anticipates further using retained earnings of \$183.2 million,  
21 or 73.6% of projected net income. In addition, the Company issued \$130 million of long-  
22 term debt to fund its needs. Similarly, during 2025, the Company anticipates further using  
23 retained earnings of \$178.4 million, or 67% of projected net income, as well as issuing

1 \$200 million of long-term debt to fund its needs. Funding needs during 2024 and 2025  
2 include distribution capital expenditures, of which the majority are related to the  
3 Company's long-term infrastructure improvement plan (LTIIP). As a result of the  
4 increased retained earnings balances expected during the FTY and FPFTY, offset by the  
5 increased long-term debt, the Company's equity as a percentage of total capitalization is  
6 projected to decrease to 53.95% by the end of the FPFTY.

7

8 **Q. What capital structure ratios did the Company use to calculate the revenue**  
9 **requirement in this proceeding?**

10 A. For calculating the revenue requirement, the Company used a capital structure ratio of  
11 46.05% debt and 53.95% equity, which represents the Company's estimated equity  
12 capitalization on December 31, 2025. This capital structure is in line with the average of  
13 the prior three years, as provided in DFR III A-2, and is consistent with Duquesne Light's  
14 capital structure in the FPFTY. Further, as described by Mr. Paul Moul in his testimony,  
15 DLC St. No. 11, this capital structure is within a range of capital structures employed by  
16 Duquesne Light's peers. This capital structure is also supportive of the Company's  
17 projected increased earnings projected to be retained to fund and supports the Company's  
18 capital program and for maintaining the Company's investment grade credit ratings.

19

## 20 **Cost of Long-term Debt**

21 **Q. What is the cost of long-term debt for Duquesne Light?**

22 A. The total adjusted long-term cost of debt requested in the Company's 2021 distribution rate  
23 case was 4.29%. Given the increase in interest rates, future anticipated long-term debt

1 issuances, and the amortization of certain issuance and redemption expenses during the  
2 FTY and FPFTY, the total adjusted long-term cost of debt is expected to increase to  
3 approximately 4.64% by the end of the FPFTY as presented in DFR III-A-1.  
4

5 **Importance of Maintaining Duquesne Light's Credit Ratings**

6 **Q. Why is it important for the Company to maintain its creditworthiness?**

7 A. Duquesne Light's creditworthiness is used to determine whether, and at what cost, capital  
8 should be lent to the Company. The Company's credit ratings are an accepted indication  
9 of creditworthiness used by the capital markets. A low credit rating reduces the availability  
10 and sources of debt capital and makes it more expensive. A company with a non-investment  
11 grade rating may have a smaller universe of buyers for its bonds, which increases the  
12 execution risk of issuing debt and increases the interest rate. This is especially important  
13 with the increase in interest rates that have occurred over the last year. Duquesne Light has  
14 ongoing needs to access the capital markets to fund many uses, most notably its capital  
15 expenditures needed to maintain reliable service to its customers. The Company must be  
16 able to attract this needed capital at reasonable terms in order to fund these requirements.  
17

18 **Q. Please describe Duquesne Light's credit ratings.**

19 A. Duquesne Light's current issuer or corporate credit rating is A3 and BBB+ as rated by  
20 Moody's and Standard & Poor's, respectively. In its Credit Opinion released on September  
21 13, 2023, Moody's noted that Duquesne Light's A3 rating reflects the Company's strong  
22 financial metrics and low-risk business model. Moody's also notes that Duquesne Light is

1 operating in Pennsylvania, a credit supportive regulatory environment characterized by a  
2 transparent and consistent framework.

3

4 On November 13, 2023, Standard & Poor’s affirmed the BBB+ issuer credit rating noting  
5 the Company’s lower-risk, regulated operations. Standard & Poor’s also notes that the  
6 Company operates in a constructive regulatory environment, noting the existence of several  
7 regulatory mechanisms, including future test years and distribution system improvement  
8 charge rider.

9

10 Please see Attachment DFR III-F-4c - Rating Agency Reports for a table illustrating  
11 Duquesne Light’s credit ratings relative to the entire ratings table of Moody’s and Standard  
12 & Poor’s. Duquesne Light’s current issuer credit ratings from Moody’s and Standard &  
13 Poor’s are at the lower end of the investment grade spectrum. A3 is four notches above  
14 non-investment grade and BBB+ is three notches above non-investment rating. As  
15 indicated in Attachment DFR III-F-4c - Rating Agency Reports, ratings below Baa3 for  
16 Moody’s and BBB- for Standard & Poor’s are considered “non-investment” grade and  
17 certain investors are not permitted or are limited in the amount they may invest in bonds  
18 with non-investment grade ratings.

19

20 Duquesne Light’s Corporate Credit Ratings are also at the low end of the Electric Group  
21 provided by Paul Moul in Exhibit PRM-1, Page 6 of 29, Schedule 3 [2 of 2]. There is only  
22 one Electric Group peer with a rating below Duquesne Light’s A3 Corporate Credit Rating

1 assigned by Moody's. Duquesne Light's BBB+ Corporate Credit Rating assigned by  
2 Standard & Poor's is the lowest of the Electric Group.

3

4 **Q. Do you believe that Duquesne Light's current credit ratings provide the Company**  
5 **with the financial flexibility it requires to meet customer needs at reasonable rates?**

6 A. Yes, Duquesne Light's current investment grade ratings are adequate to allow the Company  
7 to efficiently access the capital markets and do so at a reasonable cost. However, the  
8 Company must be able to continue to show cash flows sufficient to recover costs and earn  
9 a reasonable return in the future to maintain these ratings. The requested equity  
10 capitalization is also key to maintaining Duquesne Light's current ratings as it helps to  
11 offset other risks the Company faces such as its small geographic footprint.

12

13 Any downward pressure on the rating agency's credit metrics could result in a downgrade  
14 of the issuer rating to non-investment grade by one or both agencies, which, in turn, could  
15 result in higher financing costs and greater execution risk when accessing the capital  
16 markets. A one notch downgrade in credit ratings by both agencies could increase interest  
17 rates of the by approximately 25 basis points under the terms of its current Credit  
18 Agreement and 50 to 100 basis points on new long-term debt issued, depending on the  
19 tenor, or time to maturity, and other relevant factors. Maintaining current credit ratings  
20 ensures lower borrowing costs for Duquesne Light. Lower borrowing costs for Duquesne  
21 Light benefit ratepayers as lower rates.

22

1 **Q. Are the results of this rate proceeding important to the Company’s ability to maintain**  
2 **its current credit ratings?**

3 A. Yes, as noted, the ability to recover costs and earn a reasonable return is an important  
4 criterion used by the rating agencies in determining the Company’s creditworthiness. As  
5 noted, the support of the regulatory bodies is an important qualitative factor considered by  
6 the rating agencies. In its Credit Opinion released on September 13, 2023, Moody’s states  
7 that “a deterioration in credit metrics” or the “regulatory jurisdiction becomes less credit  
8 supportive such that regulatory lag increases, or cost recovery is negatively affected” as  
9 factors that could lead to a downgrade.

10

11 In addition to the regulatory environment, the rating agencies assess the Company’s market  
12 position, geographic diversity, and its overall financial strength. Moody’s notes that  
13 Duquesne Light’s “relatively small size and scale” represents a challenge to its credit  
14 ratings and Standard & Poor’s similarly includes a lack of diversity for Duquesne Light as  
15 a key risk. Due to Duquesne Light’s small size and lack of geographic and market  
16 diversification, it is required to have stronger financial metrics and lower overall business  
17 risk to attain a similar rating as a larger, more geographically diverse utility. Stronger  
18 financial metrics would include having a capital structure with higher equity capitalization  
19 and stronger cash flows compared to interest and debt levels.

20

21 **Liability Driven Investment Strategy for the Company’s Pension Assets**

22 **Q. Has Duquesne Light faced any challenges related to pension funding requirements**  
23 **because of market volatility and the economy in general over that past several years?**

1 A. Yes, Duquesne Light’s pension plan was more than fully funded at year-end 2007, but by  
2 year-end 2008 the funded status had deteriorated due to the sharp decline in the equity  
3 markets during that period. The deterioration in the funded status resulted in higher  
4 required contributions to be made to the plan, as prescribed by The Pension Protection Act  
5 of 2006 (“PPA”).

6

7 **Q. Has the Company taken any steps to manage the funding risks presented by the**  
8 **pension plan?**

9 A. Yes, the Company closed entry into its defined benefit plan for new management hires in  
10 2007 and new union hires in 2010. The tangible benefits of closing the plan take several  
11 years to realize. As of January 1, 2023, there were just 367, or 21%, of active employees  
12 in the pension plan and accruing benefits. 86% of the 4,235 total participants are retired as  
13 of January 1, 2023. The risks associated with the pension liability related to active  
14 membership will continue to decrease as these members retire or are no longer employed  
15 by Duquesne Light. The Company also executed two lump sum buyouts of terminated and  
16 vested employees since 2015 that reduced the size of the pension plan liability, while  
17 providing a beneficial option to those former employees.

18

19 **Q. Are there any additional strategies for managing the volatility of the pension’s funded**  
20 **status and, thereby, manage the volatility of the pension funding requirements, which**  
21 **the Company is pursuing?**

22 A. Yes, the Company began implementing a Liability Driven Investment (“LDI”) strategy in  
23 2012 to mitigate the volatility associated with pension plan funding. LDI is an investment

1 strategy that focuses on managing pension assets in relation to pension liabilities and is  
2 similar to the investment strategy insurance companies have used for many years under the  
3 name of Asset Liability Management. The strategy has been adopted by pension plan  
4 sponsors with a significant motivation to manage volatility of the pension funded status.  
5 Reduced volatility in pension plan funded status and pension plan funding can provide  
6 greater predictability to the Company's cash management and capital planning and provide  
7 more stable rates for customers.

8

9 **Q. How does LDI mitigate funded status and funding requirement risks of the pension**  
10 **plan?**

11 A. LDI is a risk and volatility mitigation strategy, but it does not eliminate risk and volatility.  
12 The overall goal of LDI is to minimize the volatility of Plan funded status, and thus  
13 contribution volatility, by investing in long duration fixed income strategies that attempt to  
14 better match the duration of the Plan's liabilities. To see how the volatility of the funding  
15 status is reduced by LDI, consider the following example. Assume interest rates decline.  
16 The discount rate used to calculate the present value of the pension plan liabilities declines,  
17 which results in the present value of the pension plan liabilities increasing due to the  
18 discounting of future benefit payments at lower rates. Simultaneously, as interest rates  
19 decline the market value of the pension plan fixed income assets increases due to the  
20 discounting of future coupon payments at lower rates. With perfect correlation, which is  
21 unattainable, the changes in the pension plan liability would move dollar for dollar with a  
22 change in the pension plan assets and vice versa. Nevertheless, the offsetting effects of the

1 LDI strategy on assets and liabilities should dampen variations in the funded status of the  
2 Plan.

3

4 **Q. Are there any negative aspects of an LDI strategy?**

5 A. An underfunded plan that switches to an LDI strategy could have higher funding  
6 contributions to return the plan to a fully funded status due to the plan's investments  
7 earning less. To offset this need for higher contributions, Duquesne Light has transitioned  
8 from its former return seeking strategy to an LDI strategy over time as funded status of the  
9 pension improves. This implementation plan balanced the near-term need for assets with  
10 higher expected returns with a longer-term recognition that lower funded status volatility  
11 strategies is a more suitable investment strategy for the pension plan. As funded status  
12 improves, the plan has and will continue to increase the amount of assets invested in LDI  
13 mandate investments which will help to preserve the improved funded status. At present,  
14 the plan is close to 100% funded and has approximately 75% of its pension assets in an  
15 LDI mandate. A limit on the effectiveness of LDI is that even after LDI has been fully  
16 implemented by the Company, the pension plan will still not be perfectly hedged from  
17 movement in its liabilities, as interest-rate movements do not compose all variables that  
18 impact liabilities. In addition, it is never possible to perfectly match the liability discount  
19 rate with returns from fixed income of the same duration, so all the risks associated with  
20 funding status will never be eliminated. For this reason and to offset service costs, as  
21 explained by Ms. Nayden's testimony in Statement No 2, the Company recommends  
22 continuing to contribute \$10 million annually to the pension plan going forward.

23

1 Market volatility during the last several years created a good test for the funded status of  
2 the pension plan and the Company's LDI strategy. Despite the S&P 500 index decreasing  
3 in value by more than 19% during 2022, the funded status of the Duquesne Light pension  
4 plan remained steady at approximately 100% and has remained there to the present. Going  
5 forward, assuming the Duquesne Light continues to make the \$10 million annual voluntary  
6 contributions, the funded status is projected to maintain a funded status around 99%.

7

8 **Q. Is LDI a common investment strategy for pension plans?**

9 A. Yes, and it is increasing in popularity, especially with companies that are seeking to  
10 manage funded status volatility to avoid a recurrence of the large pension funding status  
11 deteriorations that have occurred in the past.

12

13 **Q. Does that conclude your testimony?**

14 A. Yes, it does.