STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

FILED
July 26, 2017
INDIANA UTILITY
REGULATORY COMMISSION

PETITION OF INDIANA MICHIGAN POWER COMPANY, AN INDIANA CORPORATION, FOR (1) AUTHORITY TO INCREASE ITS RATES AND CHARGES FOR ELECTRIC UTILITY SERVICE THROUGH A PHASE IN RATE ADJUSTMENT; (2) APPROVAL OF: REVISED DEPRECIATION RATES; ACCOUNTING RELIEF; INCLUSION IN BASIC RATES AND CHARGES OF QUALIFIED POLLUTION CONTROL PROPERTY, CLEAN ENERGY PROJECTS AND COST OF BRINGING I&M'S SYSTEM TO ITS PRESENT STATE OF EFFICIENCY; RATE ADJUSTMENT MECHANISM PROPOSALS; COST DEFERRALS; MAJOR STORM DAMAGE RESTORATION RESERVE AND DISTRIBUTION VEGETATION MANAGEMENT PROGRAM RESERVE; AND AMORTIZATIONS; AND (3) FOR APPROVAL OF NEW SCHEDULES OF RATES, RULES AND REGULATIONS.	)	CAUSE NO. 44967-NONE

SUBMISSION OF DIRECT TESTIMONY OF FRANZ D. MESSNER

Petitioner, Indiana Michigan Power Company (I&M), by counsel, respectfully submits the direct testimony of Franz D. Messner in this Cause.

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CERTIFICATE OF SERVICE

The undersigned certifies that the foregoing was served upon the following via electronic email, hand delivery or First Class, or United States Mail, postage prepaid this 26th day of July, 2017 to:

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I&M Exhibit: _____

INDIANA MICHIGAN POWER COMPANY

PRE-FILED VERIFIED DIRECT TESTIMONY

OF

FRANZ D. MESSNER

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PRE-FILED VERIFIED DIRECT TESTIMONY OF FRANZ D. MESSNER ON BEHALF OF INDIANA MICHIGAN POWER COMPANY

Q. Please state your name and business address.

A. My name is Franz D. Messner. My business address is 1 Riverside Plaza, Columbus, Ohio 43215.

Q. By whom are you employed and in what capacity?

A. I am employed by American Electric Power Service Corporation (AEPSC) as Managing Director of Corporate Finance. AEPSC supplies engineering, financing, accounting, planning, advisory, and other services to the subsidiaries of the American Electric Power (AEP) system, one of which is Indiana Michigan Power Company (I&M or the Company).

Q. Please briefly describe your educational background and business experience.

A. I earned a Bachelor of Science in Systems Engineering from the United States Naval Academy in 1990. I earned a Master of Business Administration from the Fisher College of Business at the Ohio State University in 1999.

In June 1999, I was hired by AEPSC as an associate in a finance associate development program. My primary roles have been in the areas of financial analysis, budgeting, and forecasting. In July 2007, I was named Manager in Corporate Planning and Budgeting and subsequently promoted to Director in November 2009. In May 2016, I assumed my current position as Managing Director of Corporate Finance.

PURPOSE OF TESTIMONY

Q. What is the purpose of your testimony in this proceeding?

A. The purpose of my testimony in this proceeding is to present and support the following:

- Capital structure and weighted average cost of capital for I&M.
- Financing activity between December 31, 2016, the end of the historical period, and December 31, 2018, the end of the forward-looking test year (Test Year).
- Credit ratings of I&M, including the impact of the Rockport Unit 2 Lease on those ratings.

Q. Are you sponsoring any exhibits in this proceeding?

A. I am sponsoring the following exhibit:

- I&M Exhibit A-7: Projected Capital Structure and Weighted Average Cost of Capital.

Q. Are you sponsoring any workpapers in this proceeding?

A. I am sponsoring the following part of WP-I&M-1:

- WP-I&M-1-6: Historical Capital Structure and Weighted Average Cost of Capital.

Q. Were the exhibit and workpaper that you are sponsoring prepared by you or under your direction?

A. Yes.

WEIGHTED AVERAGE COST OF CAPITAL

Q. What is I&M's proposed weighted average cost of capital for rate making purposes in this proceeding?

A. The Company is proposing an overall weighted average cost of capital of 5.94% at the beginning of the Test Year (December 31, 2017) and 5.88% at the end of the Test Year (December 31, 2018). In both cases, the Company utilizes a Return on Equity (ROE) of 10.60%, supported by Company witness Hevert.

Q. Please describe I&M's projected capital structure and weighted average cost of capital as shown in Exhibit A-7.

A. Exhibit A-7 computes the weighted average cost of capital for I&M with both permanent capital and ratemaking adjustments. As shown in Exhibit A-7, I&M's projected overall weighted average cost of capital, inclusive of ratemaking adjustments, is 5.94% at the beginning of the Test Year (December 31, 2017), and 5.88% at the end of the Test Year (December 31, 2018). Both of these are lower than the 7.38% rate I&M reflected in Cause No. 44075, I&M's last Indiana basic rate proceeding. Figures FDM-1 and FDM-2 summarize the Company's projected weighted average cost of capital as shown in Exhibit A-7 for the beginning and end of the Test Year.

Figure FDM-1
Projected Weighted Average Cost of Capital at the Beginning of the Test Year, December 31, 2017
(Exhibit A-7, Pg. 1)

Line No.	(a) Description	(b) Total Company Capitalization	(c) Percent of Total	(d) % Cost Rate [(1)]	(e) % Weighted Average Cost Rate
1		$			
2	Long Term Debt	2,306,411,585	38.49%	5.02%	1.93%
3	Common Equity	2,219,221,019	37.04%	10.60%	3.93%
4	Customer Deposits	34,318,118	0.57%	6.00%	0.03%
5	Acc. Def. FIT	1,398,076,372	23.33%	0.00%	0.00%
6	Acc. Def. JDITC	34,075,627	0.57%	7.76%	0.04%
7					
8	Total	5,992,102,721	100.00%		5.94%
9					
10					
11					
12	Cost of Investor Supplied Capital				
13	Long Term Debt	2,306,411,585	50.96%	5.02%	2.56%
14	Common Equity	2,219,221,019	49.04%	10.60%	5.20%
15	Total	4,525,632,604	100.00%		7.76%

Figure FDM-2
Projected Weighted Average Cost of Capital at the End of the Test Year, December 31, 2018
(Exhibit A-7, Pg. 3)

Line No.	(a) Description	(b) Total Company Capitalization	(c) Percent of Total	(d) % Cost Rate [(1)]	(e) % Weighted Average Cost Rate
1		$			
2	Long Term Debt	2,604,833,347	40.57%	5.14%	2.09%
3	Common Equity	2,260,801,136	35.21%	10.60%	3.73%
4	Customer Deposits	34,318,118	0.53%	6.00%	0.03%
5	Acc. Def. FIT	1,491,396,430	23.23%	0.00%	0.00%
6	Acc. Def. JDITC	29,388,703	0.46%	7.68%	0.04%
7					
8	Total	6,420,737,734	100.00%		5.88%
9					
10					
11					
12	Cost of Investor Supplied Capital				
13	Long Term Debt	2,604,833,347	53.54%	5.14%	2.75%
14	Common Equity	2,260,801,136	46.46%	10.60%	4.93%
15	Total	4,865,634,483	100.00%		7.68%

Exhibit A-7 computes the projected weighted average cost of capital for I&M, including deferred taxes and customer deposits. Pages 1 and 3 of Exhibit A-7 (shown in Figures FDM-1 and FDM-2) show the computation of the overall weighted average cost of capital for I&M. Column (a) shows the components of capital, which includes long-term debt, common equity, customer deposits, accumulated deferred federal income taxes (Acc. Def. FIT), and accumulated deferred job development investment tax credits (Acc. Def. JDITC). Column (b) shows the capitalization by component at December 31, 2017 (Figure FDM-1) and December 31, 2018 (Figure FDM-2). Column (c) identifies each component's percentage of I&M's total capital, and Column (d) identifies the cost rates associated with each component. Column (e) shows the weighted average cost of capital by component.

Q. Please describe I&M's projected cost of long-term debt as shown in Exhibit A-7.

A. Pages 2 and 4 of Exhibit A-7 show a detailed schedule of long-term debt, reflecting projected balances outstanding and associated costs at the beginning of the Test Year (December 31, 2017) and at the end of the Test Year (December 31, 2018).

Q. What is the source of the other cost rates in Exhibit A-7?

A. The 10.60% rate of return on common equity was provided to me by Company Witness Hevert. The cost rate assigned to accumulated deferred job development investment tax credits (JDITC) is the weighted average cost rate of investor-provided capital. No cost was assigned to the accumulated deferred federal income tax. A 6.0% cost rate was applied to the balance of customer deposits consistent with Commission rules. The cost of capital calculations are consistent with the Commission's order in I&M last basic rate proceeding, Cause No. 44075.

Q. How did the Company project the common equity balances in Exhibit A-7?

A. I&M's projected common equity balances – $2,219,221,019 at December 31, 2017 and $2,260,801,136 at December 31, 2018 – were derived from the Company's forecast for 2017-2018 supported by Company Witness Lucas.

Q. How did the Company determine the balances of customer deposits in Exhibit A-7?

A. The balances in customer deposits in Exhibit A-7 were derived from the Company forecast for 2017-2018 supported by Company Witness Lucas.

Q. How did the Company determine the balances of accumulated deferred income taxes (ADIT) and accumulated deferred job development investment tax credits (JDITC) in Exhibit A-7?

A. The data used to determine the balances of ADIT and JDITC in Exhibit A-7 was derived from the Company forecast for 2017-2018 supported by Company Witness Lucas. The balances of ADIT and JDITC were calculated and provided by Company Witness Bartsch.

Q. How were the historical capital structure and weighted average cost of capital determined in Work paper WP-I&M-1-6?

A. The historical calculations in WP-I&M-1-6 are based on actual data reflected in the Company 10-K. The calculations were prepared in a manner similar to the projected calculations in Exhibit A-7.

FINANCING ACTIVITY

Q. Please describe I&M's financing activity between December 31, 2016, the end of the historical period, and December 31, 2018, the end of Test Year.

A. In March 2017, the Company refinanced the City of Lawrenceburg Series 2008 H and I pollution control bonds for $77,000,000. In May 2017, the Company refinanced the City of Rockport Series D pollution control bonds for $40,000,000. In June 2017 the Company issued $300,000,000 of new long term debt to supplement the cash flow needs of its ongoing capital investment program. In June 2017 the Company repurchased the $50,000,000 City of Rockport Series 2002 A pollution control bonds and currently holds them in trust. The Company intends to refinance them in September 2017. The Company intends to renew the $200,000,000 local bank term loan facility in May 2018. In addition, the Company intends to issue $300,000,000 of new long term debt and refinance both of the City of Rockport Series 2009 A and B pollution control bonds for $100,000,000 in June 2018. See below the assumptions associated with this projected financing activity:

- City of Lawrenceburg Series 2008 H and I – The variable rate demand notes were previously backed by Bank of Nova Scotia Letters of Credit

(LC), which expired in March 2017. Following the LC expirations, the Company refinanced the bonds without credit enhancement.

- City of Rockport Series D – The pollution control bonds were previously held in trust. In May 2017, the Company refinanced the bonds at a fixed rate with a mandatory put date of June 1, 2021.

- City of Rockport Series 2002A – The bonds were repurchased on June 1, 2017. The Company intends to refinance the bonds in September 2017 for an additional 8 year tenor, maturing in 2025.

- New long term debt – The Company plans to issue approximately $600,000,000 of Senior Unsecured Notes to supplement the needs of its capital investment program. On June 29, 2017 the Company issued $300,000,000 of this amount with a coupon of 3.75% and a tenor of 30 years. Due to the proximity of this issuance to the base case filing, the Company did not adjust its weighted average cost of capital calculation to reflect this issuance.

- Local Bank Facility – The current facility expires in May 2018. At that time, the Company expects to renew and extend its current agreement for an additional 3 years.

- City of Rockport Series 2009 A and B – The bonds are subject to mandatory tender on June 1, 2018. The Company intends to refinance the bonds for an additional four year tenor, through June 2022. The Company will then refinance for an additional three year tenor, maturing in June 2025.

CREDIT RATINGS

Q. Please Discuss I&M's position with the credit rating agencies.

A. I&M's senior unsecured ratings are A- at Standard & Poor's (S&P) and Baa1 at Moody's Investors Service (Moody's). As shown in the Company's response to Minimum Standard Filing Rule (MSFR) 170 IAC 1-5-13(a)(10), on February 2, 2017, S&P upgraded I&M and all other AEP operating companies from BBB+ to A-. In January 2014, Moody's upgraded I&M's credit rating from Baa2 to its current rating of Baa1. On March 1, 2017, Moody's upgraded I&M's outlook on its credit rating from Baa1 (stable) to Baa1 (positive). According to Moody's published credit opinion, the positive outlook recognizes the significant number of automatic and transparent rate recovery mechanisms that have been put in place for I&M over the years. The positive outlook is also due to the historically strong financial credit metrics for the Company's Baa1 rating.

Q. Generally describe the methodology of each rating agency.

A. S&P evaluates the credit of each operating company utilizing a family approach, factoring in the ratings of all AEP system subsidiaries. S&P's family approach to bond ratings for individual operating companies stresses the inherent benefits and risks associated with having a diversified family of operating companies across AEP's eleven-state service territory.

Unlike S&P's family methodology, Moody's rates each individual operating company based on the merits of the underlying operations and credit profile of that individual operating company. Therefore, Moody's will be my primary focus when discussing I&M's credit adjusted capitalization.

Q. Does the historical capitalization represented in Workpaper WP-I&M-1-6 differ from the capitalization measured by Moody's?

A. Yes, in Workpaper WP-I&M-1-6, the Company has reflected a capitalization consistent with current accounting principles accepted in the United States, otherwise known as Generally Accepted Accounting Principles (GAAP). There is a significant divergence from GAAP capitalization and the capitalization measured by Moody's. This difference is primarily due to Moody's capitalization adjustments, which are made available in published reports. Most significantly, Moody's includes all leases as debt. I will refer to this as credit-adjusted debt.

Q. Please explain Moody's credit adjustments on I&M's per books capitalization.

A. Moody's adjusts the Company's per books debt balance for:

- Capital and operating lease obligations.
- The amount of underfunded pension plans.
- Securitized borrowings associated with the sale of accounts receivable.

Additionally, Moody's adjusts the Company's per book equity balance for deferred taxes and capitalized interest.

Q. What is the primary driver of Moody's credit adjusted debt for I&M?

A. Operating leases account for the largest adjustment to the per books debt balance at I&M due to the Rockport Plant Unit 2 Lease.

Q. Please briefly summarize the Rockport Plant Unit 2 Operating Lease.

A. As discussed by company witness Thomas, on December 7, 1989, AEP Generating Company (AEG), a subsidiary of AEP, and I&M each sold its 50% undivided interest in Rockport Unit 2 to Owner Trustees of six separate trusts (Lessors) established for the benefit of six equity investors (Owner Participants) for an aggregate purchase price of $1.7 billion. Simultaneously, each Lessor leased the undivided interest it purchased back to the Company and AEG under a separate long-term lease. Lease payments are made semi-annually by AEG and I&M.

Q. Please explain how Moody's calculates the credit adjustment for operating leases.

A. Because of a lease's inherent contractual obligation qualities, Moody's recognizes all leases as debt-like instruments. Moody's operating lease adjustment is calculated using the present value of the lease commitments.

Q. What is the approximate debt adjustment calculated by Moody's for I&M's operating leases?

A. At December 31, 2016, the total future minimum operating lease commitments at I&M were approximately $528 million. Utilizing Moody's lease methodology, the net present value of the future minimum operating lease commitments results in a debt adjustment of approximately $467 million, of which $393 million is attributable to the Rockport Unit 2 Lease.

Q. Overall, is the Company's per books capitalization appropriate for ratemaking?

A. Yes. It is critically important to understand the credit impacts resulting from lease obligations in order to prudently manage the Company's capital structure and to protect its credit profile, which ultimately benefits our customers because the Company is able to competitively source capital at lower interest rates.

Q. Does this complete your pre-filed verified direct testimony?

A. Yes.

VERIFICATION

I, Franz D. Messner, Managing Director of Corporate Finance for American Electric Power Service Corporation, affirm under penalties of perjury that the foregoing representations are true and correct to the best of my knowledge, information, and belief.

Date: July 24, 2017

Franz D. Messner