



**NORTH CAROLINA
PUBLIC STAFF
UTILITIES COMMISSION**

June 10, 2016

Ms. Gail L. Mount, Chief Clerk
North Carolina Utilities Commission
4325 Mail Service Center
Raleigh, North Carolina 27699-4300

Re: Docket Nos. E-2, Sub 1095, E-7, Sub 1100, and G-9, Sub 682
Duke-Piedmont Merger Application

Dear Ms. Mount:

In connection with the above-referenced dockets, I transmit herewith for filing the testimony of James G. Hoard, Director of the Accounting Division of the Public Staff.

By copy of this letter, I am forwarding a copy of the above to all parties of record.

Yours very truly,

Electronically submitted
/s/ Antoinette R. Wike
Chief Counsel
antoinette.wike@psncuc.nc.gov

ARW/bll
Enclosures
c: Parties of Record

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PUBLIC STAFF – NORTH CAROLINA UTILITIES COMMISSION
DIRECT TESTIMONY OF JAMES G. HOARD
BEFORE THE NORTH CAROLINA UTILITIES COMMISSION
DOCKET NOS. E-2, SUB 1095, E-7, SUB 1100, AND G-9, SUB 682

June 10, 2016

1 Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS, AND
2 PRESENT POSITION.

3 A. My name is James G. Hoard, and my business address is 430 North
4 Salisbury Street, Raleigh, North Carolina. I am the Director of the
5 Accounting Division of the Public Staff. My qualifications and
6 experience are provided in Appendix A.

7 Q. PLEASE DESCRIBE THE PURPOSE OF YOUR TESTIMONY IN
8 THIS PROCEEDING.

9 A. The purpose of my testimony is to present the results of the Public
10 Staff's investigation of the application filed on January 15, 2016, by
11 Duke Energy Corporation (Duke Energy) and Piedmont Natural Gas
12 Company, Inc. (Piedmont) (collectively, the Applicants), pursuant to
13 G.S. 62-111(a) for authority to engage in the proposed business
14 combination transaction (Merger) as set forth in the Merger
15 Agreement attached to the application as Exhibit A; and to revise and
16 apply Duke Energy Carolinas, LLC's (DEC) and Duke Energy
17 Progress, LLC's (DEP) Regulatory Conditions and Code of Conduct
18 to Piedmont. In my testimony, I describe the scope of the Public

1 Staff's investigation of the proposed Merger; discuss the balancing
2 of costs and benefits of a proposed business combination; describe
3 major provisions of the Agreement and Stipulation of Settlement
4 (Stipulation) between the Applicants and the Public Staff (the
5 Stipulating Parties); discuss the rules governing affiliate transactions;
6 describe the new Regulatory Conditions and Code of Conduct
7 provisions related to the Merger; and present the Public Staff's
8 recommendation regarding Commission approval of the transaction.

9 Q. PLEASE DESCRIBE THE PUBLIC STAFF'S INVESTIGATION.

10 A. A task force of accountants, engineers, attorneys, and financial
11 analysts conducted an investigation of the proposed Merger,
12 including the market power and cost-benefit analyses submitted with
13 the application. The Public Staff submitted data requests to the
14 Applicants and reviewed the responses to those data requests. The
15 Public Staff also reviewed the Merger proxy statements and other
16 documents filed by the Applicants with the Securities and Exchange
17 Commission, and the Applicants' submissions to the Federal Trade
18 Commission and the US Department of Justice pursuant to the Hart-
19 Scott-Rodino Antitrust Improvements Act.

20 Q. WHY IS IT IMPORTANT TO IDENTIFY AND BALANCE THE
21 COSTS AND BENEFITS OF A PROPOSED MERGER OR
22 BUSINESS COMBINATION?

1 A. G.S. 62-111(a) provides that no merger or combination affecting any
2 public utility shall be made through acquisition or control by stock
3 purchase or otherwise, except after Commission approval, which
4 "shall be given if justified by the public convenience and necessity."
5 This statute requires the Commission to review all aspects of a
6 proposed merger and to balance all potential benefits and costs of
7 the merger in determining whether the transaction should be
8 approved. In reviewing applications for merger approval, the
9 Commission has considered such factors as the maintenance of or
10 improvement in service quality, the extent to which costs can be
11 lowered and rates can be maintained or reduced, the extent to which
12 the merger could have anticompetitive effects, the continuation of
13 effective state regulation, and the relationships between and among
14 the various units of the merged firm. In approving a merger
15 application, the Commission has sought to ensure that the proposed
16 transaction would have no adverse impact on the rates charged and
17 the service provided to North Carolina jurisdictional ratepayers,¹ that
18 ratepayers were protected and insulated to the maximum extent
19 possible from all known and potential costs and risks associated with
20 the transaction, and that the benefits of the transaction to ratepayers
21 were sufficient to offset those potential costs and risks.

¹ Includes North Carolina retail customers of DEC and DEP and North Carolina customers of Piedmont.

1 The Commission's *Order Requiring Filing of Analyses* issued
2 November 2, 2000, in Docket No. M-100, Sub 129, requires that
3 merger applications be accompanied by a market power analysis
4 and a cost-benefit analysis. The Applicants submitted that the cost-
5 benefit analysis and market power analysis attached to the
6 application comply with this requirement. In its *Order Scheduling*
7 *Hearing, Establishing Procedural Deadlines, and Requiring Public*
8 *Notice* issued on March 2, 2016, in the current proceeding, the
9 Commission found and concluded that the application satisfies the
10 requirements of the *Order Requiring Filing of Analyses*. An
11 investigation and verification of the cost-benefit analysis and market
12 power analysis is an essential part of the Commission's
13 consideration of the proposed Merger and the application of the
14 statutory standard for approval. As evidenced by the Stipulation, the
15 Public Staff believes the quantitative benefits, together with the
16 agreed upon regulatory conditions, are sufficient to meet that
17 standard.

18 Q. PLEASE DESCRIBE THE PROPOSED TRANSACTION.

19 A. Duke Energy proposes to pay \$60 per share, all cash, for the
20 outstanding common stock of Piedmont, which results in a purchase
21 price of approximately \$4.85 billion.² Based on Piedmont's book
22 value as of October 31, 2015, of \$1.42 billion, the purchase will result

² Duke Energy will also assume approximately \$1.8 billion in existing Piedmont debt.

1 in a \$3.43 billion acquisition premium, which will be recorded at the
2 Duke Energy holding company level and will not impact Piedmont's
3 financial statements. Upon the close of the Merger, Piedmont will no
4 longer be a publicly traded company, but will continue to exist as a
5 wholly-owned direct subsidiary of Duke Energy. Piedmont is
6 expected to retain its current name, corporate form and
7 headquarters. In addition, it is expected that Frank Yoho, who
8 currently serves as Piedmont's Senior Vice President and Chief
9 Commercial Officer and is an existing member of Piedmont's senior
10 management team, will manage Duke Energy's natural gas
11 operations. These post-Merger natural gas operations will consist of
12 Piedmont, Duke Energy's existing Midwest local distribution
13 company (LDC) operations, and gas infrastructure investments
14 across Duke Energy.

15 Q. PLEASE EXPLAIN THE MAJOR PROVISIONS OF THE
16 STIPULATION.

17 A. Presented below is a description of the matters agreed upon by the
18 Applicants and Public Staff in the Stipulation:

19 Merger-related Costs Savings. On March 11, 2016, Piedmont filed
20 in Docket No. G-9, Sub 686, an Application for Approval of Deferred
21 Accounting Treatment of Certain Distribution Integrity Management
22 Costs. In that filing, Piedmont estimated that its costs subject to
23 deferral would be as high as \$18.03 million for North Carolina over

1 the next five years, or approximately \$3.6 million per year. The
2 Stipulating Parties have agreed Piedmont will withdraw that request
3 for deferral accounting.

4 In addition, the Stipulating Parties have agreed that Piedmont will
5 commit to credit its North Carolina Integrity Management Deferred
6 Account (IM Deferred Account) a total of \$10 million to its North
7 Carolina customers, \$5 million per year for the first two years
8 following the close of the Merger. The credits recorded in the IM
9 Deferred Account reduce the amount that ratepayers will pay related
10 to Piedmont's Integrity Management Rider by \$10 million.

11 To avoid potential double-counting of Merger-related cost savings,³
12 the Stipulating Parties have agreed that in the event of a Piedmont
13 general rate case with rates effective no more than two years from
14 the Merger close, (1) Piedmont reserves the right to reflect an
15 adjustment in the general rate case that would increase its revenue
16 requirement for a portion of the \$10 million in savings that Piedmont
17 has agreed to credit to its IM Deferred Account and (2) should
18 Piedmont exercise its right to reflect such an adjustment, the Public
19 Staff reserves the right to incorporate the effect of additional Merger-
20 related savings in its proposed revenue requirement calculation.

³ This issue arose in the context of the Duke-Cinergy merger docket (Docket No. E-7, Sub 795) and subsequent DEC rate case proceeding (Docket No. E-7, Sub 828).

1 Annual Community Support and Charitable Contributions. Beginning
2 January 1, 2017, DEC, DEP, and Piedmont will fund The Duke
3 Energy Foundation and Piedmont Natural Gas Foundation for four
4 years at annual levels no less than \$9.65 million, \$6.375, and \$1.5
5 million, for community support and charitable contributions in the
6 North Carolina service territories of DEC, DEP and Piedmont,
7 respectively. Comparable levels of community support and
8 charitable contributions in the North Carolina service territories of
9 DEC and DEP were \$9.2 million and \$7.328 million, respectively,
10 agreed to in connection with the 2012 merger of Duke Energy and
11 Progress Energy.

12 Other Contributions. Within twelve months of the close of the
13 Merger, DEC, DEP, and Piedmont will contribute a total of \$7.5
14 million to their respective foundations for workforce development and
15 low income energy assistance as may be agreed upon with the
16 Public Staff. These contributions will be allocated among the North
17 Carolina service territories of DEC, DEP, and Piedmont in proportion
18 to the number of North Carolina jurisdictional customers served by
19 each. The Duke-Piedmont transaction is considerably smaller than
20 the 2012 Duke-Progress transaction, and thus a smaller agreed-
21 upon contribution in connection with this transaction relative to the
22 \$15 million for workforce development and low-income energy

1 assistance agreed to in connection with the 2012 Duke-Progress
2 transaction is reasonable.

3 Revised GS-1 Report. Effective upon the close of the Merger,
4 Piedmont will begin utilizing a revised NCUC GS-1 Earnings
5 Surveillance Report (GS-1 Report) format that is similar to the format
6 of the ES-1 Earnings Surveillance Report (ES-1 Report) that is
7 submitted to the Commission by the major electric utilities. The
8 ES-1 Report currently submitted by DEC and DEP includes
9 comprehensive computations of the return on equity for each
10 jurisdiction in which the utilities operate, along with supporting
11 financial reports, supplemental information, and computations.
12 Piedmont currently submits only the supporting financial reports and
13 supplemental information. With the change in report format,
14 Piedmont will provide the computations of the jurisdictional returns
15 on equity and supporting computations, in addition to the information
16 currently provided.

17 Merger-related Direct Expenses. The direct expenses associated
18 with the Merger will be excluded from the regulated expenses of
19 Piedmont, DEC, and DEP for Commission financial reporting and
20 ratemaking purposes. Direct merger costs are composed of change-
21 in-control payments made to terminated executives, regulatory
22 process costs, and transaction costs, such as investment banker and
23 legal fees for transaction structuring, financial market analysis, and

1 fairness opinions based on formal agreements with investment
2 bankers. The Applicants have estimated transaction costs of \$125
3 million. In addition, Piedmont estimates in its Definitive Proxy
4 Statement dated December 14, 2015 (Definitive Proxy Statement)
5 that change in control payments to Piedmont executives could total
6 as much as \$46.8 million.⁴ Piedmont, DEC, and DEP have agreed
7 to file a summary report of their final accounting for Merger-related
8 direct expenses within 60 days after the close of the Merger, and
9 supplemental reports, as necessary, within 60 days after each
10 quarter.

11 Merger-related Transition Costs. In order to hold the North Carolina
12 ratepayers of Piedmont and the North Carolina retail ratepayers of
13 DEC and DEP harmless from any adverse effect of the Merger on
14 rates, the Stipulating Parties agreed that Merger-related transition
15 costs will be treated as follows:

- 16 (a) DEC, DEP, and Piedmont may request recovery through
17 depreciation or amortization, and inclusion in rate base, as
18 appropriate and in accordance with normal ratemaking
19 practices, their respective shares of capital costs associated
20 with achieving merger savings, such as system integration
21 costs and the adoption of best practices, including information
22 technology, provided that such costs are incurred no later

⁴ Definitive Proxy Statement, page 51, the sum of the amounts shown in the Total column.

1 than three years from the close of the Merger and result in
2 quantifiable cost savings that offset the revenue requirement
3 effect of including the costs in rate base. Only the net
4 depreciated costs of such system integration projects at the
5 time the request is made may be included, and no request for
6 deferrals of these costs may be made.

7 (b) DEC's, DEP's, and Piedmont's Merger-related severance
8 costs will be excluded from DEC's, DEP's, and Piedmont's
9 cost of service for ratemaking purposes.

10 Pursuant to Regulatory Condition 5.19, DEC and DEP, in their
11 respective ES-1 Reports, and Piedmont in its GS-1 Report must
12 reflect these costs to achieve Merger savings in accordance with
13 generally accepted accounting principles and identify the North
14 Carolina portions of these costs.

15 Employee Incentive and Benefit Plan Costs. Piedmont, DEC, and
16 DEP will exclude from their regulated expense and plant accounts
17 the effects of all Piedmont long-term incentive plan (performance
18 shares and restricted stock units/shares) costs that result from the
19 increase in the Piedmont stock price above the \$42.22 per share
20 closing price on October 23, 2015, adjusted for changes in the stock
21 price that would have occurred absent the Merger. Piedmont's
22 executives and some employees receive incentive compensation in
23 the form of Piedmont stock. Duke Energy is purchasing the

1 Piedmont stock at a price more than 40% above the level that the
2 stock traded at the time of the Merger announcement. The
3 Applicants have agreed to record the portion of the specified costs
4 that exceeds a pro forma cost determined based on an LDC peer
5 group proxy in non-regulated below-the-line accounts for ES-1 and
6 GS-1 Report purposes. Essentially, the portion of the costs that
7 would have been incurred absent the Merger will be recorded in
8 regulated above-the-line accounts, and the remaining costs will be
9 recorded in below-the-line accounts.

10 Interest Rate on Deferred Gas Cost Accounts. The Stipulating
11 Parties agreed that beginning with the month in which the Merger
12 closes, Piedmont will use the net-of-tax overall rate of return from its
13 last general rate case as the applicable interest rate on all amounts
14 over-collected or under-collected from customers reflected in its
15 Sales Customers Only, All Customers, and Hedging Deferred Gas
16 Cost Accounts (collectively, the Deferred Gas Cost Accounts).⁵ The
17 net-of-tax overall rate of return is the interest rate used by Piedmont
18 for its Margin Decoupling and Integrity Management Rider deferred
19 accounts. Currently, the interest rate is 6.58%. The methods and

⁵ Pursuant to the Commission's July 22, 1991, *Order Granting Partial Rate Increase*, in Docket No. G-9, Sub 309, Piedmont has been using an interest rate of 10% on these accounts. Order at page 65.

1 procedures used by Piedmont for the accrual of interest on the
2 Deferred Gas Cost Accounts will remain unchanged.

3 Plant Accounting Closing Process. In the Public Staff's opinion,
4 Piedmont has not been unitizing completed plant projects or
5 recording retirements in a timely manner. Piedmont's recent
6 extensive integrity management construction program has
7 exacerbated what has previously been a relatively minor Public Staff
8 concern. Pursuant to the Stipulation, within 180 days after the close
9 of the Merger, Piedmont will begin to implement procedures to
10 ensure that project unitization and plant retirements are finalized
11 within 180 days of project completion. Piedmont will file semi-annual
12 status reports report with the Commission detailing its progress in
13 implementing these practices, with the first report due twelve months
14 from the close of the Merger.

15 Q. PLEASE DESCRIBE THE PURPOSE OF AFFILIATED
16 TRANSACTION RULES.

17 A. Affiliated transactions rules, such as those set forth in the current
18 Regulatory Conditions and Code of Conduct of DEC and DEP
19 approved by the Commission in the Duke-Progress Merger Order,⁶
20 are designed to: (1) fairly allocate the cost of common goods and

⁶ The Regulatory Conditions were subsequently modified by the Commission's *Order Approving Revisions to Regulatory Conditions Nos. 7.7 and 7.8* issued March 24, 2015, in Docket Nos. E-7, Subs 986 and 986A, and E-2, Subs 998 and 998A, and *Order Approving Transfer of Employees and Amendment to Regulatory Condition [No. 5.3]* issued November 25, 2015, in Docket Nos. E-7, Sub 986 and E-2, Sub 998.

1 services among affiliates, (2) protect the ratepayers of utilities from
2 overcharges by non-regulated affiliates, and (3) prevent cross-
3 subsidization of non-regulated affiliates by utility affiliates. DEC and
4 DEP have developed a cost allocation manual (CAM) pursuant to
5 these Regulatory Conditions to allocate the costs of common goods
6 and services from Duke Energy Business Services, LLC, the service
7 company, to the affiliates and between or among utilities. DEC and
8 DEP have also implemented a Code of Conduct that has been
9 approved by the Commission that governs affiliate issues such as
10 joint purchases, the sharing of customer information and confidential
11 system operations information with affiliates, and the potential of
12 favoritism toward affiliates over non-affiliates in general business
13 practices. In addition, DEC and DEP are required by the Regulatory
14 Conditions to comply with certain affiliated transaction audit
15 requirements, file affiliated transaction reports and inter-utility service
16 agreements with the Commission, and provide the Commission
17 advance notice in the event of certain corporate or regulatory events.
18 In this proceeding, the Stipulating Parties have agreed to a number
19 of changes to the DEC and DEP Regulatory Conditions and Code of
20 Conduct necessitated by the Merger between Duke Energy and
21 Piedmont.

22 Q. PLEASE DESCRIBE PROPOSED NEW REGULATORY
23 CONDITIONS AND CODE OF CONDUCT PROVISIONS THAT

1 ADDRESS MATTERS RELATED TO THE AFFILIATE
2 RELATIONSHIP OF PIEDMONT'S LOCAL DISTRIBUTION GAS
3 COMPANY OPERATIONS WITH THE ELECTRIC UTILITY
4 OPERATIONS OF DUKE ENERGY.

5 A. Provisions have been added to the Regulatory Conditions and Code
6 of Conduct to address matters such as: (a) priority of natural gas
7 service for electric generation, (b) separation of gas and electric
8 operations and potential discrimination against gas-fired non-utility
9 electric generators, (c) natural gas sales transactions between
10 Piedmont and its two electric utility affiliates, and (d) natural gas-
11 electric competition. These provisions include the following:

12 **Priority of Natural Gas Service for Electric Generation**

13 Code of Conduct Section III.B.10.: Unless otherwise directed by
14 order the Commission, electric generation shall not receive a priority
15 of use from Piedmont that would supersede or diminish Piedmont's
16 provision of service to its human needs firm residential and
17 commercial customers.

18 **Separation of Gas and Electric Operations and Potential**
19 **Discrimination Against Gas-fired Non-utility Electric Generators**

20 Regulatory Conditions Section XV – Procedures for Determining
21 Long-term Sources of Pipeline Capacity and Supply

22 15.1 Cost-benefit Analysis. The appropriate source(s) for the
23 interstate pipeline capacity and supply shall be determined by DEC

1 and DEP on the basis of the benefits and costs of such source(s)
2 specific to their respective electric customers. The appropriate
3 source(s) for the interstate pipeline capacity and supply shall be
4 determined by Piedmont on the basis of the specific benefits and
5 costs of such source(s) specific to its natural gas customers,
6 including electric power generating customers.

7 15.2 Ownership and Control of Contracts. Piedmont shall retain
8 title, ownership, and management of all gas contracts necessary to
9 ensure the provision of reliable Natural Gas Services consistent with
10 Piedmont's best cost gas and capacity procurement methodology.

11 Code of Conduct Section III.B.11.: Piedmont shall file an annual
12 report with the Commission summarizing all requests or inquiries for
13 Natural Gas Services made by a non-utility generator, Piedmont's
14 response to the request, and the status of the inquiry.

15 Code of Conduct Section III.D.3.(e): All Piedmont deliveries to DEC
16 and DEP pursuant to intrastate negotiated sales or transportation
17 arrangements and combinations of sales and transportation
18 transactions shall be at the same price and terms that are made
19 available to other Shippers having comparable characteristics, such
20 as nature of service (firm or interruptible, sales or transportation),
21 pressure requirements, nature of load (process/heating/electric)
22 generation, size of load, profile of load (daily, monthly, seasonal,

1 annual), location on Piedmont's system, and costs to serve and
2 rates. Piedmont shall maintain records in sufficient detail to
3 demonstrate compliance with this requirement.

4 **Natural Gas Sales Transactions between Piedmont and Its Two**
5 **Electric Utility Affiliates**

6 Code of Conduct Section III.D.3.(f): All gas supply transactions,
7 interstate transportation and storage transactions, and combinations
8 of these transactions, between DEC or DEP and Piedmont shall be
9 at the fair market value for similar transactions between non-affiliated
10 third parties. DEC, DEP, and Piedmont shall maintain records, such
11 as published market price indices, in sufficient detail to demonstrate
12 compliance with this requirement.

13 Code of Conduct Section III.D.3.(g): All of the margins, also referred
14 to as net compensation, received by Piedmont on secondary market
15 sales to DEC and DEP shall be recorded in Piedmont's Deferred Gas
16 Cost Accounts and shall flow through those accounts for the benefit
17 of ratepayers. None of the margins on secondary market sales by
18 Piedmont to DEC and DEP shall be included in the secondary market
19 transactions subject to the sharing mechanism on secondary market
20 transactions approved by the Commission in its Order Approving
21 Stipulation, dated December 22, 1995, in Docket No. G-100, Sub 67.

22 Code of Conduct Section III.E.3.: If Piedmont supplies any of

1 Natural Gas Services, with the exception of Natural Gas Services
2 provided pursuant to Commission-approved contracts or service
3 agreements, used by either DEC or DEP to generate electricity,
4 DEC or DEP, as applicable, shall file a report with the Commission
5 in its annual fuel and fuel-related cost recovery case
6 demonstrating that the purchase was prudent and the price was
7 reasonable.

8 **Natural Gas – Electricity Competition**

9 Code of Conduct Section III.H.: Natural Gas/Electricity Competition.
10 DEC, DEP and Piedmont shall continue to compete against all
11 energy providers, including each other, to serve those retail
12 customer energy needs that can be legally and profitably served by
13 both electricity and natural gas. The competition between DEC or
14 DEP and Piedmont shall be at a level that is no less than that which
15 existed prior to the .Merger. Without limitation as to the full range of
16 potential competitive activity, DEC, DEP and Piedmont shall
17 maintain the following minimum standards:

- 18 1. Piedmont will make all reasonable efforts to extend the
19 availability of natural gas to as many new customers as
20 possible.
- 21 2. In determining where and when to extend the availability of
22 natural gas, Piedmont will at a minimum apply the same
23 standards and criteria that it applied prior to the Merger.

- 1 3. In determining where and when to extend the availability of
2 natural gas, Piedmont will make decisions in accordance with
3 the best interests of Piedmont, rather than the best interest of
4 DEC or DEP.
- 5 4. To the extent that either the natural gas industry or the
6 electricity industry is further restructured, DEC, DEP, and
7 Piedmont will undertake to maintain the full level of
8 competition intended by this Code of Conduct subject to the
9 right of DEC, DEP, Piedmont or the Public Staff to seek relief
10 from or modifications to this requirement by the Commission.

11 Q. IN THE PUBLIC STAFF'S OPINION, DO THE NEW AFFILIATE
12 TRANSACTION RULES INCORPORATE REFINEMENTS THAT
13 WILL APPROPRIATELY ADDRESS THE POTENTIAL ISSUES
14 RAISED BY THE MERGER?

15 A. Yes.

16 Q. WHAT IS THE PUBLIC STAFF'S RECOMMENDATION WITH
17 REGARD TO THE PROPOSED MERGER?

18 A. The Public Staff recommends that the proposed Merger of Duke
19 Energy and Piedmont be approved, subject to the provisions of the
20 Stipulation and the agreed upon Regulatory Conditions.

21 Q. DOES THIS CONCLUDE YOUR TESTIMONY?

22 A. Yes.