23

FILE

EXHIBIT NO. _____

BEFORE
THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Application of	)	
Columbus Southern Power Company For	)	
Approval of its Electric Security Plan	)	Case No. 08- 917-EL-UNC
Including Related Accounting Authority;	)	
an Amendment to its Corporate	)	
Separation Plan; and the Sale or Transfer	)	
Certain Generating Assets	)	
	)	
and	)	
	)	
	)	
In the Matter of the Application of	)	
Ohio Power Company for Approval of	)	
its Electric Security Plan Including	)	Case No. 08-918-EL-UNC
Related Accounting Authority; and an	)	
Amendment to its Corporate Separation	)	
Plan	)	

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REBUTTAL TESTIMONY
OF
DR. ANIL MAKHIJA
ON BEHALF OF
COLUMBUS SOUTHERN POWER COMPANY
AND
OHIO POWER COMPANY

Filed: December 8, 2008

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REBUTTAL TESTIMONY OF
DR. ANIL MAKHIJA
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OHIO POWER COMPANY
PUCO CASE NO.- 08-917-EL-UNC
PUCO CASE NO. - 08-918-EL-UNC

1   **I.**   **INTRODUCTION AND SUMMARY**

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

3   A.   My name is Anil Kumar Makhija. My business address is 700 E. Fisher Hall,

4   Fisher College of Business, The Ohio State University, Columbus, Ohio 43210.

5   **Q.**   **DID YOU PREVIOUSLY PRESENT TESTIMONY IN THIS**

6   **PROCEEDING?**

7   A.   Yes. I presented Direct Testimony on behalf of Columbus Southern Power

8   Company (CSPCo) and Ohio Power Company (OPCo.) (collectively, the

9   Companies or AEP Ohio) with respect to the Significantly Excessive Earnings

10   Test (SEET) of Section 4928.143(P), Ohio Revised Code, which will be applied

11   to AEP Ohio annually, after each year of their Electric Security Plans starting in

12   2010.

13   **Q.**   **WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?**

14   A.   AEP Ohio has asked me to respond to the testimony filed by Richard Cahaan on

15   behalf of the Staff of the Public Utilities Commission of Ohio (Commission); Dr.

16   J. Randall Woolridge on behalf of the Office of the Ohio Consumers' Counsel

17   (OCC); Charles King on behalf of the Ohio Energy Group (OEG); and Michael

1   Gorman on behalf of the Commercial Group. I will discuss the methodologies

2   that each witness proposes for determining whether the electric utility has had

3   significantly excessive earnings. I also reply to criticisms that these witnesses

4   have made concerning the methodology that I proposed in my direct testimony.

5   Q.   **HOW HAVE YOU ORGANIZED THE SUBJECT MATTER OF YOUR**

6   **REBUTTAL TESTIMONY?**

7   A.   I address three subject matter categories in response to the criticisms of my

8   proposed methodology: (1) issues concerning the formation of the group of

9   publicly traded companies that have comparable business and financial risks to

10   the subject electric utility, (2) issues regarding the proper method for determining

11   equity returns for the comparable group of companies and the subject electric

12   utilities, and (3) issues dealing with the significantly excessive earnings test and,

13   in particular, why a statistical approach to devising the test is appropriate.

14   Q.   **PLEASE SUMMARIZE YOUR REBUTTAL TESTIMONY.**

15   A.   The main issues center around the identification of comparable firms and the

16   setting of the threshold for significantly excessive earnings. I review the

17   methodologies proposed by King, Gorman, and Woolridge, and conclude that

18   their selection of comparable firms does not conform with the SEET. Their

19   comparable firms are proposed without properly matching the business and

20   financial risks of the subject utility. Their selection of comparable firms is ad hoc

21   and can match any number of utilities, and yet not necessarily the subject utility.

22   In contrast, I apply to the subject utility well-grounded risk measures that

23   specifically capture risks explicitly named in the SEET (business and financial

3

1   risks), and then identify matching comparable firms. I also defend the use of a

2   statistical approach to determine the cutoff for significantly excessive earnings,

3   which addresses the objections raised by Mr. Cahaan.

4

5

6   **II.**   **RESPONSE TO METHODOLOGIES PROPOSED BY OTHER WITNESSES**

7   **AND TO CRITICISMS OF MY METHODOLOGY BY OTHER WITNESSES.**

8

9   **Q.**   **WHAT ARE THE ISSUES SURROUNDING THE IDENTIFICATION OF**

10   **THE COMPARABLE GROUP?**

11

12   **A.**   SEET specifically requires that the comparable sample of firms are those "that

13   face comparable business and financial risk." The list of business risks is

14   extensive, including in it uncertainties associated with revenues and expenses,

15   regulatory risks, demand fluctuations, etc., which are all the risks faced by an all-

16   equity firm. In addition, financial risks to common equity holders arise from the

17   extent of leverage because debt obligations must be repaid before any payments

18   are made to common shareholders.

19

20   In Makhija Direct, I have proposed metrics for the measurement of business risk

21   and financial risk. In particular, the unlevered beta is a comprehensive measure

22   for business risk, while the book equity ratio measures financial risk. I will return

23   below to the relative merits and application of these measures after I review the

4

1   .other methodologies that have been proposed for the formation of the comparable

2   group.

3

4   <u>Woolridge Procedure to Identify Comparable Group</u>

5

6   Woolridge has proposed a multiple step procedure to identify the group of

7   comparable firms. Essentially the procedure has the following steps: (a) First, he

8   identifies a so-called "proxy group" of electric utility companies. (b) Then, he

9   estimates the business and financial risks of these "proxy group" of electric

10   utilities to establish a range of values for business risk and financial risk.

11   Business risk is measured with Value Line betas and Asset Turnover (which is a

12   measure of capital intensity and is defined as Revenue/Total Book Assets,

13   according to his cross-examination testimony). (c) Finally, he forms the

14   comparable group by identifying all firms (from the universe of firms available on

15   Value Line) that have business risk and financial risk within the ranges for the

16   "proxy group."

17

18   There are several problems with this procedure. First of all, the procedure limits

19   matching comparable firms to only those that have the characteristics of other

20   electric utilities. This is contrary to the language and spirit of the SEET, which

21   requires that the matching firms include non-utility firms. Not surprisingly, with

22   his restrictive "proxy group" of electric utilities only as the starting point, the

23   procedure is hard-wired to produce a comparable sample of firms that is

1   overwhelmingly made up of regulated firms: Only about 10% of the sample of 64

2   comparable firms are non-utility firms.

3

4   The limitations of the Woolridge procedure become apparent when we consider

5   the list of his "proxy group" of firms in his Table 1 (Woolridge Direct, page 6)

6   and their characteristics in his Table 2. Woolridge's method for selecting his

7   "proxy group" leads to the same list of firms for each electric utility in Ohio that

8   he evaluates. In fact, the particulars --business and risk characteristics-- of the

9   subject utility never even enter the procedure in the determination of the final

10   comparable group of firms. The same final list of comparable firms is identified

11   (Exhibit JRW-2 in Woolridge Direct with the same mean ROE for 2007 of

12   11.37% and the same standard deviation 4.52% for each Ohio electric utility that

13   he evaluates.

14

15   Yet, we know that Woolridge does not believe that all electric utilities are the

16   same, in that they have different business and financial risks as seen in step (b).

17   After all, in his Table 2 for the "proxy group" the betas range from 0.6 to 1.06, a

18   maximum value that is nearly 77% greater than the minimum value. The

19   comparable figures for the ranges for Asset Turnover and Common Equity Ratio

20   are 233% and 107%, respectively. Though his ranges restrict us to a largely

21   regulated sample of comparable firms, it does not distinguish among utilities

22   despite these remarkable differences.

23

1	A specific example from Ohio itself can illustrate material risk differences among
2	electric utilities. First Energy's EDUs are insulated from generation and
3	transmission risks, while the risks of generation and transmission are integrated in
4	the AEP EDUs' businesses and makes those EDUs riskier. The point is that we
5	can not *a priori* presume away differences in business and financial risks across
6	utilities.
7	
8	So, what went wrong? The chief difficulty is that the characteristics of the
9	comparable group were pre-decided in step (a) once the "proxy group" was
10	chosen without regard to any business or financial risk measures of the subject
11	utility. Though the SEET does not restrict the comparable set of firms to a
12	specific industry, Woolridge actively sought to do so. Prior to laying out the
13	procedure, he prejudged the type of firms that should be of comparable risk for
14	purposes of the SEET: "Presumably, this would mean capital intensive, service
15	industries. Nonetheless, in my opinion, the most comparable companies would be
16	public utilities" Woolridge Direct (page 3, lines 8-10).
17	
18	The measurement of business risk is also inadequate, besides being invoked too
19	late in the procedure to meaningfully allow non-utility firms into the group of
20	comparable firms. Woolridge highlights the capital intensity of the subject firms
21	(e.g. OPCo, CSPCo, etc.), but this is just one feature of the business risks of these
22	firm – albeit an important one. The other measure used by Woolridge is the

1   Value Line beta, but that mixes up business and financial risk. Thus, there is no

2   comprehensive measure of business risk in his procedure.

3

4   King Procedure to Identify Comparable Group

5   Though the SEET requires the formation of one comparable group of firms with

6   non-utility and utility firms, King proposes the formation of two comparable

7   groups. Essentially, one group consists of almost the entire list of 64 publicly

8   traded electric utilities in Value Line's Datafile. He finds that they had an

9   average ROE of 10.68% in 2007. He forms a second group of comparables from

10   all the firms in Value Line's Datafile after eliminating electric, gas, and water

11   utilities, as well as those with gross plant to asset ratios outside of the range 1.2 to

12   5.0. He further keeps only those firms with gross plant over $1 billion. Finally,

13   he is left with a final list of 219 firms for which he has data available on Value

14   Line's Datafile. The 2007 ROE of these firms is 14.14%.

15   This procedure fails to apply the SEET on several grounds. There is simply no

16   single group of "publicly traded companies, including utilities" as required by the

17   SEET. In fact, King explicitly arbitrarily removes electric, gas, and water utilities

18   from his non-utility group. Furthermore, by his own admission, his non-utility

19   group is not comparable to the subject utilities, since he asserts that they have

20   different (beta) risks.

21   As for matching business risk and financial risk, King's procedures are

22   inadequate. There is no control for financial risk at all in forming the comparable

23   sample, although later he attempts to correct for capital structure differences using

8

1	the book equity ratio. As for business risk, he does consider capital intensity, but
2	in an arbitrary manner. He restricts his comparable firms to those with gross plant
3	to revenue ratios (his definition of capital intensity) between 1.2 to 5.0. His
4	justification is that this is the range of values for his comparable group of 64
5	electric utilities. Thus, business risk of the subject electric utility is never taken
6	into account in the entire procedure. Mr. King's method will, indeed, produce the
7	same resulting final sample of 219 comparable non-utility firms (as well as the
8	same group of electric utilities) for each Ohio electric utility because it is
9	independent of the specific subject Ohio electric utility. Yet, he notes that capital
10	intensity ranges from 1.2 to 5.0, which is 317% higher than the low end.
11	
12	Even if King had taken into account the specific capital intensities of the subject
13	electric utilities, he would have matched on only one aspect of business risk.
14	Thus, in forming the comparable sample, King employs no comprehensive
15	measure of business risk and furthermore ignores the business risk of the subject
16	utility.
17	
18	Gorman
19	Gorman does not develop a comparable group at all, which leaves his procedure
20	at odds with the requirements clearly laid out by the SEET. Instead, he
21	recommends the use of an allowed rate of return on equity as the benchmark
22	return, and then adds 200 basis points to arrive at the threshold beyond which the
23	returns should be considered significantly excessive. Gorman ignores the fact that

1	the SEET is retrospective, in contrast to the allowed rate of return procedure
2	which is forward-looking. His approach might apply in a traditional cost of
3	service rate-making environment, but it has no place in the retrospective setting of
4	the SEET under SB 221.
5	
6	Without forming a comparable sample, Gorman simply does not address the
7	issues surrounding the measurement of business risk and financial risk.
8	
9	Cahaan's views and other potential procedures for forming a comparable group
10	While Cahaan expresses concerns about certain uses of the comparable group
11	(e.g., using the ROEs for the comparable group of firms to determine the
12	threshold for excessive earnings), he does not oppose the formation of the
13	comparable group. As for the method for identifying, he offers his opinion when
14	he says that, "I have some major reservations regarding the methodology's use of
15	"beta" as a primary discriminator in this case." I take up this issue and other
16	concerns about beta later below. Cahaan has also expressed a concern that the
17	comparable group should have firms that have some recognizable comparability
18	(Cahaan Direct, Oct 6, 2008). However, these are the reasons that can lead one to
19	prejudge what are "comparable industries" rather than use measures that match
20	the business risk and financial risk of the comparable firms with the subject
21	utility.
22	The common shortcoming in the selection procedures we have reviewed is the
23	following: The comparables are formed by restricting the sample to some chosen

1		"comparable industries" and then hoping that the firms in these industries will
2		match the specific business and financial risks of the subject utility. The
3		particular business and financial risks of the subject utility are likely to be missed
4		since they are not directly used to match and find comparable publicly traded
5		firms.
6		
7		
8	Q.	**HOW DOES YOUR PROPOSED METHODOLOGY MEET THE**
9		**REQUIREMENTS OF THE SEET?**
10		
11	A.	In Makhija Direct, I propose that comparable firms are selected by matching
12		the unlevered beta for business risk and the book common equity ratio for
13		financial risk. In addition, I am not opposed to adding capital intensity,
14		measured as the ratio of Revenues to Total Assets, as an additional check to
15		ensure that an important business risk of the subject electric utility is taken
16		into account. Indeed, similarly one can supplement the matching of the
17		financial risk too by employing an additional metric, say the Standard and
18		Poor's Issuer Long-Term Credit Rating. My suggested methodology is
19		versatile, in the sense that we need not be overly reliant on any one metric,
20		and can hone in more precisely on the business and financial risks of the
21		subject utility and the matching comparable firms. (In fact, there is a tradition
22		in Finance of doing just this, as exemplified by one of the most cited papers in
23		Finance by Eugene F. Fama and Kenneth R. French, The Cross-Section of
24		Expected Stock Returns, Journal of Finance XLVII (2), June 1992, 427-465).

1	I discuss each of the selection criteria for the formation of the comparable
2	group below.
3	
4	<u>Unlevered Beta</u>
5	There are several compelling reasons to recommend the use of unlevered
6	betas:
7	
8	1. The unlevered beta is derived from the Capital Asset Pricing Model for which
9	William Sharpe received the 1990 Nobel Prize. It captures the risk that
10	shareholders can not diversify away.
11	2. The survey of CFOs by John Graham and Campbell R. Harvey ("The theory
12	and practice of corporate finance: Evidence from the field," *Journal of*
13	*Financial Economics* 61 (2001), 187-243) shows that by far the CAPM is the
14	most widely used model for risk measurement.
15	3. Betas and the Capital Asset Pricing Model are regularly accepted by public
16	utility commissions (PUCs) across the United States, including the Public
17	Utility Commission of Ohio. In particular, since Value Line betas are
18	routinely used before PUCs, shareholders may "count" their risk in terms of
19	Value Line betas.
20	4. Specifically, the use of unlevered betas was accepted by the Commission, in
21	Case No. 96-922-TP-UNC, when it based its cost of equity capital
22	determination in its June 19, 1997 Opinion and Order in that case upon the
23	Testimony of AT&T witness Prof. Bradford Cornell. Indeed, I use exactly

12

1	the same formula for unlevered betas as was employed by Prof. Bradford
2	Cornell. Unlevered betas are not conceptually removed from betas, since they
3	are the corresponding betas if the firm were to become an all-equity firm.
4	That is, they are the betas left after the "subtraction" of financial risk.
5	5. The use and calculation of unlevered betas goes back decades to Robert
6	Hamada ("The effect of a firm's capital structure on the systematic risk of
7	common stock, *Journal of Finance* 27, 1972, 435-452).
8	6. There has been no specific concern raised about betas or unlevered betas as
9	risk measures in any testimony filed on the SEET by King, Gorman, or
10	Woolridge. In fact, Woolridge (on behalf of Ohio Consumers Counsel) and
11	King (on half of Ohio Energy Group) have used betas for the measurement of
12	risk.
13	7. Unlevered betas are a summative measure of total business risk, while other
14	measures such as capital intensity (Revenues to Total Assets) capture only a
15	specific aspect of business risk.
16	
17	To be sure, betas, and thus unlevered betas, too have been challenged in the
18	finance literature. However, as a practical matter, betas have greater acceptance
19	then alternative measures of risk (John Graham and Campbell R. Harvey, *Journal*
20	*of Financial Economics* 61 (2001), 187-243). It is this acceptance in practice that
21	provides betas their importance, irrespective of the academic debate.
22	

1	A practical concern regarding betas may be that they can change over the year.
2	That may well be the strength of betas because they actively reflect changes in
3	risk. As to the point in time at which one should measure betas, since Value Line
4	may update it several times in a year, the average beta over the year can capture
5	the risks actually experienced by shareholders. This would be no different from
6	measuring the book equity ratio over the year (average book equity over average
7	total assets).
8	
9	Finally, there is also the practical issue that betas are only available for firms with
10	traded stock. This is not usually an issue for the formation of the comparable
11	sample since there are many traded firms (with Value Line betas available for
12	them). So, we are looking for those firms that have comparable unlevered beta
13	risks that match the subject utility, which itself need not be traded. In the matter
14	of Ohio electric utilities, these risks can confidently be imputed from the traded
15	parent firm. Indeed, the market explicitly recognizes this. Todd Shipman, says in
16	the July 13, 2007 issue of Standard and Poor's *RatingsDirect* that "The ratings on
17	Ohio Power Co. are based on the consolidated credit profile of American Electric
18	Power Co, Inc. (AEP). .... Ohio Power's liquidity is managed by its
19	parent...Corporate Credit Rating: BBB/Stable/-." Furthermore, Todd Shipman
20	uses the same language to equate Columbus Southern Power's financial condition
21	to its parent, AEP (July 12, 2007 issue). The SEET does not prevent us in
22	estimating risks of the subsidiary firm in the best way possible – even if we
23	impute it from the parent -- while the focus of the SEET remains on a subject

1 subsidiary. Specifically, the SEET only says that "the commission shall not

2 consider, directly or indirectly, the revenue, expenses, or earnings of any affiliate

3 or parent company."

4

5 Book Common Equity

6

7 There is little controversy among proponents of different methodologies for the

8 SEET regarding what constitutes financial risk and that some version of the book

9 common equity ratio is an appropriate measure for it. While using the book

10 common equity to illustrate the application of the SEET, I have also made a case

11 in Makhija Direct for the market equity ratio. Changing market conditions are

12 better captured by the market equity ratio. However, credit agencies do pay

13 attention to the book equity ratio, and that the book equity ratio is more stable.

14 Consequently, it is with the book equity ratio that I illustrate the application of the

15 SEET with 2007 data. I define the book equity ratio as the ratio of the book

16 equity divided by total assets. In some cases, as in Woolridge Direct, the common

17 equity ratio is instead defined as shareholder's equity divided by total capital,

18 where total capital is the sum of long-term debt, preferred equity, and common

19 equity. While typically short-term debt may be fixed according to working

20 capital needs, some firms may choose to roll over extra short-term debt

21 continually instead of issuing long-term, which is a problem for the equity to

22 capital ratio.

23

1   <u>Asset Turnover</u>

2

3   In addition to the summative measure of business risk, unlevered beta, I am not

4   opposed to including a check on my selection of comparables through the use of

5   the capital intensity of the comparable group of firms. Though not a replacement

6   for unlevered beta -- which captures total business risk-- the additional use of

7   capital intensity would reduce an over-reliance on a single measure of business

8   risk.   King and Woolridge rely primarily on this characteristic, though they

9   define it differently.

10

11   **Q. HOW DO YOU MEASURE EARNED RETURNS ON COMMON EQUITY AND**

12   **HOW DOES THAT COMPARE WITH MEASURES EMPLOYED BY KING**

13   **AND WOOLRIDGE?**

14

15   Q. The SEET specifically refers to "earned return on common equity". This means that

16   returns on preferred equity are not to be comingled with returns to equity holders. While

17   Woolridge recognizes this requirement in his definition of the appropriate measure of

18   earnings (Woolridge Direct, page 3, lines 1-3), he improperly mixes returns on common

19   with preferred in his later analysis. We can see this in his Exhibit JRW – 4, where he

20   backs out the implied return to equity for CSPCo and OPCo based on the total return to

21   capital for his comparable firms. Debt and its cost is taken into account, but preferred

22   seems to be mixed in with common. Since preferred is less risky than common, the net

23   effect can be to lower the earned rates to common. King similarly does not account for

16

1	preferred return elements. In Makhija Direct, I examined returns earned strictly by
2	common equity.
3	
4	There is a further methodological problem with the manner in which capital structure is
5	taken into account by Woolridge. For purposes of capital budgeting for long term
6	projects, it is common practice to define the relevant capital in terms of long-term
7	financing, adding up long-term debt, preferred equity, and common equity. But, this is
8	not the nature of the problem we are dealing with here. Instead, we are interested in what
9	rate was earned by common equity holders if the comparable firms had the same capital
10	structure as the subject utility. So, we should begin with the total returns for the
11	comparable firms to all capital, including short-term debt. (We can not assume away that
12	the working capital is always such that there is no net short-term debt). Next, after
13	finding the total returns for the comparable firms, we need to determine earned rates to
14	common by re-leveraging at the debt level of the subject utility. Again short-term debt
15	and its interest costs should be incorporated, but are ignored by Woolridge. Of course,
16	the necessary data may not be readily available, which makes this approach inherently
17	harder to implement and recommend. In essence, Woolridge is taking a familiar
18	approach from the rate making type of exercise for allowed rates for equity and applying
19	it in a situation where it does not fit.
20	
21	Another issue regarding the earned rate on common concerns the inclusion or exclusion
22	of non-recurring one-time items. If one's goal is to capture the full impact on common
23	shareholders, net income after discontinued, non-recurring and extraordinary items

1   reflects that objective. Indeed, that is the bottom line frequently used in reporting net

2   income (and earnings per share). This was the measure used in Makhija Direct to

3   determine the earned return on common equity." However, the one-time adjustments to

4   income can produce large fluctuations in earned rates, and corresponding volatility in

5   earned rates which may not reflect earnings in the firm's regular business. The intent of

6   SEET could be interpreted to be directed at those earnings in the normal functioning of

7   the firm and not at one-time exceptional events. Consequently, I would not be opposed

8   to using earned returns on common equity after deduction of all expenses including taxes,

9   minority interests, and preferred dividends paid or accumulated, but before inclusion of

10   any non-recurring, special, and extraordinary items.

11

12   Q. ONCE THE COMPARABLE GROUP OF FIRMS HAS BEEN

13   IDENTIFIED, YOU HAVE PROPOSED USING ITS STANDARD

14   DEVIATION OF EARNED RETURNS ON EQUITY TO DETERMINE A

15   THRESHOLD FOR EXCESSIVE EARNINGS. MR. CAHAAN HAS

16   QUESTIONED THIS STATISTICAL APPROACH. HOW DO YOU

17   RESPOND TO HIS CRITICISM?

18

19   A. Mr. Cahaan appears to be comfortable in using the mean return for the

20   comparable firms as a starting benchmark in the determination of the cutoff for

21   excessive earnings. The mean return for a sample of returns is, of course, itself a

22   statistical construct. Moreover, the description of the returns to the comparable firms

23   would be quite deficient if it was restricted to merely the mean without a sense of the

1	variation around that mean. This is just what the standard deviation captures. Yet (at
2	least for normally distributed earned rates), all that is needed are the mean and
3	standard deviation to logically determine the probabilities of different levels of higher
4	earned rates. The confidence levels are merely the probabilities of observing these
5	returns. In other words, the issue at hand, determination of threshold earned rates,
6	naturally lends itself to a statistical approach.
7	
8	Q. AT PAGE 20 OF HIS TESTIMONY, MR. CAHAAN SAYS THAT HE
9	THINKS THE VARIANCE SHOWN BY THE SAMPLE STATISTICS OF
10	THE COMPARABLE GROUP GROSSLY OVERSTATES THE
11	VARIANCE INHERENT IN THE COMPANIES' PROPOSED ESPs, DUE
12	TO THE EARNINGS STABILITY THAT HE STATES HAS BEEN AN
13	IMPORTANT CONSIDERATION IN THE COMPANIES' ESP
14	PROPOSALS. WHAT IS YOUR RESPONSE?
15	
16	A. If the methodology for matching business and financial risk is effective, the
17	stabilization impact of the ESP will show up in the EDU's unlevered beta, capital
18	intensity, and book equity ratio. Only the firms that match these risks will enter
19	the set of comparable firms. Thus, if the SEET is well designed, there is no
20	reason why the variation in earned rates for the comparable firms will be
21	overstated. Moreover, given the asymmetrical nature of the SEET, certain Ohio
22	utilities may face additional risks not present for comparable firms.
23	

1   Q.   SEVERAL WITNESSES (WOOLRIDGE, KING) HAVE

2   RECOMMENDED USING A 150 TO 200 BASIS POINT ADDER TO THE

3   MEAN EARNED RETURN OF THE COMPARABLE GROUP IN ORDER

4   TO DEFINE THE THRESHOLD FOR A SIGNIFICANTLY EXCESSIVE

5   EARNED RETURN, BASED ON THE ADDER THAT THE FERC USES

6   TO INCENT INVESTMENT IN NEW TRANSMISSION LINE PROJECTS.

7   WHAT IS YOUR VIEW OF SUCH AN ADDER, INSTEAD OF THE

8   THRESHOLD THAT YOU HAVE RECOMMENDED BASED ON A

9   STANTISTICAL ANALYSIS?

10

11   A.   The SEET explicitly leads us to determine the threshold for excessive earned rates

12   based on the matching of business and financial risks of an EDU with a set of

13   comparable firms. Use of the FERC adder completely ignores this basic

14   requirement of the SEET. The 200 basis point adder need neither reflect the

15   business or financial risks of a subject EDU nor would it change with changes in

16   the economic conditions and performance of the comparable firms. In short, it

17   would be an arbitrary adder.

18

19   Q.   MR. CAHAAN HAS RECOMMENDED USING AN ADDER WITHIN A

20   RANGE, WITH THE LOWER OF THE RANGE BEING 200 BASIS

21   POINTS, BASED ON THE WOOLRIDGE AND KING PROPOSALS, AND

22   THE UPPER END BEING 400 BASIS POINTS, BASED ON AN

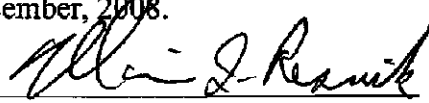|		
1		EQUITY/BOND RISK PREMIUM. WHAT IS YOUR OPINION
2		REGARDING MR. CAHAAN'S PROPOSED THRESHOLD RANGE?
3		
4	A.	To the extent that the upper end of 400 basis points does not reflect the business
5		and financial risks of the subject utility and its comparables, it is just as arbitrary
6		as the 200 basis point adder. Furthermore, it relies on prospective return
7		differences, while the SEET is clearly retrospective.
8		
9	Q,	WHAT IS YOUR ASSESSMENT OF MR. CAHAAN'S APPROACH TO
10		THE STATUTORY TEST?
11		
12	A.	Mr. Cahaan criticizes the significantly excessive earnings test that I have
13		proposed because, in my approach, significantly excessive earnings occur only if
14		the electric utility's earned return exceeds by a significant amount the average
15		earned return of the group of comparable risk firms. Mr. Cahaan believes that this
16		approach reverses the burden of proof that the statute puts on the electric utility to
17		prove that significantly excessive earnings did not occur. He recommends,
18		instead, that the "null hypothesis" would have to be reversed so that the earned
19		returns are considered to be significantly excessive unless the utility can
20		demonstrate that they are not.
21		
22	Q.	IS IT FEASIBLE TO REVERSE THE NULL HYPOTHESIS IN THE
23		MANNER THAT MR. CAHAAN RECOMMENDS SHOULD BE DONE?

1

2   A.   No. Implementing Mr. Cahaan's proposal regarding the null test would require

3   identification of a group of comparable risk firms that already have significantly

4   excessive earned returns. Then, we would measure the subject electric utility's

5   earned return against the average of the significantly excessive returns of the

6   comparison group to determine whether the subject utility's earned return is

7   "indistinguishable" from the returns to these comparables with known excessive

8   returns. The flaw in Mr. Cahaan's recommendation is that there is no sample of

9   firms with significantly excessive earned returns, and there is no method I am

10   aware for constructing such a sample.

11

12   **Q.**   **DOES THAT CONCLUDE YOUR TESTIMONY?**

13   A.   Yes, it does.

CERTIFICATE OF SERVICE

I hereby certify that a copy of Columbus Southern Power Company's and Ohio Power Company's Rebuttal Testimony of Dr. Anil K. Makhija was served by electronic mail upon counsel identified below this 8th day of December, 2008.

Marvin I. Resnik

Marvin I. Resnik

EMAIL

sbaron@jkenn.com
lkollen@jkenn.com
charlieking@snavely-king.com
mkurtz@bkllawfirm.com
dboehm@bkllawfirm.com
grady@occ.state.oh.us
etter@occ.state.oh.us
roberts@occ.state.oh.us
idzkowski@occ.state.oh.us
stnourse@aep.com
dconway@porterwright.com
jbentine@cwslaw.com
myurick@cwslaw.com
mwhite@cwslaw.com
khiggins@energystrat.com
barthroyer@aol.com
gary.a.jeffries@dom.com
nmoser@theOEC.org
trent@theOEC.orgs
henryeckhart@aol.com
nedford@fuse.net
rstanfield@nrdc.org
dsullivan@nrdc.org
ed.hess@puc.state.oh.usc
thomas.lindgren@puc.state.oh.us
werner.margard@puc.state.oh.us
john.jones@puc.state.oh.us
sam@mwncmh.com
lmcalister@mwncmh.com
jclark@mwncmh.com
drinebolt@aol.com
cmooney2@columbus.rr.com
msmalz@oslsa.org
jmaskovyak@oslsa.org
ricks@ohanet.org
tobrien@bricker.com

todonnell@bricker.com
cvince@sonnenschein.com
preed@sonnenschein.com
ehand@sonnenschein.com
tommy.temple@ormet.com
steven.huhman@morganstanley.com
dmancino@mwe.com
glawrence@mwe.com
gwung@mwe.com
stephen.chriss@wal-mart.com
lgearhardt@ofbf.org
cmiller@szd.com
gdunn@szd.com
aporter@szd.com
erii@sonnenschein.com
agamarra@wrassoc.com
kschmidt@ohiomfg.com
sbloomfield@bricker.com
cynthia.a.fonner@constellation.com
david.fein@constellation.com
mhpetricoff@vssp.com
smhoward@vssp.com
bsingh@integrysenergy.com
cgoodman@energymarketers.com
lbell33@aol.com