BEFORE
THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Investigation into the Development of the Significantly Excessive Earnings Test Pursuant to S.B. 221 for Electric Utilities.	))))	Case No. 09-786-EL-UNC

COLUMBUS SOUTHERN POWER COMPANY'S AND OHIO POWER COMPANY'S INITIAL COMMENTS

By Entry issued September 23, 2009, the Commission directed that a workshop be conducted on the development of the significantly excessive earnings test (SEET) that would be applied under §§4929.142(D)(4) and 4928.143(E) and (F) in connection with an electric distribution utility's approved Market Rate Offer (MRO) and Electric Security Plan (ESP). The September 23 Entry also directed the Staff to develop and file recommendations for the SEET. A list of topics for discussion at the workshop was published

The topics for discussion at the workshop, in the form of a list of Staff questions regarding the SEET, was published on the Commission's website, and on October 5, 2009, the Staff held a workshop at which those topics were discussed. On November 18, 2009, the Staff filed its recommendations regarding the SEET. By Entry issued November 19, 2009, the Commission's Attorney Examiner directed interested persons to file initial comments on the Staff's recommendations by December 14, 2009, and reply comments by January 4, 2009.

Columbus Southern Power Company (CSP) and Ohio Power Company (OP) (collectively, "AEP Ohio") submit the following initial comments on the Staff's SEET recommendations. AEP Ohio's comments are organized according to the list of questions discussed at the workshop and the Staff's November 18 recommendations. AEP Ohio thanks the Commission for this opportunity to submit comments.

1. Should off-system sales (OSS) be included in the significantly excessive earnings test (SEET)

Staff Recommendation: Staff recommends including OSS margins in earnings used to calculate the electric distribution utility's (EDU's) return on equity for purposes of the SEET.

Comment The entire focus of S.B. 221 is on retail sales, and the focus of the SEET in §4928.143(F) specifically provides that only earnings resulting from adjustments included in the EDU's ESP are subject to the SEET. Clearly, off-system-sales revenues are not an adjustment to AEP Ohio's ESP.

Consequently, it would be unlawful to treat earnings that result from wholesale transactions and also that are not the result of any adjustment included in a provision of the EDU's ESP as significantly excessive. AEP Ohio believes that the most efficient approach to complying with §4928.143(F) and respecting the FERC's jurisdiction is to remove earnings resulting from OSS margins from the calculation of the utility's return on equity at the outset of the exercise.

Second, AEP Ohio believes that it would not be appropriate to require a refund to customers of revenues based on a return on equity that results, in part, from off-system sales (OSS) margins. Instead, OSS margins should be removed from the calculation of the EDU's return on equity. First, OSS margins result from wholesale, not retail, transactions whose rates are authorized by the Federal Energy Regulatory Commission (FERC). Ordering earnings that result from FERC jurisdictional wholesale rates to be returned to retail customers would be unlawful.[1]

2. Should the Commission determine SEET on a single-entity basis or company-wide basis?

Staff Recommendation: Staff recommends that the SEET should be calculated on a single-entity basis, rather than on a combined basis. In the case of AEP Ohio, the Staff's recommendation would mean that, for purposes of determining significantly excessive earnings, the SEET would be applied to CSP and OP individually, rather than on a combined basis. The Staff appears to base its recommendation on the language of §4928.143(F) that states, "[i]n making its determination of significantly excessive earnings under this division, the Commission shall not consider, directly or indirectly, the revenue, expenses, or earnings of any affiliate or parent company."

Comment: AEP Ohio maintains that there are compelling policy reasons for performing the SEET on CSP and OP on a combined basis. These two Ohio electric distribution utilities are vertically integrated utilities (generation, transmission and distribution) and are operated as a single entity, with a single management structure. Therefore, combining affiliated Ohio EDUs for purposes of performing the SEET helps to promote efficient investment and operating

[1] Under well-settled federal constitutional law, the State is preempted from interfering with the Companies' ability to realize revenue rightfully received from wholesale power sales pursuant to contracts or rates approved by the Federal Energy Regulatory Commission. *Pacific Gas & Electric v. Energy Resources Comm.*, 461 U.S. 190 (1983); *Nantahala Power & Light Co. v. Thornburg*, 476 U.S. 953 (1986); *Mississippi Power & Light v. Mississippi*, 487 U.S. 354 (1988); *Pacific Gas & Electric Co. v. Lynch*, 216 F. Supp. 2d 1016 (N.D. Cal. 2002). Just as the State may not trap FERC-approved wholesale power costs, it may not in effect capture or siphon the revenue the Companies receive from FERC-approved wholesale sales for the purpose of reducing the retail rates paid by Ohio customers. Any such order by the Commission would conflict with the Federal Power Act and Congress' power under the Supremacy Clause. It also would be the type of economic protectionism legislation that would violate the federal Commerce Clause. *New England Power Co. v. New Hampshire*, 455 U.S. 331 (1982).

practices. It encourages affiliated EDUs to seek out and achieve the scale economies that are available when their operations are conducted on a combined basis. Conversely, performing the SEET on a separate company basis would assume that investment and O&M spending are determined on a stand-alone company basis. Indeed, separate company determinations of SEET could punish one of the affiliated EDUs for management's focus on maximizing efficient investment and O&M spending on a combined-company basis. For example, it makes little sense, and would be unfair to their common shareholders, to require an affiliated EDU to refund excessive earnings while another affiliated EDU, with the same common shareholders, may be simultaneously earning a return on common equity that is significantly below an excessive return. Clearly, the public interest is advanced by performing the SEET on a combined company basis when there are two or more affiliated EDUs in Ohio, as is the case with CSP and OP. This would be consistent with the Commission's analysis of the Standard Service Offer. In that regard, the Commission analyzed AEP Ohio's Electric Security Plan (ESP) on an AEP Ohio combined basis, not as two distinct companies. The Commission's Opinion and Order in AEP Ohio's ESP proceeding considered and resolved all issues that were applicable to both Companies in a consistent fashion.

While it is true that CSP and OP rate structures differ, those differences do not preclude performing the SEET's earned return on equity calculation on a combined company basis. Moreover, those differences could be appropriately taken into account, in the event significantly excessive earnings are determined to have occurred (on a combined company basis), as part of the remedy the Commission adopts for returning such earnings to customers.

The restriction in §4928.143(F) against considering the revenues, expenses, or earnings of "any affiliate or parent company" in the significantly excessive earnings determination, need not preclude the Commission from applying the SEET on a combined company basis. The proper interpretation of the reference to "affiliates" in that provision is that it addresses only related entities that are not electric distribution utilities, such as competitive retail electric service providers or generation-only and transmission-only companies.

Even if the Commission were to determine that the applicable statutory language precludes calculating return on equity on a combined company basis, the Commission still should consider the policy concerns identified above when considering the extent of any SEET refund. If one EDU's return on equity is considered to be significantly excessive, the statute does not preclude the Commission from considering the combined return on equity of the affiliated EDUs. If that combined return is not significantly excessive that fact can and should be a factor for the Commission to consider and should reduce or eliminate the refund that might otherwise be imposed by the Commission.

3. What adjustments should be included in the SEET calculation? and
11. How should write-offs and deferrals be reflected on equity calculations for SEET?

There are several aspects of the Staff's recommendation on the subject matters addressed by Items 3 and 11. AEP Ohio's comments on each aspect are provided below.

a. <u>Staff Recommendation</u>: Staff states that extraordinary items should be excluded from the EDU's earned return in order to provide a reasonable, representative, and consistent measure of return on equity, and that, where applicable, adjustments should be made to remove items associated with non-Ohio service areas.

<u>Comment</u>: AEP Ohio agrees. In particular, the recommendation to make adjustments to remove items associated with non-Ohio service areas reflects AEP Ohio's position that earnings attributable to activities in jurisdictions other than the Ohio Commission's jurisdiction should be

excluded from the SEET. Therefore, this recommendation supports an adjustment for off-system sales since they are FERC-jurisdictional and "are associated with non-Ohio service areas."

b. Staff Recommendation: Staff states that the adjustments created by the implementation of an ESP or MRO are what should be determined on a company-specific basis, although this calculation is necessary "only if financial results [*i.e.*, the earned returns on equity] are deemed to be excessive." The Staff recommends that if these adjustments, in total, are excluded from the earned return deemed to be excessive and, consequently, reduce that return to a level no longer deemed excessive, then it is requisite to return the amount of the excess to consumers.

Comment: First, AEP Ohio agrees that the focus must be, as the statutory provisions require, on the earnings that result from adjustments created by the ESP or MRO. AEP Ohio also concurs with the Staff's recommendations concerning when earnings should be returned to consumers. However, AEP offers several suggestions. First, the Staff refers to the criterion as "excessive earnings" or "excessive earned returns." The statutory criterion is "significantly excessive" earnings or earned returns. Second, it is worth emphasizing that "the amount of the excess" that is subject to being returned to consumers is only that portion of earnings resulting from adjustment that is above the "significantly excessive" threshold. Third, the statute allows the Commission to consider other factors such as the capital requirements of future committed investments in Ohio prior to ordering any refund. Fourth, as the Staff recommends in connection with its response to Question No. 10, the Commission should not, at this point, decide specifically how, in the event significantly excessive earnings do occur, such earnings should be returned to consumers. Rather, the Commission should retain the flexibility to fashion how and when earnings are returned in a manner that is appropriate to the circumstances and that maximizes the benefits to consumers and the public interest.

c. Staff Recommendation: Staff proposes that extraordinary items that are created as an adjustment in the ESP or MRO should be included in the SEET; while such items that are not created by adjustments in the ESP or MRO should not be included in the SEET, either in earnings or as an adjustment.

Comment: AEP Ohio agrees.

d. Staff Recommendation: Regarding OSS margins, Staff recommends that only if OSS are included as an adjustment to an EDU's MRO or ESP should OSS then be included as part of the SEET calculation; and, conversely, if OSS margins are not included as an adjustment to the MRO or ESP, then they should be excluded from the SEET calculation.

Comment: AEP Ohio agrees that OSS margins that are not the result of adjustments in the ESP or MRO should be excluded from the SEET calculation. However, AEP Ohio recommends that, for legal reasons as explained above, the exclusion should occur at the outset, in the calculation of earnings, rather than at a point further downstream during the SEET calculation.

4. What is the precise accounting definition of "earned return on common equity" that should be used?

Staff Recommendation: The Staff recommends that the "earned return" should be "the net income for the year divided by the average common equity over all months of the year," and that "[e]xtraordinary items should be excluded."

Comment: In order to provide further clarity, AEP Ohio requests that the Commission confirm that the numerator, net income, consistent with the Staff's recommendation, is profit after deduction of all expenses including taxes, minority interests, and preferred dividends, paid or accumulated, and excluding any non-recurring, special, and extraordinary items. With regard to the denominator, AEP Ohio requests that the Commission confirm that it is average book equity, and clarify that the average is determined by averaging beginning-of-the-year equity and end-of-the-year book equity.

Moreover, earned return on common equity should not include FAC expenses that are being deferred for recovery in a future period. It is unreasonable to conclude that dollars that the EDU has not been paid should result in a determination of earned return on common equity when the purpose of that determination is determining whether a refund to customers is appropriate. An EDU should not be made to refund deferred amounts it has not yet collected.[2] Instead, during the deferral portion of AEP Ohio's 10-year phase-in (2009-2011) all deferrals of FAC expenses would be excluded from the SEET and during the recovery period of the phase-in (2012-2018) the FAC expenses, associated with the amounts previously deferred, will be excluded from the SEET.

5. What is the definition of "significantly in excess of the return on common equity"?

Staff Recommendation: Staff proposes using as a threshold for significantly excessive earned return on common equity equal to the greater of 200 basis points above the mean earned return or 1.28 standard deviations (expressed as basis points) above the mean earned return of the comparable group. Staff notes that the 200 basis points threshold would act as a backstop when earnings are low.

Comment: AEP Ohio concurs with the use of a statistical approach using both the mean and the standard deviation statistics to set a threshold for the point at which an EDU's earned return is significantly in excess of the return on equity earned by publicly traded companies,

[2] The Staff's Recommendations did not address the treatment of FAC deferrals in the context of conducting the SEET.

including utilities that face comparable business and financial risk. AEP Ohio also agrees that a backstop of 200 basis points, as an alternative threshold, is appropriate.

However, AEP Ohio recommends that the multiplier for the standard deviation-based adder should be 2.00, rather than 1.28 as the Staff proposes. The 2.00 standard deviation level (corresponding to a 95% confidence level) is a more commonly used measure of what is significantly above (or below) the mean than is a 1.28 standard deviation level (corresponding to a 90% confidence level). *See* Direct and Rebuttal Testimony of Dr. Anil Makhija in Case Nos. 08-917 and 918-EL-SSO, the AEP Ohio Companies' SSO cases.

6. How should companies "that face comparable business and financial risk" be determined? And

9. How should the earnings of a comparable company be adjusted to compensate for this financial risk difference associated with the differences in capital structure?

Staff Recommendation: Staff believes that a comparable group sample should be determined and utilized on a case-by-case basis, and the mean value of the return on common equity for the comparable group as well as the standard deviation statistic should be derived from the comparable group sample. Staff reiterates its recommendation that a realized return that is greater than 1.28 standard deviations (expressed in basis points) above the comparable group's mean return should be considered excessive, subject to the alternative threshold of a 200 basis points above that mean return. The Staff states that, while the amount of debt leverage can be used as a factor in selection of the comparable group, it believes that not using leverage as a screening factor for the selection of the group (and instead adjusting returns for the comparable group to reflect variations in leverage) is preferable, because that approach enables a larger comparable group sample to be used. Yet, Staff also recommends leaving this choice to the discretion of the EDU.

Comment: AEP Ohio concurs in general with the Staff's recommendation and observations and in particular, the recommendation that the choice for selecting the comparable group would be at the discretion of the company. However, for the reasons provided above, AEP Ohio believes that the 2.0 standard deviations, rather than 1.28 standard deviations, should be used as the adder to the mean return on equity in order to establish that statistical measure for the threshold beyond which the earned return on equity becomes significantly excessive.

7. **How are "significantly excessive earnings" to be determined? (Located in the third sentence of Section 4928.143(F), Revised Code.)**

Staff Recommendation: Staff recommends, consistent with the statutory language, that significantly excessive earnings should be measured by whether the earned return on common equity of the EDU is significantly in excess of the return on common equity that was earned during the same period by publicly traded companies, including utilities, that face comparable business and financial risk, with such adjustments for capital structure as may be appropriate. Staff recommends implementing the statutory standard by endorsing a concept whereby a return on common equity in excess of 1.28 standard deviations above the mean of a comparable group of companies should be defined as significantly excessive, except in a low earnings environment in which a 200 basis point adder should be substituted for the 1.28 standard deviation adder.

Comment: AEP Ohio agrees in general with the approach that the Staff has recommended, but would recommend issuing a 2.00 standard deviation instead of 1.28 standard deviations as the adder, for the reasons provided above.

8. What does "in the aggregate" mean in relation to the adjustments resulting in *significantly excess earnings*?

Staff Recommendation: Staff states that "in the aggregate" means that the total of all the adjustments created by the implementation of an ESP is to be assessed for its impact in determining whether the EDU achieved a significantly excessive earned return on equity.

Comment: AEP Ohio concurs with the Staff's statement.

10. What mechanism should be employed to return to customers the amount of excess earnings?

Staff Recommendation: Staff recommends that the mechanism for returning earnings determined to be significantly excessive should be decided on a case-by-case basis in each company's annual SEET proceeding. Staff notes that the case-by-case approach would allow the Commission discretion, based on the situation and time-sensitive circumstances, to determine appropriate mechanisms; and that the Commission would also have the latitude to return significantly excessive earnings over varying time periods and as reductions to other EDU imposed charges as the Commission determines is appropriate.

Comment: AEP Ohio concurs that the mechanism, whether it is a refund, reduction to certain charges, or some other device, and the timing for returning significantly excessive earnings should be determined on a case-by-case basis in the annual SEET proceedings. However, that case-by case determination should be addressed by the parties after a Commission determination of significantly excessive earnings has been made. Such a two-step process would enable parties to consider the appropriate mechanism in the context of the amount of the significantly excessive earnings.

CONCLUSION

For the foregoing reasons, AEP Ohio recommends that its initial comments be considered and adopted by the Commission in finalizing its SEET process.

Respectfully submitted,

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