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October 31, 2008

VIA FACSIMILE AND FEDERAL EXPRESS

Public Utilities Commission of Ohio
Docketing Division
180 East Broad Street
Columbus, OH 43215-3793

Re: Case Nos. 08-917-EL-SSO and 08-918-EL-SSO

Dear Sir or Madam:

Enclosed for filing please find an original and 20 copies of the Direct Testimony of Michael P. Gorman on behalf of The Commercial Group in the above-referenced cases.

Also enclosed are two extra copies of the document to be date-stamped and returned in the enclosed Federal Express envelope. Please do not hesitate to contact me at the number above if you have any questions.

Thank you for your assistance in this matter.

Sincerely,

Douglas Mancino

Douglas M. Mancino

cc: Grace C. Wung, Esq.

DMM/maj
Enclosures

BEFORE
THE PUBLIC UTILITIES COMMISSION OF OHIO

IN THE MATTER OF THE APPLICATION OF THE COLUMBUS SOUTHERN POWER COMPANY FOR APPROVAL OF ITS ELECTRIC SECURITY PLAN; AN AMENDMENT TO ITS CORPORATE SEPARATION PLAN; AND THE SALE OR TRANSFER OF CERTAIN GENERATING ASSETS	))))))	**Case No. 08-917-EL-SSO**
IN THE MATTER OF THE APPLICATION OF OHIO POWER COMPANY FOR APPROVAL OF ITS ELECTRIC SECURITY PLAN; AND AN AMENDMENT TO ITS CORPORATE SEPARATION PLAN	)))))))	**Case No. 08-918-EL-SSO**

Direct Testimony and Exhibits of

Michael Gorman

On behalf of

The Commercial Group

October 31, 2008
Project 9049

BAI

BRUBAKER & ASSOCIATES, INC.
CHESTERFIELD, MO 63017

BEFORE
THE PUBLIC UTILITIES COMMISSION OF OHIO

IN THE MATTER OF THE APPLICATION OF THE COLUMBUS SOUTHERN POWER COMPANY FOR APPROVAL OF ITS ELECTRIC SECURITY PLAN; AN AMENDMENT TO ITS CORPORATE SEPARATION PLAN; AND THE SALE OR TRANSFER OF CERTAIN GENERATING ASSETS	)	**Case No. 08-917-EL-SSO**
IN THE MATTER OF THE APPLICATION OF OHIO POWER COMPANY FOR APPROVAL OF ITS ELECTRIC SECURITY PLAN; AND AN AMENDMENT TO ITS CORPORATE SEPARATION PLAN	)	**Case No. 08-918-EL-SSO**

Direct Testimony of Michael Gorman

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A Michael Gorman. My business address is 16690 Swingley Ridge Road, Suite 140, Chesterfield, MO 63017.

Q WHAT IS YOUR OCCUPATION?

A I am a consultant in the field of public utility regulation and a managing principal with the firm of Brubaker & Associates, Inc., ("BAI") energy, economic, and regulatory consultants.

Q PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.

A These are set forth on Appendix A.

Q ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?

A I am appearing on behalf of Wal-Mart Stores East, LP; Sam's East, Inc.; and Macy's Inc. (collectively, the "Commercial Group"). The Commercial Group purchases electricity from Columbus Southern Power Company and Ohio Power Company (collectively, "American Electric Power" or "AEP" or "Company").

Q WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A I will respond to certain aspects of AEP's proposed Electric Security Plan ("ESP") for its affiliates Columbus Southern Power Company and Ohio Power Company.

Q PLEASE SUMMARIZE YOUR RECOMMENDATIONS AND FINDINGS IN THIS TESTIMONY.

A My recommendations and findings are summarized as follows:

1. AEP's proposed fuel adjustment clause (FAC) and non-FAC generation charges should be modified to reflect seasonal, and on-peak/off-peak differentiated generation charges in an effort to provide more accurate price signals to customers. In turn, more accurate generation price signals will contribute to more successful demand-side management and energy conservation programs, because customers can better receive the benefits of achieving energy conservation in high-cost periods.

2. I recommend the Company's proposed FAC be modified to include only fuel and purchased power energy-related charges consistent with AEP's current FAC. The only modification from the cost recovered in the current FAC should be expanded to include variable environmental compliance costs that are not already recovered in the FAC. However, purchased power capacity costs, and environmental capacity type costs should not be recovered through the FAC. Rather, these costs should be recovered through the non-FAC generation charges.

3. The Company's ESP is proposing to defer certain FAC-related expenses and recover those over an eight-year period. AEP proposes to defer these FAC costs in a regulatory asset account, and record a carrying charge on the deferred balance. I recommend rejecting any deferral and recovering all FAC-related expenses on a current basis. However, if the Commission approves a deferral, I recommend that the carrying charge accrued on the deferred FAC balance be minimized to the greatest extent possible. As such, the carrying charge should be calculated based on the "net" of tax balance of the deferred fuel expenses, and at a carrying charge rate equal to the cost of short-term debt.

4. The Company's energy efficiency and peak demand reduction cost recovery rider is designed to properly allow mercantile customers to opt out of this rider if they are implementing programs to conserve energy and reduce peak demand on their own. Concerning this opt-out provision, I recommend the following for mercantile customers that opt-out:

    a. That these customers' historic usage be removed from the Company's base line used to measure the utility's compliance with the conservation and peak demand reduction obligations.

    b. The Company should implement a program that will allow these customers to participate in the PJM demand response programs with administrative help from AEP. A PJM demand response rate mechanism should allow AEP to fully recover its administrative costs of assisting its mercantile customers to participate in these wholesale demand response programs. The Company's proposal to restrict retail customers from participating in these wholesale market demand response programs should be rejected. Instead, the Company should act as a facilitator for its retail customers to participate in these wholesale programs and recover its cost of providing this service.

5. The Company's proposed methodology to determine significantly excessive earnings is flawed, would result in volatile excess earnings determinations, and is not properly tied to companies that have comparable business and financial risk to the AEP Ohio distribution subsidiaries.

6. I recommend the significantly excessive earnings test be based on the Commission-approved return on equity of 10.5% for AEP, plus a spread of 200 basis points. To the extent the Company's earned return on equity exceeds this 12.5% threshold, then earnings in excess of this level should be considered significantly excessive, and subject to refund or rejection of the Company's ESP.

Fuel Adjustment Clause

Q IS THE COMPANY PROPOSING TO MAINTAIN ITS CURRENT FUEL ADJUSTMENT CLAUSE (FAC)?

A No. AEP witness Philip J. Nelson proposed to modify the FAC and allow recovery of costs in the new FAC that were not recovered in the old FAC.

Q PLEASE DESCRIBE AEP'S OLD FAC.

A Mr. Nelson describes the Company's current FAC at pages 3 and 4 of his testimony. In that testimony, he states that the FAC currently allows the Company to recover fuel expense as recorded in Account 501, and purchased power energy expense typically related to economic purchased power. He describes the combination of these two accounts to reflect the net energy costs (NEC) of AEP. He states that the current FAC does not recover fuel handling costs and purchased power demand charges. These costs are recovered in non-FAC charges.

Q **HOW DOES MR. NELSON PROPOSE TO MODIFY AEP'S FAC?**

A Mr. Nelson is proposing to modify the FAC to allow for non-energy-related costs to be recovered through the FAC. Specifically, Mr. Nelson proposes to recover not only the NEC costs recovered in the current FAC charges, but to also allow recovery of all purchased power costs, including capacity costs, and fuel handling expenses.

Q **IS THE COMPANY'S PROPOSED MODIFICATION OF THE TYPE OF COSTS RECOVERABLE THROUGH THE FAC APPROPRIATE?**

A No. The Company's proposal to recover non-variable costs through the FAC, is inappropriate for several reasons including the following:

1. The Company's allocation of FAC costs is on a kWh basis. As such, in order to ensure that customers' rates actually reflect their cost of service, only costs that vary on a kWh basis should be recovered in the FAC.
2. The Company's proposed semi-annual true-up of the FAC reflects the volatility of the costs recovered in this factor. As such, more stable costs such as capacity costs and fuel handling cost should continue to be recovered in non-FAC charges.
3. The non-FAC charges will provide a better allocation and rate design for costs that do not vary with energy.

Q HOW DO YOU PROPOSE THAT PURCHASED POWER CAPACITY COSTS AND OTHER FIXED COSTS BE RECOVERED?

A I recommend that purchased power capacity costs, fuel handling and all other costs that do not vary with energy (kWh) should continue to be recovered in the Company's non-FAC generation charges. These costs can then be properly allocated between customers on demand (kWh) rather than an energy (kWh) basis, and the Company will be made whole for the non-fuel and energy costs related to provision of standard service offer.

Q DO YOU BELIEVE THE COMPANY'S PROPOSED DESIGN OF FAC CHARGES IS REASONABLE?

A No. The Company is proposing a single average FAC charge differentiated only on service level voltage.[1] This proposed rate design is inappropriate because it does not properly distinguish the difference in cost of fuel and purchased power energy based on seasonal and on-peak/off-peak daily periods. In order to improve price signals, I recommend the Company's proposed FAC be adjusted to differentiate prices by season and on-peak/off-peak periods. For example, the FAC should include a winter (October-May) period and a summer (June-September) period, and an on-peak/off-peak period charge. Further, the Company should offer a time-of-day FAC rate option.

Q WHY SHOULD THE FAC PRICING BE DIFFERENTIATED BY SEASON, AND ON-PEAK/OFF-PEAK DAILY VARIATIONS?

A Generation charges including fuel and purchased power energy vary based on the cost of generating resources used to meet the system load conditions. When loads are high, more generating resources are dispatched to meet that load, including higher-cost

[1] See AEP witness Roush, Exhibit DMR-9, at 147, and Exhibit DMR-10, at 146.

generation resources. The economic dispatch of generating resources mandates that the lowest cost generation resources are dispatched first, and then higher-cost generating resources are dispatched as needed to meet increasing customer demands. As such, generation prices will be higher during peak periods such as summer periods, because more expensive generating units are dispatched to meet greater customer demands. Modifying the proposed FAC to reflect energy charges based on these seasonal and on-peak/off-peak periods will send more accurate price signals to customers and encourage economic consumption decisions.

Q **WOULD SEASONAL AND ON-PEAK/OFF-PEAK FAC PRICE DIFFERENTIATION SUPPORT ENERGY CONSERVATION AND DEMAND RESPONSE PROGRAMS?**

A Yes. The objective of the ESP is to encourage customers to undertake conservation measures, and demand-side management activities to reduce consumption and energy cost. Developing utility prices which properly reflect the costs of energy during on-peak and off-peak periods, will encourage customers to maximize savings by reducing consumption when the price (or avoided cost) is higher. Avoiding the high-cost energy periods will increase conservation savings and, potentially, justify larger investments in energy conservation and peak demand programs. This, in turn, will provide an economic incentive to maximize participation with economic conservation and demand response programs.

Non-FAC Generation Charges

Q DO YOU HAVE ANY COMMENTS CONCERNING THE COMPANY'S PROPOSED NON-GENERATION FAC CHARGES?

A Yes. The Company's proposed non-generation FAC charges should also be separated by season. This pricing differential will, again, provide more accurate price signals to customers, and will encourage more demand-side management actions to reduce peak demand and demand billing units during high-cost peak periods. Further, reducing demand on the peak will help reduce, delay or avoid the need for more generating capacity.

Q DO THE COMPANY'S NON-FAC GENERATION CHARGES VARY BASED ON THE SEASON?

A Yes. The Company invests in more generating resources in order to meet summer peak load conditions than it does during average load periods. As such, in order to send accurate price signals to customers, the cost of generation demand should be higher during system peak periods to reflect the additional investment made to meet the system peak load demands. Again, these higher non-FAC generation charges will encourage customers to make investments to reduce peak demand and/or to shift production to off-peak periods. Either of these actions will result in achieving energy conservation, and reducing peak demand on the system.

Energy Efficiency and Peak Demand Reduction Cost Recovery Factor

Q **DO YOU HAVE ANY COMMENTS CONCERNING THE COMPANY'S PROPOSED ENERGY EFFICIENCY AND PEAK DEMAND REDUCTION COST RECOVERY FACTOR?**

A Yes. In its proposed rate schedules, the Company has properly recognized that the Commission can approve mercantile customers to be exempted from this charge if they undertake conservation actions on their own. However, I recommend several modifications to the Company's proposed energy efficiency and peak demand reduction programs. Those include the following:

1. If the Commission approves a mercantile customer to be exempt from this program, then the Company should be allowed to remove the mercantile customer's load from the utility's base line conservation benchmark. This would excuse the utility from implementing conservation and demand response programs needed to comply with the law's reduction in energy and peak demand for the exempted customers.

2. The Company should implement a rider for exempt mercantile customers to participate in PJM demand response programs. Many mercantile customers may find it beneficial to participate in these programs, which will provide economic incentives for them to reduce demand in response to market pricing signals, thereby making the wholesale and retail generation markets more efficient. This could contribute to a reduction in peak demand.

3. The Company's proposed pricing structure for its energy efficiency and demand response programs is based on a charge per kWh. This rate design and cost allocation should be modified to better assign the cost of energy efficiency and demand response programs with the benefits of these programs. I propose, that demand response programs should be based on a demand-based credit, and energy conservation be based on an energy charge. For residential customers that do not have demand meters, the allocation of demand response costs and benefits for residential customers should be allocated to the class based on demand usage and then converted to a kWh charge.

<u>The Company's Proposed Accounting Treatment for Deferred FAC Costs</u>

Q PLEASE DESCRIBE THE COMPANY'S PROPOSED ACCRUAL OF INCREMENTAL FAC COSTS.

A The Company is proposing to defer incremental FAC costs not recovered in its initial ESP. As discussed by AEP witness Leonard Assante, the Company is proposing to record the amount of base FAC revenue less collections in a regulatory asset account and accrue a carrying charge on this balance. The Company will defer unrecovered FAC costs during the period 2009 through 2011, and begin to amortize these costs starting in year 2010 and amortize the deferrals over a seven-year period ending in 2018. The Company is proposing a deferral carrying charge rate of 11.15% based on a 50%/50% debt-equity capital structure, and a 10.5% return on equity. The Company has shown on Mr. Assante's Exhibit LVA-1, page 1, and Exhibit LVA-2, that the Company is proposing to accrue a carrying charge on the <u>gross</u> balance of deferred FAC expenses.

Q DO YOU SUPPORT THE COMPANY'S PROPOSAL TO DEFER A PORTION OF THE FUEL ADJUSTMENT COSTS DURING THE ESP PERIOD?

A No. I recommend customers pay the full cost of fuel during the ESP.

Q IF THE COMMISSION APPROVES RECOVERY OF CERTAIN COSTS ON A DEFERRED BASIS, DO YOU BELIEVE THE COMPANY'S PROPOSED CARRYING CHARGE METHOD IS REASONABLE?

A No. If the Commission approves recovery on a deferred basis, the carrying charge should be established in a manner that minimizes costs to customers. Specifically, the Company should accrue a carrying charge on the <u>net</u> of tax balance of deferred fuel expenses, not on the gross balance as proposed by the Company. Second, since the

Company is proposing a relatively short recovery period on these deferred costs, it is not appropriate to provide it with its weighted average cost of capital for the carrying charge on these deferrals.

Q PLEASE DESCRIBE HOW YOU RECOMMEND TO MODIFY THE COMPANY'S PROPOSED INCREMENTAL FAC DEFERRAL COSTS.

A I propose that the carrying charge be accrued on the net of tax balance of incremental FAC charges, and the carrying charge rate be set at the Company's incremental cost of short-term debt.

Q WHY IS IT APPROPRIATE TO INCLUDE A CARRYING CHARGE ON THE NET OF TAX BALANCE OF INCREMENTAL FAC COSTS?

A The Company can expense the fuel expense in the year it is incurred. As such, by not recovering fuel expense in a year, the Company will reduce its current tax expense, and record a deferred tax obligation. This deferred tax will represent a temporary recovery of these fuel expenses via a reduction to current income tax expense. That income tax will ultimately be paid to government taxing authorities after the incremental fuel cost is recovered from customers. However, while deferred, the Company will partially recover its deferred fuel balance via reduced income tax expense.

What this means in terms of a carrying charge is the Company will only need to rely on investor capital to support the after-tax balance (or net of tax balance) of deferred fuel expense until the expense is recovered from customers. The gross balance less the temporary deferred tax balance, represents a deferred fuel balance that must be carried by investor capital. If the Company is permitted to accrue a carrying charge on the gross balance, then it will over-recover its actual cost of carrying these deferred fuel balances.

Q WHY DO YOU RECOMMEND THE CARRYING CHARGE RATE BE SET AT THE UTILITY'S COST OF SHORT-TERM DEBT RATHER THAN ITS WEIGHTED AVERAGE COST OF CAPITAL?

A The Company will accrue these deferrals over three years, and recover them over a seven-year period. As such, these accruals are a temporary investment and not a permanent investment. The Company's weighted average cost of capital represents long-term capital, not intermediate term capital. It would not be appropriate to issue long-term capital to support a temporary intermediate term asset. A more appropriate carrying charge rate and capital source for these temporary deferrals would be the Company's short-term borrowing facilities and cost rates.

A short-term borrowing facility is an appropriate capital source because it can be increased as the Company accumulates deferred fuel balances, and then paid down as the Company recovers the deferred fuel balance. As such, the Company's short-term debt borrowing facility will more properly match the capital balance with the temporary deferral asset balance, and minimize the Company's actual cost of carrying these temporary assets.

Significantly Excessive Earnings Test

Q PLEASE DESCRIBE THE COMPANY'S PROPOSED SIGNIFICANTLY EXCESSIVE EARNINGS TEST.

A AEP witness Dr. Anil Makhija proposes a statistical methodology of comparable proxy groups to develop an historical earned return on book equity. For calendar year 2005 through 2007, Dr. Makhija estimates the threshold for significantly excessive earnings test to be 21.19%, 22.59% and 27.33%, respectively. (Direct Testimony at 8). Dr. Makhija bases this range on earned returns on book equity for certain proxy groups, with adjustments based on variations and beta estimates for AEP relative to his proxy groups.

Q DO YOU BELIEVE DR. MAKHIJA'S SIGNIFICANTLY EXCESSIVE EARNINGS TEST AND PROPOSED RETURN ON EQUITY THRESHOLDS ARE REASONABLE?

A No. Dr. Makhija's significantly excessive earnings test methodologies should be rejected for several reasons including the following:

1. The proxy groups he selected are not comparable in business risk to AEP's Ohio distribution utility affiliates, and therefore his methodologies do not meet the requirements of the law.

2. His studies produce volatile results which will produce wide swings in the earned return on equity thresholds for the excessive earnings test. Therefore, this methodology will not meet the Ohio law's primary objective of establishing an ESP which will stabilize rates, and supports the economic development of the state of Ohio.

Q PLEASE EXPLAIN WHY YOU BELIEVE DR. MAKHIJA'S PROPOSED METHODOLOGY WILL PRODUCE VOLATILE RESULTS.

A This is apparent from a review of his own exhibits. Indeed, a review of the variations in the excessive earnings test threshold produced wide variations just in the three years he studied. Specifically, from 2005 to 2007, the return on equity threshold moved from 21.19% up to 27.33%. This is clearly not a stable threshold for establishing whether or not the prices embedded in the ESP will support the Ohio economic development and ensure customers' interests are protected.

Q **WOULD DR. MAKHIJA'S EARNED RETURN ON BOOK EQUITY ESTIMATE BE COMPARABLE IF PUBLICLY AVAILABLE SOURCES OF THE EARNED RETURNS ON EQUITY FOR HIS COMPARABLE GROUPS WERE USED?**

A No. As shown on the attached Exhibit MPG-1, the utility proxy group proposed by Dr. Makhija, had earned returns on equity in the mid 12% area in 2005, which increased over 14% to 2007 and 2008. The *Value Line* projected 3-5 year earned return on equity for these companies is around 14%.

As can be clearly seen on the proxy group however, the average return on equity is impacted by some outlier companies. For example, Exelon had earned returns on book equity in excess of 23% in each year of the 2005 through 2008 period, and is projected to have an earned return on equity of over 25% through the next five years. Exelon is a company that is not directly comparable to a low-risk distribution utility such as Columbus Southern Power Company, and Ohio Power Company. For example, Exelon has a nuclear generation subsidiary which was created from the spinoff of regulated nuclear generating subsidiaries into an unregulated nuclear power subsidiary. The cost of those generating assets were generally written down before they were spun into the unregulated subsidiary. The operating cost of a nuclear station is quite low, thereby producing very large profits as the nuclear units sell power into a competitive marketplace. As such, the earned return on equity for the nuclear generating subsidiaries, and the consolidated earnings of Exelon are not a reasonably comparable proxy nor useful in estimating an appropriate excess earnings target for a low-risk distribution utility company.

Other companies in the group also include deregulated generation subsidiaries which are producing high profits in today's very volatile and high-cost wholesale market. Those include Allegheny Energy, Southern Company, PPL Corp., FPL Corp., First Energy, Entergy, and Dominion Resources. As such, this proxy group simply does not produce a reasonable return on equity base from which to estimate excess earnings for AEP's Ohio distribution utility affiliates.

Q WOULD A LARGER GROUP OF PRIMARILY REGULATED UTILITY OPERATIONS PRODUCE A LOWER EARNED RETURN ON EQUITY PROXY GROUP THAN THAT USED BY DR. MAKHIJA?

A Yes. As shown on Exhibit MPG-2, using all the publicly traded companies that were designated as "Regulated" entities by the Edison Electric Institute, and relying on *Value Line*'s earned return on common equity data, shows that regulated companies' earned return on equity has averaged about 9% over the period 2005 through 2008, and is projected to be 10.25% over the next 3 to 5 years.

Further, the distribution of the earned returns for this industry proxy group places more earned returns under the average than over the average. Indeed, setting 12.5% as a return on equity threshold, approximately four to six of the observations in each year fall above this 12.5% return on equity threshold. Hence, over the period 2005 through 2008, and projected out for the next 3 to 5 years, approximately 85% of the earned return on equity observations for these regulated electric utility companies fall at 12.5% return on equity or less. Based on this assessment, a 12.5% return on equity is an appropriate threshold to constitute significantly excessive earnings, because it includes over 85% of the primarily regulated utility companies followed by *The Value Line Investment Survey.*

Q WHY DO YOU BELIEVE DR. MAKHIJA'S STUDIES ARE BASED ON COMPANIES THAT ARE NOT COMPARABLE IN BUSINESS RISK TO AEP?

A This is apparent from an independent review of credit analysts' assessments of the business risk profile of companies included in Dr. Makhija's studies, and that of AEP.

Further, a review of the operating risk assessment by the Edison Electric Institute corroborates that finding by Standard & Poor's (S&P) and also shows that AEP has much lower business risk than many of the companies included in Dr. Makhija's study. Therefore, Dr. Makhija's study does not meet the requirements of the law to identify an earnings threshold that corresponds with a company with comparable business and financial risk to the distribution utility.

Q PLEASE DESCRIBE THE INDEPENDENT CREDIT RATING ANALYSTS' AND EEI FACTORS THAT SHOW THAT AEP'S OPERATING RISK IS LOWER THAN THE BUSINESS RISK OF MANY OF THE COMPANIES INCLUDED IN DR. MAKHIJA'S PROXY GROUP.

A This is shown on my Exhibit MPG-3. As shown on that exhibit, S&P's current operating risk assessment for AEP is "Excellent," on a five-notch scale of "Vulnerable" (highest risk) to "Excellent" (lowest risk). S&P uses this five-notch scale in its credit rating review of utility and corporate bond issuers. In comparison, many of the companies' business risk factors from S&P for the companies included in Dr. Makhija's group are weaker than "Excellent," thereby indicating higher business risk than AEP (Ohio Power, and Columbus Southern Power). As such, Dr. Makhija's proxy group does not have comparable business risk as AEP.

Similarly, EEI publishes an assessment of many electric utility companies and identifies whether or not the companies are primarily engaged in regulated or non-regulated activities. As shown on the attached Exhibit MPG-3, EEI's assessment shows that while AEP is primarily engaged in regulated operations, many of the companies included in Dr. Makhija's group do not fall into this same low-risk category. Indeed, certain companies are classified as "Diversified" companies, which indicates they have large investments in non-regulated energy assets, and others are "Mostly

Regulated," which also indicates they are *not* truly comparable in operating business risk to AEP. Therefore, this independent assessment also illustrates that AEP does not have comparable business risk to the proxy group relied on by Dr. Makhija.

Q WHAT EARNINGS THRESHOLD DO YOU RECOMMEND FOR A SIGNIFICANTLY EXCESSIVE EARNINGS TEST?

A An appropriate threshold would be to apply a rate of return spread over AEP's current market cost of equity. As such, I recommend an earnings spread of approximately 200 basis points to AEP's current market cost of equity. AEP witness Mr. Assante stated that the Commission recently approved a return on equity for AEP of 10.5%. (Direct Testimony at 8). As such, a return on equity threshold of 12.5% is an appropriate and stable threshold to use to estimate whether or not the prices charged under AEP's ESP are just and reasonable. This is also supported by the analysis of the electric utility industry actual and projected earned return on equity study described above and shown on my Exhibit MPG-2.

For these reasons, to the extent the earnings exceed 12.5%, the Commission should suspend increases in AEP's ESP pricing mechanisms, or require AEP to refile its ESP pricing structure.

Q HOW DID YOU DETERMINE A 200 BASIS POINT SPREAD OVER AEP'S CURRENT MARKET COST OF EQUITY IS AN APPROPRIATE THRESHOLD FOR ESTABLISHING SIGNIFICANTLY EXCESSIVE EARNINGS?

A This is based on the variation of the beta estimates for the companies included in Dr. Makhija's study. Indeed, as shown on Exhibit MPG-4, the group average beta for those companies is around 0.81. The highest beta in his proxy group is 1.10, or 0.29 above the group average beta. Applying this to Dr. Makhija's market risk premium of

7.0%, would indicate a spread between the average risk and extreme risk of his proxy group to be about 200 basis points. Further, the beta for the market of 1.0, less regulated companies' current betas of 0.8, would imply a spread of 0.2 or 1.4 percentage points. Hence, a 2 percentage point spread is very conservative in arriving at an excessive earnings threshold.

Q **DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?**

A Yes.

Qualifications of Michael Gorman

Q **PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

A Michael Gorman. My business mailing address is 16690 Swingley Ridge Road, Suite 140, Chesterfield, MO 63017.

Q **PLEASE STATE YOUR OCCUPATION.**

A I am a consultant in the field of public utility regulation and a managing principal with Brubaker & Associates, Inc., energy, economic and regulatory consultants.

Q **PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND WORK EXPERIENCE.**

A In 1983 I received a Bachelor of Science Degree in Electrical Engineering from Southern Illinois University, and in 1986, I received a Master's Degree in Business Administration with a concentration in Finance from the University of Illinois at Springfield. I have also completed several graduate level economics courses.

In August of 1983, I accepted an analyst position with the Illinois Commerce Commission ("ICC"). In this position, I performed a variety of analyses for both formal and informal investigations before the ICC, including: marginal cost of energy, central dispatch, avoided cost of energy, annual system production costs, and working capital. In October of 1986, I was promoted to the position of Senior Analyst. In this position, I assumed the additional responsibilities of technical leader on projects, and my areas of responsibility were expanded to include utility financial modeling and financial analyses.

In 1987, I was promoted to Director of the Financial Analysis Department. In this position, I was responsible for all financial analyses conducted by the staff.

Among other things, I conducted analyses and sponsored testimony before the ICC on rate of return, financial integrity, financial modeling and related issues. I also supervised the development of all Staff analyses and testimony on these same issues. In addition, I supervised the Staff's review and recommendations to the Commission concerning utility plans to issue debt and equity securities.

In August of 1989, I accepted a position with Merrill-Lynch as a financial consultant. After receiving all required securities licenses, I worked with individual investors and small businesses in evaluating and selecting investments suitable to their requirements.

In September of 1990, I accepted a position with Drazen-Brubaker & Associates, Inc. In April 1995 the firm of Brubaker & Associates, Inc. ("BAI") was formed. It includes most of the former DBA principals and Staff. Since 1990, I have performed various analyses and sponsored testimony on cost of capital, cost/benefits of utility mergers and acquisitions, utility reorganizations, level of operating expenses and rate base, cost of service studies, and analyses relating industrial jobs and economic development. I also participated in a study used to revise the financial policy for the municipal utility in Kansas City, Kansas.

At BAI, I also have extensive experience working with large energy users to distribute and critically evaluate responses to requests for proposals ("RFPs") for electric, steam, and gas energy supply from competitive energy suppliers. These analyses include the evaluation of gas supply and delivery charges, cogeneration and/or combined cycle unit feasibility studies, and the evaluation of third-party asset/supply management agreements. I have also analyzed commodity pricing indices and forward pricing methods for third party supply agreements, and have also conducted regional electric market price forecasts.

In addition to our main office in St. Louis, the firm also has branch offices in Phoenix, Arizona and Corpus Christi, Texas.

Q **HAVE YOU EVER TESTIFIED BEFORE A REGULATORY BODY?**

A Yes. I have sponsored testimony on cost of capital, revenue requirements, cost of service and other issues before the Federal Energy Regulatory Commission and numerous state regulatory commissions including: Arkansas, Arizona, California, Colorado, Delaware, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Louisiana, Michigan, Missouri, Montana, New Jersey, New Mexico, New York, North Carolina, Oklahoma, Oregon, South Carolina, Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, Wyoming, and before the provincial regulatory boards in Alberta and Nova Scotia, Canada. I have also sponsored testimony before the Board of Public Utilities in Kansas City, Kansas; presented rate setting position reports to the regulatory board of the municipal utility in Austin, Texas, and Salt River Project, Arizona, on behalf of industrial customers; and negotiated rate disputes for industrial customers of the Municipal Electric Authority of Georgia in the LaGrange, Georgia district.

Q **PLEASE DESCRIBE ANY PROFESSIONAL REGISTRATIONS OR ORGANIZATIONS TO WHICH YOU BELONG.**

A I earned the designation of Chartered Financial Analyst ("CFA") from the CFA Institute. The CFA charter was awarded after successfully completing three examinations which covered the subject areas of financial accounting, economics, fixed income and equity valuation and professional and ethical conduct. I am a member of the CFA Institute's Financial Analyst Society.

AEP-Ohio

Return on Equity

Makhija's Utility Group

Line	Utility	2005 (1)	2006 (2)	2007 (3)	2008 (4)	3-5 Year Projection (5)
1	Allegheny Energy	9.05%	15.32%	16.27%	16.26%	12.13%
2	Ameren Corp.	9.87%	8.31%	9.32%	9.45%	9.58%
3	Consol. Edison	9.84%	9.36%	10.56%	9.02%	8.83%
4	Constellation Energy	12.61%	15.12%	14.91%	13.68%	14.43%
5	Dominion Resources	10.10%	13.20%	15.03%	16.70%	14.90%
6	Duke Energy	N/A	4.14%	7.18%	7.58%	7.99%
7	Entergy Corp.*	12.18%	13.82%	14.75%	N/A	N/A
8	Exelon Corp.	23.70%	23.76%	26.92%	26.04%	25.71%
9	FirstEnergy Corp.	10.35%	14.00%	14.58%	13.86%	15.38%
10	FPL Group	10.42%	12.90%	12.22%	13.51%	12.82%
11	PPL Corp.	16.73%	17.56%	18.56%	15.46%	22.40%
12	Progress Energy	9.04%	6.20%	8.23%	9.05%	9.49%
13	Public Serv. Enterprise	14.25%	11.21%	18.13%	18.33%	14.55%
14	Southern Co.	15.16%	14.14%	14.39%	13.47%	14.18%
15	Average	12.56%	12.79%	14.36%	14.03%	14.03%
16	Median	10.42%	13.51%	14.67%	13.68%	14.18%
17	Amer. Elec. Power	11.40%	12.02%	11.38%	11.99%	11.83%

Notes:
*Due to recent hurricanes affecting Louisiana, *Value Line* has suspended earnings estimates temporarily.

Source:
The Value Line Investment Survey; August 8, August 29, and September 26, 2008.

AEP-Ohio

Return on Equity

Regulated Utility Group

Line	Utility	2005 (1)	2006 (2)	2007 (3)	2008 (4)	3-5 Year Projection (5)
1	ALLETE, Inc.	11.28%	11.61%	11.80%	9.73%	9.34%
2	Ameren Corp.	9.87%	8.31%	9.32%	9.45%	9.58%
3	Amer. Elec. Power	11.40%	12.02%	11.38%	11.99%	11.83%
4	Avista Corporation	6.12%	8.19%	4.21%	8.14%	8.33%
5	Central Vermont P.S.	0.64%	10.32%	8.37%	8.24%	8.42%
6	CH Energy Group, Inc.	8.99%	8.07%	8.34%	6.32%	8.31%
7	Cleco Corporation	10.96%	8.53%	7.88%	9.67%	11.32%
8	CMS Energy Corporation	10.64%	7.07%	7.89%	13.13%	12.53%
9	Consol. Edison	9.84%	9.36%	10.56%	9.02%	8.83%
10	DPL, Inc.	12.01%	17.64%	24.24%	25.06%	18.91%
11	El Paso Electric Company	6.58%	10.59%	11.22%	11.13%	9.72%
12	Empire District Electric Company	6.05%	8.52%	6.16%	7.90%	10.53%
13	Energy East Corporation	8.99%	9.11%	7.87%	7.10%	7.67%
14	Great Plains Energy Incorporated	13.42%	9.51%	10.16%	4.74%	9.13%
15	IDACORP, Inc.	6.21%	8.90%	6.82%	7.57%	7.71%
16	MGE Energy, Inc.	9.34%	11.30%	11.41%	12.08%	12.73%
17	Northeast Utilities	5.29%	4.51%	8.63%	9.28%	8.80%
18	NSTAR	12.91%	13.18%	13.12%	13.41%	14.44%
19	PG&E Corporation	12.52%	14.43%	11.76%	12.25%	12.09%
20	Pinnacle West Capital Corporation	6.52%	9.20%	8.46%	7.76%	8.06%
21	PNM Resources, Inc.	8.29%	7.21%	3.54%	0.50%	6.28%
22	Portland General Electric Company	5.35%	5.80%	11.02%	8.39%	8.60%
23	Progress Energy	9.04%	6.20%	8.23%	9.05%	9.49%
24	Puget Energy, Inc.	7.22%	7.91%	7.33%	7.67%	8.70%
25	Sierra Pacific Resources	4.18%	9.11%	6.58%	7.02%	8.63%
26	Southern Co.	15.16%	14.14%	14.39%	13.47%	14.18%
27	TECO Energy, Inc.	13.25%	14.14%	13.18%	8.80%	13.33%
28	UIL Holdings Corporation	5.77%	9.86%	10.06%	10.38%	10.40%
29	UniSource Energy Corporation	7.48%	10.58%	8.46%	7.21%	7.70%
30	Vectren Corporation	11.96%	9.27%	11.60%	10.77%	10.99%
31	Westar Energy, Inc.	9.52%	10.74%	9.22%	9.18%	8.64%
32	Wisconsin Energy Corporation	11.37%	10.86%	10.90%	10.38%	11.99%
33	Xcel Energy, Inc.	9.25%	9.78%	9.14%	10.06%	10.98%
34	Average	9.01%	9.88%	9.79%	9.60%	10.25%
35	Median	9.25%	9.36%	9.22%	9.18%	9.49%
36	Number of Companies with ROE >12.5%	5	5	4	4	6

Source:
The Value Line Investment Survey; August 8, August 29, and September 26, 2008.

AEP-Ohio

Business Risk Summary

Makhija's Utility Group

Line	Utility	Standard & Poor's Business Risk[1] (1)	Standard & Poor's Business Risk[2] (2)	Beta[3] (3)	EEI Risk Assessment[4] (4)
1	Allegheny Energy	Strong	7	1.10	Diversified
2	Ameren Corp.	Satisfactory	7	0.80	Regulated
3	Consol. Edison	Excellent	2	0.75	Regulated
4	Constellation Energy	N/R	n/a	0.85	Diversified
5	Dominion Resources	Excellent	7	0.75	Mostly Regulated
6	Duke Energy	Excellent	5	N/A	Mostly Regulated
7	Entergy Corp.	Strong	6	0.80	Mostly Regulated
8	Exelon Corp.	N/R	n/a	0.85	Mostly Regulated
9	FirstEnergy Corp.	Strong	7	0.75	Mostly Regulated
10	FPL Group	Excellent	5	0.80	Mostly Regulated
11	PPL Corp.	Excellent	3	0.85	Mostly Regulated
12	Progress Energy	Excellent	5	0.75	Regulated
13	Public Serv. Enterprise	Excellent	3	0.85	Mostly Regulated
14	Southern Co.	Excellent	4	0.65	Regulated
15	Average	Excellent	5	0.81	Mostly Regulated
16	Amer. Elec. Power	Excellent	5	0.85	Regulated
17	Ohio Power Co.	Excellent	4		
18	Columbus Southern Power Co.	Excellent	4		

Sources:

[1] *Standard & Poor's,* U.S. Electric Utility Companies, Strongest to Weakest; January 2, 2008. 5 categories: Excellent (lowest risk) to Vulnerable (highest risk).

[2] *Standard & Poor's,* U.S. Integrated Electric Utility Companies, Strongest to Weakest; November 1, 2007. 10 point scale: 1 (lowest risk) to 10 (highest risk).

[3] *The Value Line Investment Survey;* August 8, August 29, and September 26, 2008.

[4] *Edison Electric Institute;* Stock Performance, 3Q 2008 Financial Update.

AEP-Ohio

Beta

Makhija's Utility Group

Line	Utility	Current Beta
1	Allegheny Energy	$\boxed{1.10}$
2	Ameren Corp.	0.80
3	Consol. Edison	0.75
4	Constellation Energy	0.85
5	Dominion Resources	0.75
6	Duke Energy	N/A
7	Entergy Corp.	0.80
8	Exelon Corp.	0.85
9	FirstEnergy Corp.	0.75
10	FPL Group	0.80
11	PPL Corp.	0.85
12	Progress Energy	0.75
13	Public Serv. Enterprise	0.85
14	Southern Co.	0.65
15	Average	0.81
16	Amer. Elec. Power	0.85
17	Spread: High to Average	0.29

Source:
The Value Line Investment Survey;
August 8, August 29, and
September 26, 2008.

Before the
The Public Utilities Commission of Ohio

IN THE MATTER OF THE APPLICATION OF THE COLUMBUS SOUTHERN POWER COMPANY FOR APPROVAL OF ITS ELECTRIC SECURITY PLAN; AN AMENDMENT TO ITS CORPORATE SEPARATION PLAN; AND THE SALE OR TRANSFER OF CERTAIN GENERATING ASSETS	)	Case No. 08-917-EL-SSO
IN THE MATTER OF THE APPLICATION OF OHIO POWER COMPANY FOR APPROVAL OF ITS ELECTRIC SECURITY PLAN; AND AN AMENDMENT TO ITS CORPORATE SEPARATION PLAN	)	Case No. 08-918-EL-SSO

Affidavit of Michael Gorman

State of Missouri)
) **SS**
County of St. Louis)

Michael Gorman, being first duly sworn, on his oath states:

1. My name is Michael Gorman. I am a consultant and managing principal with Brubaker & Associates, Inc., having its principal place of business at 16690 Swingley Ridge Road, Suite 140, Chesterfield, Missouri 63017. We have been retained by The Commercial Group, Inc. in this proceeding on its behalf.

2. Attached hereto and made a part hereof for all purposes are my direct testimony and exhibits which were prepared in written form for introduction into evidence in the Public Utilities Commission of Ohio Case Nos. 08-917-EL-SSO and 08-918-EL-SSO.

3. I hereby swear and affirm that the testimony and exhibits are true and correct and show the matters and things they purport to show.

Michael Gorman

Subscribed and sworn to before me this 29th day of October, 2008.

Notary Public

MARIA E. DECKER
Notary Public, State of Missouri
St. Louis City
Commission # 05706793
My Commission Expires May 05, 2009

CERTIFICATE OF SERVICE

I hereby certify that I caused a copy of the "Direct Testimony of Michael P. Gorman on behalf of The Commercial Group" to be served either via first class mail or electronic mail upon the following parties of record on the 31st day of October, 2008.

Grace C. Wung

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