BEFORE THE PUBLIC UTILITIES COMMISSION OF OHIO

\- - -

In the Matter of:	
	Case No. 09-786-EL-UNC
In the Matter of the Investigation Into The Development Of The Significantly Excessive Earnings Test Pursuant to S.B. 221 For Electric Utilities.	

\- - -

MEETING

of The Public Utilities Commission of Ohio, at the Public Utilities Commission of Ohio, 180 East Broad Street, Room 11-B, Columbus, Ohio, called at 10:00 a.m. on Thursday, April 1, 2010.

\- - -

Commissioners:

Mr. Alan R. Schriber, Chair
Mr. Paul A. Centolella
Ms. Ronda Harman Fergus
Ms. Valerie A. Lemmie
Ms. Cheryl Roberto

\- - -

ARMSTRONG & OKEY, INC.
222 East Town Street, Second Floor
Columbus, Ohio 43215-5201
(614) 224-9481 - (800) 223-9481
Fax - (614) 224-5724

\- - -

APPEARANCES:

American Electric Power:

Dr. Anil Makhija, Chairman, Finance Department, The Ohio State University

Mr. Daniel R. Conway, Porter Wright, Morris & Arthur, LLP.

Dayton Power & Light Company:

Mr. Frederick J. Boyle, Senior Vice President and Chief Financial Officer.

Duke Energy Corp:

Mr. Don Wathen, Director, Revenue Requirements

Mr. John Finnegan, Associate General Counsel.

FirstEnergy:

Harvey Wagner, Controller
Mr. Arthur E. Korkosz, Senior Counsel.

Ohio Energy Group:

Mr. Michael L. Kurtz, Bohem, Kurtz & Lowry.

Ohio Consumers' Counsel:

Ms. Maureen R. Grady, Assistant Consumers' Counsel.

Ohio Partners for Affordable Energy:

Mr. David C. Rinebolt.

Staff of the Public Utilities Commission of Ohio:

Mr. Stephen R. Chaney.

\- - -

Thursday Morning Session,
April 1, 2010.
- - -

COMMISSIONER SCHRIBER: Let's call to order the special meeting of the Public Utilities Commission for the purpose of allowing the Commissioners to question parties with respect to some issues of clarification or confusion or whatever with respect to the significant excessive earnings test.

We do not desire or need prepared comments from any of the parties. We thought this would just be free-flowing on our part. We will ask questions. Answer as you will, you know, the stream of consciousness, I don't care, but it will be something we do want to have the answers to. We want to be clear on where we are going with this because it is not altogether clear to us, and that's why we are having it. We have a list of questions that were issued that were posted, and I have them.

The case number, for the record, is 09-786-EL-UNC. It is not really necessary for everybody to respond to each and every question here. Again, we will ask the questions because this more or less will jog our memories and our interests and we will let it flow from here.

Let me, if I may, launch the first question. I'm being told I need to take appearances first, I forgot.

So we can start, Mike.

MR. KURTZ: Mike Kurtz for the Ohio Energy Group.

MS. GRADY: Maureen Grady for the Office of Consumers' Counsel and on behalf of the customer parties, the Office of Consumers' Counsel, the Ohio Energy Group, the Ohio Manufacturers Association, the Ohio Hospital Association, and Citizen Power, Inc.

MR. RINEBOLT: On behalf of the Ohio Partners for Affordable Energy, Dave Rinebolt.

MR. WATHEN: I am Don Wathen on behalf of Duke Energy Ohio.

MR. CONWAY: I am Dan Conway. I am here on behalf of AEP-Ohio, and with me is Dr. Anil Makhija, chair of the Finance Department at OSU. Just so you understand what our separation of responsibilities are, I'm primarily responsible for responding to questions about things other than the composition of the comparable risk group and the structure of the significant earnings threshold itself, which Dr. Makhija is primarily responsible for.

Art Korkosz on behalf of FirstEnergy and with me here today is Harvey Wagner, FirstEnergy controller, and I suppose just generally our division of responsibility would be to the extent there are legal issues, regulatory issues, that I would be addressing those. Mr. Wagner would be addressing accounting, the detail, and given that questions that are likely to cross, we will take our pick.

MR. BOYLE: Fred Boyle with Dayton Power & Light. With me is Judi Sobecki, who is legal counsel and may be answering some of the questions.

MR. CHANEY: I am Steve Chaney with the staff.

COMMISSIONER SCHRIBER: Okay. Anyone else I forgot?

Let me begin and we will get into this further. As I read 4928.143(F), there is a discussion about adjustments that are made to the ESP, specifically things such as fuel and what have you, primarily fuel. And it says, "If any such adjustments resulted in excessive earnings as measured by whether the earned return on common equity of the electric distribution utility is significantly in excess of the return on common equity that was earned during the same period by publicly traded companies," and so forth.

My question would be -- and I think there's significant dispute on this -- do the adjustments themselves result in excess earnings, or is the establishment of an SSO on the basis of an ESP in of itself establishing excess earnings, significant excess earnings? Does everybody understand?

MR. CONWAY: Sounds like question No. 4.

COMMISSIONER SCHRIBER: That's pretty much what it is. Yes, it is question No. 4, but I wanted to point to the statute.

Mike, I'm sure you have a comment.

MR. KURTZ: We do, Mr. Chairman. First of all, we filed, Ohio Energy Group and OCC, Ohio Manufacturers Association, filed written comments which the Commissioners all should have.

It's our point of view, our position, reading the statute, that the adjustments, which are essentially the ESP rate increases, in the case of Columbus Southern, for example, in 2009, a 7 percent rate increase was the max, more than $100 million, it's the ESP rate increases, which was comprised of environmental, fuel, purchased power O&M, a whole myriad of things, but the ESP rate increase, that's this adjustment and that's what is subject to return under the earnings test.

Now, I think one of the questions you are getting at, there is a dispute between staff as expressed in their November position paper and the customer parties, what happens if the utility goes into an ESP and already has excess profits?

The staff's position is that if the utility already has excess profits and they get an ESP rate increase of $100 million, they get to keep the $100 million because the $100 million didn't cause excess profits, in their point of view.

Our way of looking at it is that the $100 million rate increase in this example, certainly it exacerbated the excess earnings and caused excess earnings, and in and of itself a utility that is already excessively profitable should have to return all the increase in that example.

When you approved these ESP rate increase in the first go-around, it was late 2008 or in the case of AEP because of the timing, early 2009, you could not have known and you didn't know what the utilities' 2009 year-end profitability would be. You did not know what the profitability would be of all the comparable companies, but you had to grant a rate increase.

When you look back on that prospectively now in the first quarter of 2010, if it turns out that the utility was already excessively profitable, then essentially the whole rate increase should be returned.

Now, it turns out -- and this is attached to our comments -- that for 2009 the rate of return on equity after tax of Columbus Southern was almost 21 percent; before tax that is about 32 percent. That is twice the profit margin on rate of return that utilities around the country -- and this is in our initial comments, we listed all the Commission decisions for the last 12 years I think that were publicly available. The normal return is in the 10-12 percent range. Columbus Southern actually earned 21 percent. And the rate increase, the $100 million plus rate increase granted, certainly contributed to that excess.

Now, the staff's position is, well, if they were already excessively profitable, they should keep the $100 million increase or the $200 million or the $500 million or the one billion. It doesn't make any difference. Staff's position would have them keep any rate increase no matter how big it was if the utility was already too profitable going in.

That does not comport with the legislative intent, in our minds, and it also creates this sort of anomalous result. If the Commission decided, well, we're really going to be tough on these utilities. We are going to pick a low threshold benchmark for the earnings test. We're going to pick 8 percent or 7 percent. We're going to really be tough, what that would do, the irony is the counterintuitive result is all the utilities would start out with excess profits. If you set a low benchmark, all the utilities start out with excessive profits and so anything that they were granted in an increase they get to keep under the staff's method. That counterintuitive result of a low threshold actually helping the utilities is not what the Legislature intended.

So on this question we think it's a matter of really common sense and statutory interpretation. We're not trying to be punitive at all to these utilities in any sense of the word. We thinks the statute gives the utilities the normal regular rate of return that utilities get, 10 to 12 percent, plus a premium of 200 basis points, in our mind. Just to put that in context, for every 100 basis points, every one percent on equity results in Duke Energy Ohio, for example, earning $25 million extra after-tax net income. That's one percent. That's on our exhibit to the comments we filed.

The staff's original position was that the utilities should get a 200 to 400 basis point premium. That's not unreasonable, but that is more of a premium that the customer parties think is appropriate. But even under that 200 to 400 basis points, you add that on to a normal rate of return so that Columbus Southern, for example, would go from 10, 11, 12 to 14, 15, 16, whatever the number is. That's a very generous return. That would make Columbus Southern the most profitable utility on the AEP system by far at that level. 21 percent is out of this world.

COMMISSIONER SCHRIBER: May I interrupt you. We want to stick to the question, please. We have time constraints.

COMMISSIONER ROBERTO: Can I --

COMMISSIONER SCHRIBER: I am just going to add one more thing. We are talking also about question No. 2, and in question No. 2 there is a reference in 143(B), 4928.143(B), that says, "The plan may provide for or include, without limitation, any of the following." It talks about the automatic recovery of adjustments.

I guess the question then, to drill down a little bit deeper, I assume then you are including that any increase that was granted in the ESP is considered an adjustment, notwithstanding what it says here, that the automatic recovery of any of the costs, fuel, purchased power, cost of energy, capacity and so forth in meeting allowances. Those the clearly adjustments, correct?

MR. KURTZ: Yes. Those are all rate increases.

COMMISSIONER SCHRIBER: You are also adding as an adjustment the rate increase that was given in the ESP.

MR. KURTZ: Well, all those factors constituted the rate increase. In Duke it was negotiated. There was a stipulation. In the AEP cases all of those components went into the rate increase that was awarded to Columbus Southern and Ohio Power Company, and those were all adjustments. They all add new money to the utility, all contributed to earnings.

COMMISSIONER SCHRIBER: Those automatic

adjustments -- I'm not giving up an opinion here. I'm just trying to get to the answer. It seems to me that when it talks about adjustments, these are automatic adjustments that are done every year, and those may or may not lead to excessive earnings.

Now, if there's an ESP, a three-year ESP, you have a one-time increase in rates, at least for that period of time over which that ESP takes place. Each year within that ESP you have adjustments, okay. So you're not making a distinction then between that one increase and the adjustments that are automatic year by year.

MR. KURTZ: They're all rate increases. They all cost consumers the same amount of money.

COMMISSIONER SCHRIBER: But are they adjustments?

MR. KURTZ: Yes, they are.

COMMISSIONER SCHRIBER: So that one time increase is an adjustment.

MR. KURTZ: Yes, it is. It's a rate increase that adds the earnings. It costs the consumer the same dollar no matter how you calculate it.

COMMISSIONER SCHRIBER: Dan.

MR. CONWAY: Thank you, Chairman

Schriber. Let me answer the fourth question first and then touch on the second question, if I could.

The question is, does a return become excessive as a result of the adjustments or as a result of establishing a standard service offer. And I think the answer is under the statute that if the EDU's earned return on equity is significantly excessive, if it exceeds the threshold that is established under the statute for significantly excessive earnings, the excess could be the result of rate adjustments that are included in the ESP if those rate adjustments are earnings-driving kinds of rate adjustments.

The excess could be the result of things other than the earnings-related ESP adjustments. It could be the result of things such as off-system sales markets, which are not only not ESP adjustments, they're not even retail. They're not even retail activities; they are wholesale activities. The excess earnings could be the result of a deferral program that the Commission has authorized has ordered to phase in what the rate increases would otherwise be.

And our view is that deferrals that otherwise boost earnings should not be the basis --

even though they contribute to the return that is actually earned by the utility, they should not be available to be returned to customers before the cash dollars related to them are even collected from customers.

And there could be adjustments in the ESP itself that are not earnings-driving adjustments. If the adjustments are simply recovering costs, then in our view they are not earnings-related adjustments even though they're in the ESP.

So there are a variety of reasons why an earned return becomes in excess of the threshold established under the SEET test. I don't think that in any conception the standard service offer that is established as part of ESP or MRO is itself an adjustment. And particularly in the case of an ESP, the SSO that was established for one EDU or another EDU is not itself an adjustment which is contemplated by the statutory language that you queried.

So I think the answer to Question No. 4 is a return may become excessive as a result of ESP adjustments, but it does not become excessive simply as a result of the establishment of a standard service order. I would point out if in the case of an EDU that just simply reiterated its preexisting

SSO as its ESP SSO, for example, it didn't make any adjustments, it just simply continued forward and somehow in the first year of that ESP SSO, its earned return ended up being greater than whatever the threshold is, there would be no adjustments that could have contributed to that.

Where did they come from? They came from the things I mentioned at the outset. They could be non-ESP related factors. They could potentially be wholesale transactions or paper earnings related to a deferral program.

So that's the answer I think to No. 4. The answer is no, an SSO is not an adjustment by itself.

With regard to No. 2, the question in No. 2 is, How should the Commission define and quantify adjustments that could be subject to return if there is a finding of significantly excessive earnings?

I think in my prior comments I alluded to this, but if the Commission finds significantly excessive earnings, we believe the adjustments subject to being returned to customers should be defined as tariff rate increases authorized by the ESP, not embedded in the preexisting standard service offer from the prior regime and paid by customers;

that is, not noncash kinds of adjustments, earnings-related adjustments, and such adjustments would actually create earnings as opposed to adjustments that are simply and purely cost recovery in their nature.

COMMISSIONER SCHRIBER: One more quick question. Mike, if a standard service offer is established via an auction, would that constitute an adjustment?

MR. KURTZ: Well, if FirstEnergy, for example, distribution utilities, don't make any markup on that auction. They just pass through the generation prices through standard offer service.

COMMISSIONER SCHRIBER: Right.

MR. KURTZ: That's not an adjustment subject to refund. No, that would say that the billions of dollars that the distribution utilities spend on service generation, service for people who don't shop is subject to refund, no, that would be ridiculous and not true.

One comment with what Mr. Conway said, we agree that if a utility has preexisting excess profits, so to speak, from just their standard offer service, they go into the first ESP and they are super-duper profitable, they have excess profit, we are not trying to claw that back. They keep it. That's the bargain in 221. They keep that. But if they add to it through ESP rate increases, the adjustments, that's where we say that's what should be returned to consumers.

COMMISSIONER ROBERTO: Just a quick clarification, Mike or Dan, or anybody who wants to speak to it. Is there any significance in your mind between the language used in the MRO section and the language used in the ESP section which is actually different when it talks about the trigger? In the MRO section the word is "cause," which is what you used, Mike, when you discussed it "will cause."

And, Dan, when you talked about it, you used the words "will result," which is the language used consistently through the ESP section.

I'm just wondering did the Legislature mean something different when it used those words?

MR. CONWAY: I think the "will cause" language -- and, Art, you may be able to contribute to this response -- the "will cause" language in the MRO statute I think is consistent with the prospective nature of the testing that is occurring at part of the MRO, prospective testing that is part of the MRO statute.

The "has resulted" language in the case of the annual SEET test in the ESP statute, which is division F of 4928.143, it says "will result" because it's retrospective in its nature. So I think that the difference in the language, at least in part, reflects the difference in the perspective that is being applied to the analysis, one prospective, the other retrospective.

MS. GRADY: I would add that I tend to agree with Mr. Conway's analysis, but I think that it goes further. I think you are talking about three different SEET review processes. The MRO is a review process that looks at specific adjustments, enumerated adjustments, under 4928.142(D) for specific adjustments, and it also pertains to the generation service price of the MRO that is not subject to the competitive bid, and that relates to the EDU's most recent SSO price.

Now, under 4928.143(E), you have a different SEET review. That SEET review looks at rate plans that have terms longer than three years. It's a prospective look, and it relates -- the only adjustment language used in that statute is an adjustment for capital structure.

When you go to the F portion, you are

looking at the periodic, the annual review, which looks at the effect on a retrospective basis, and there the adjustments are the same as the provisions of the ESP, as Mike explained. So I think there are three different processes aimed at three different pieces of an ESP plan.

MR. KORKOSZ: If I may, I can't resist Mr. Conway's invitation to add a couple words. Hopefully it will be helpful.

I think that both of the provisions in .142 and as well .143 need to be looked at carefully because I think there are some really challenging questions of the statutory interpretation that are posed here. I think that is reflected by the fact this was an issue litigated in the ESP cases about a year ago and has been the subject of review in workshop, the subject of staff recommendations, and now we are here today still struggling with those questions.

While there is a commonality in looking at the concept of significantly in excess as between 142(D), 143(E) and 143(F), some of the rest of the language, there is a difference between them. One distinction, as already noted, was a prospective versus retrospective look.

And I would also point out, for example, in 142(D) there is a reference to adjustments in a fairly specific context. Of course, 142(D) just is the situation of a first MRO for a company that owned generation, which is not FirstEnergy's circumstances and I will just as a caveat say that my remarks are made on behalf of FirstEnergy and in the context of FirstEnergy's circumstances, which are somewhat different than the other companies.

But having said that, 142 refers to adjustments and then the adjustments that lead to potentially significantly excessive earnings, but it defines precisely what it means by adjustments in the preliminary language.

As you move into the 143(E), which is specifically directed to ESPs that are in excess of three years, again, not applicable to FirstEnergy but by way of illustration, the word "adjustments" isn't used there at all, except in the context of adjusted capital structure, which is a different exercise.

And then finally when you move into 143(F), the precise language, I will read just a portion to make my point, "With regard to the provisions that are included in an electric security plan under this section, the commission shall consider, following the end of each annual period of the plan, if any such adjustments" -- note the word before was "provisions" and now the reference is "such adjustments" with a suggestion that there is an antecedent basis for what such adjustments are. There really isn't in there.

And for that reason I think there are lurking traps if one attempts to just casually impose notions of what a legislative intent was or the like. While legislative intent is certainly an important component in interpreting the statute, an equally, if not more important, component is looking at the words actually used in the statute and making sense of them.

One final remark I would like to make is on the usage of the term "adjustments." I think it can be -- it has meaning in a couple of different contexts and it's important to keep those distinct, and this is a point that was made in the FirstEnergy comments on the staff recommendations.

In one sense adjustments can mean those adjustments which are made to the financially reported results of the utility in question so as to make an apples-to-apples comparison to what your peer group is going to be. For example, in the

FirstEnergy ESP, there were some specific adjustments to reported earnings that would be made for purposes of calculation of the ESP that included not including the impact of a writeoff of goodwill, to exclude the -- implicit was carving out of the effect of the operations of the Pennsylvania Power Company, a wholly owned subsidiary of Ohio Edison, so that the activities in different state-regulated jurisdictions would not be a part of the to Ohio earning test.

That's adjustments in one sense. The other sense is whatever it means in the context of such adjustments in 143, and I think it is important to the discussion to not casually interchange those without appreciating there are differences in meaning.

COMMISSIONER SCHRIBER: Mr. Centolella.

COMMISSIONER CENTOLELLA: Thank you, Mr. Chairman.

If I can follow up on that, Mr. Korkosz, you spelled out the analysis exactly what I had in mind in thinking about this, and so I guess my question is one of if we follow that logical train of thought, doesn't almost the necessary antecedent in this last context of adjustments that can lead to excess earnings almost necessarily become the first part of that sentence in 143(F) where it talks to the provisions of the electric security plan? And if that's the case, doesn't that lead us back to the position that Mike talked about earlier where anything that was in a new electricity security plan that resulted -- that was a provision of that plan that resulted in earnings in excess of what had been under the prior electric security plan becomes an adjustment that can be contributing to excess earnings?

MR. KORKOSZ: At the outset, Commissioner Centolella, I will repeat I am speaking only for FirstEnergy. But I think as applying -- attempting to make sense of the statute in the context of the FirstEnergy plan, that that is a reasonable application to our circumstances and, in fact, I think it's reflective of the approach taken by the parties who participated in the litigation of that issue in our ESP case 08-935, was to take that approach.

And the thornier, more difficult question that I am not sure is necessarily applicable to FirstEnergy's circumstances simply didn't arise and was not a subject of dispute in our case. So I think, at least in terms of its application here, that effectively equating such adjustments to making provisions, that is, the provisions that may come, the components of the electric security plan do go into the pot to be considered.

MR. CONWAY: I would just add to that that the phrase is not simply "such adjustments." It's something like such adjustments that resulted in significantly excessive earnings. So our view is that the adjustments to be referred to are the adjustments established by the ESP under 4928.143, and they are adjustments that actually produce or create earnings that are part of the ESP and ultimately that are leading to significantly excessive earnings.

COMMISSIONER CENTOLELLA: Aren't you then asking us to sort of divide red dollars from green dollars and, you know, say these earnings are contributed to by X but not by Y? And I don't know how we do that. Aren't your earnings simply the net result at the end of all of your sources of revenue and all of your expenses?

MR. CONWAY: I don't think so. I think what you do to identify the adjustments that produce earnings, in the event that you do find that there is an earned return by the EDU that exceeds the significantly excessive earnings threshold, you look then to the basket of adjustments and the related earnings in the ESP that the adjustments had produced or created earnings, and you back it out of the total calculation for the EDU.

And if as a result of that calculation, once you've identified all those adjustments, it contains earnings-producing results, if you end up falling below the threshold after you backed out that basket of earnings, then the extent to which the earnings were excessive, exceed the threshold, would be subject to return.

But if you do the calculation and the basket of earnings do not reduce the result below the threshold, then I think you are done and you move on. I don't think you have green or red earnings dollars as a result of that. I think you can test it and you can determine whether and to what extent the earnings from those adjustments are contributing to the significantly excessive result.

COMMISSIONER CENTOLELLA: I do want to follow up on an earlier point that you made. You talked about deferrals contributing to earnings. I'd like to just get your view on how should the Commission look at deferrals to ensure that deferred revenues and the costs associated with those deferrals match up in the same year and that they are then being looked at comparably with the financials of other companies so we are not ending up with apples and oranges comparison.

COMMISSIONER SCHRIBER: Are we moving on to a new topic?

COMMISSIONER CENTOLELLA: I'm taking this as sort of a subset of Dan's position. He's saying that's not an adjustment, I think.

MR. CONWAY: Well, in the context of deferrals and how those should be addressed and treated, I think there are several points that you need to keep in mind as you go down the analytical path. The first point is that an EDU should not be required to return to consumers amounts that it has not yet collected from them; in other words, it shouldn't return to customers noncash earnings.

The second point is that the SEET when it's applied, for example, in the course of this annual test under 143(F), it should not be applied in a manner that undermines the probability of future recovery of deferrals that have previously been authorized. You need to take care about paying attention to that issue, which I'm sure you do, because if you didn't, you would jeopardize the EDU's ability to create the deferrals in first place. If you can't create the deferrals in the first place, you undermine their ability to use the phase-in as a tool to moderate customer rate impacts, so you have to take great care I think and pay close attention to those issues.

The third thing to keep in mind, which is a reiteration of a point I made just earlier, is that if we are talking about the fuel adjustment clause here and its impacts, our view is that the fuel adjustment clause is a dollar for dollar cost recovery mechanism that's not an earnings creating, providing adjustment in the ESP.

But with having said that, if you were going to walk down the path of what do you do about the deferrals that are essentially the result of an expense deferral program, such as Columbus Southern Power's fuel adjustment clause expenses and the deferral program associated with that, I think what you ought to do if you go down that path -- if one were to go down that path, you would first calculate the earned returns of the comparable risk group and the EDU with the deferrals left in both the EDU and to the extent they are in any of the entities in the comparable risk group, leave them in there, and develop an apples-to-apples comparison for purposes of establishing the threshold and making an initial cut as to whether or not the EDU's earned return is exceeding the threshold.

I think if it turns out you have an EDU that has a deferral program like I just described and you get past the first step and the initial cut shows there is an excess in earnings over the significantly excessive earnings threshold, I think you need to stop and you need to back out the earnings of the -- that are related to the deferrals and examine whether or not the earned return, as adjusted in that fashion, then falls back below the threshold. You need to back out those earnings so they are no longer at risk at being captured by any remedy you come up with, because if you don't do that, you jeopardize the deferrals in the first place. I think that is the first step.

Then I think with regard to the consistent next step in the future, what do you do when the customers pay for the deferrals in the future and the cash comes in, I think at that point you perform the SEET test again, and you would do it while backing out the amortization item that would be in the future period in order to reveal what the earnings are as a result of the cash that's coming in at that point in time.

COMMISSIONER SCHRIBER: Would you count the carrying charges, too, on that?

MR. CONWAY: The carrying costs are a separate item, I'd say. Frankly, there's an equity component to the carrying cost, and I think you cannot again -- I think you cannot return the carrying costs as being earned and deferred during the deferral part of the program because if you did that, you would again compromise the probability of the future recovery of that equity return component.

But I think again at the tail end when you are looking at the earnings of the utility when it's actually recovering the cash for the deferred expenses, you would include -- you would do what I suggested. You would remove the amortization piece at that point in time and look at the earnings of the utility at that time.

I do think you have to be careful. You have to consider what to do -- what you do at the tail end so that you don't at the tail end do something also that either jeopardizes or unnecessarily jeopardizes the foundation for the deferral in the first place, because if you don't do that, you jeopardize your ability to use that tool, the phase-in tool, which relies on the deferral mechanism. You jeopardize your ability to use that in the future.

COMMISSIONER SCHRIBER: But deferrals, by authorizing deferrals you have the ability to count that as earnings. If we don't authorize it, it's not earnings. So during any particular period where you have a deferral, it is an earning to you. It's not cash but it is an earning. Where and why do you make some distinction between cash and noncash earnings?

MR. CONWAY: Well, I mean, it's pretty simple. Let me give you an example. If you have $100 of revenue-related expense that's being actually laid out by the utility in year one, and you decide you want to moderate the increase that's necessary in order to recover that cost so you allow a deferral of $50 to some future period of time, my first point is that to the extent that the earnings have been boasted by not requiring the utility to recognize the expense, the whole $100 of expense in the first year, to the extent there's $50 of earnings that are essentially paper earnings in that first year, you shouldn't be returning those to customers. It's not fair to tell the utility to return cash before it's even collected.

COMMISSIONER SCHRIBER: I'm sorry, where in the law? I'm speaking to the law. Where in the law does it make the distinction between cash and noncash? How do you come to the conclusion given the statute?

MR. CONWAY: I think under section 4928.144, which allows you to do the phase-in of rate increases. It says you shall permit the recovery of the deferrals that are underpinning the phase-in, so I think the law itself clearly allows for you to recognize that you need not return cash dollars up front, the utility need not return the cash dollars up front when it hasn't yet collected them.

I don't think there is anything in the law that requires such result, and I think it would be improper and would actually conflict with 4928.144, and I think you have the ability to prevent that not only unfair but I think illegal result.

COMMISSIONER CENTOLELLA: Mr. Chairman, if I can follow up on this point.

COMMISSIONER SCHRIBER: Sure.

COMMISSIONER CENTOLELLA: If we are in a

situation where a utility has, let's just say, $100 of earnings. $50 is cash. $50 is noncash. We do the comparison on the $100 and decide there's $20 of excess earnings there, less than the cash component. In what way would it be in any way jeopardizing either the accounting treatment of the deferral or, in some sense, be inconsistent with 144 if we were to order the return of the $20, which is less than the full cash return?

MR. CONWAY: Because the risk is that requiring the return of the $20, which is matching up with a portion of the deferred amounts, could be interpreted by the auditors as assuring that there is not a probability of future recovery of the deferral that was established in the first place.

COMMISSIONER CENTOLELLA: Can you point to something specific in generally accepted accounting principles which would support that interpretation by an auditor?

MR. CONWAY: This is the view of Len Assante, who is the chief -- I'll misstate what his title is, but to me he is at the top of the hill in regulatory accounting. And this is what his concern is, which he elaborated in his testimony in the AEP-Ohio's ESP proceeding. His view is that it would have the impact of jeopardizing the probability of future recovery if you were to do what you just suggested.

COMMISSIONER SCHRIBER: Dave or Mike. Dave.

MR. RINEBOLT: I think that we need to not lose sight of the forest for the trees. The significantly excessive earnings test is about ensuring the customers pay just and reasonable rates. It's a substitute under our new regulatory paradigm for ensuring that customers are not gouged.

And so I think you have to view the totality of the revenue flowing to the utility as the forest, and if you start taking individual trees out of the forest, it's the forest that we are paying for. If you start taking individual trees out and saying, Oh, that's not really a part of the forest or that's not a part of the forest, then you undermine the purpose of the test

Deferrals are booked under generally accepted accounting principles. You do not have to undercut the recovery of those in order to make adjustments in the revenue in order to achieve the goal of the Legislature, which is to ensure that utilities do not have significantly excessive earnings.

Obviously, the utilities are going to want to adjust these things so they don't trigger recovery by ratepayers, but ratepayers' wallets are under a lot of pressure right now. The Legislature put this provision in to protect them, and I think we ought to honor it by looking at revenues in totality.

MR. KURTZ: Mr. Chairman if, I could.

COMMISSIONER SCHRIBER: Sure.

MR. KURTZ: On the deferral question, when an expense is deferred that increases the profit margin of the utility and increases the likelihood that the test would be triggered, that they would be overearning, our position, the customer party position is -- and we agree that the statute speaks in terms of earnings, not cash earnings or accounting earnings, but earnings -- but our view is that if a utility is overearning and it is deferring in that same year, it has a deferred expense, instead of returning cash to customers, we agree with Mr. Conway, that would be inappropriate.

But what you ought to do is use the overearnings to pay back the ratepayer IOU. In other words, wipe out the deferral first. So you don't give cash back. If the deferred expense contributed to overearnings, wipe out the ratepayer IOU, wipe out the deferral before you start giving cash back.

That is practical and it's also more fair to the utility than asking them to give back cash that they have not yet collected. So we think and we stated in numerous pleadings that we filed, that that would be the appropriate way to handle the deferral.

COMMISSIONER SCHRIBER: Yes, sir.

MR. WATHEN: I am not a lawyer, so this will come a little differently. There are two types of deferrals. There is a deferral with a deferred revenue with an underlying expense, which I think AEP was discussing, for example, the fuel. They have $50 million of fuel expense that they could recover in a fuel adjustment clause, but they're deferring the revenue and the expense, so from an earnings prospective it is a wash.

It would be patently unfair to make them recognize the revenue that they didn't incur -- that they didn't get in a current period when they are not going to get the revenue or even incur the expense because that is deferred as well until post AEP.

Then there are deferrals such as deferred rate increases that may not have an underlying expense, like a phase-in of rates. That is a little different question.

And your question about the carrying costs, I have give more thought to. But I definitely would be very much against accounting deferrals that have an underlying expense or underlying revenue. Deferred rate increases that don't have an expense, maybe. That's a different question.

And all these adjustments we talked about earlier, by the way, they do have different buckets. All of our riders, green and red revenue, pretty much all of the adjustments that we talk about, there is a revenue stream associated with each one of them, so it is relatively easy to track which adjustment, kind of peeling the onion back.

MR. CONWAY: May I just respond to Mike's alternative suggestion of evening up the deferral pile with some of these deferrals, I guess, and the answer deferral earnings, I guess, and I think the answer is still the same, that it does jeopardize the probability of future recovery determination by the auditors.

So I would caution you that we don't want to do that in that context, let alone in the earlier context we were talking about. And we address this in our comments to his initial comments to the staff proposal, for the answers to those question from last fall.

COMMISSIONER SCHRIBER: While we are still at 143(F), can someone tell me the meaning of following sentence? And this is question No. 8. "Consideration also shall be given to the capital requirements of future committed investments in this state." What does that have to do with 143(F)? How does that play into all this. Mike?

MR. KURTZ: The way we interpreted that is that normally the earnings test, which is essentially the comparable group earnings, which would be comprised primarily of utilities, plus the premium -- we say 200 basis points. Staff said originally 200 to 400 basis points -- that earnings capability normally covers the capital requirements of the utilities.

However, if there's a major capital expenditure coming up, a Duke nuclear plant -- now, we think that is subject to a surcharge so that mitigates that. But if there was a major capital requirement that could require additional cash flow to the utility, that should be taken into account. That's all it means.

COMMISSIONER SCHRIBER: It could go in

the denominator?

MR. KURTZ: I'm not sure I follow that.

COMMISSIONER SCHRIBER: The calculation of the equity.

MR. KURTZ: It would go into the ability for them to earn more, if they need more earnings because of a significant capital investment that's coming up. Now, again, the power plant surcharge for CWIP in the statute gives them current recovery, but that's the type of thing that we view that provision applies to.

MS. GRADY: We would not say that that's a specific adjustment to the formula but should go into a consideration of what the appropriate threshold earnings would be. We would also say that we would limit such adjustments to those plants where they have been discrete plants which the PUCO has determined there is a need for, that would be the number one requirement, which would go through their resource planning projections submitted for approval by the EDU.

And additionally we would limit that type of adjustment to consideration that occurs when those future plants occur during the rate plan term. So we would put some restrictions on that. However, we would be open to the type of sliding adjustment on -- in terms of determining the SEET threshold.

MR. KORKOSZ: Mr. Chairman, if I may, certainly those are a couple of the types of considerations, committed generating plant or identified expenditures, that come out of an ESP that could be an example of what is meant here.

Frankly, we would suggest that given that this arises in a sentence that is separated out from the preceding sentence, which has a more formula-like mechanism for comparing against a comparable group, we would interpret the statute in regards to this sentence as being a suggestion to the Commission to use a discretion that is more appropriate on a case-by-case application.

And, you know, for one utility it may be more appropriately in the context of a generating plant. For a different utility it may be more applicable to a pattern of planned expenditures with respect to the distribution system, and we think both of those are appropriate for consideration by the Commission, but they arise out of different circumstances, and that rather than prescribing prospectively a rule that this should come up in different cases and a protection, I think, against abuse here is that, obviously, that the Commission holds the deciding view on whether they should be given any weight, and also that overall it is the EDU that bears the burden of proof in a proceeding. It is the utility's proposal, one way or another, and bears the burden of proof to convince the Commission it is worthy of such consideration.

MR. RINEBOLT: Mr. Chairman, I doubt that this language will ever be triggered. I'm certainly not going to hold my breath waiting for a utility to make a significant capital investment without their banker, that would be the ratepayer, on the line to pay for it.

COMMISSIONER SCHRIBER: Well, we have heard the word "significant," haven't we? Why don't we launch into a couple things, significant, excess, peer group.

MR. KURTZ: We have been trying to be practical and clear in the comments that we filed. We think the peer group essentially, the comparable companies, ought to be heavily weighted towards utilities and other private sector businesses that have low asset turnover ratios, very capital intensive, low risk.

So the starting point, we don't think it is appropriate to have a peer group that is very, very volatile so that in the boom years of 2006 or 7, the standard is up here, and in the down years of '09 it's way down here. We think you need a stable starting group for the comparable companies.

OCC witness Dr. Woolridge had such a stable group and stable methodology. It is somewhat detailed but it is in the record. So you start with a stable group. To that you add, using the Commission's judgment and discretion, a premium essentially, 200 basis points, staff's original position was 200 to 400 basis points, that anything over that would trigger the significantly excessive test.

This would allow the utilities to be very profitable, more profitable than essentially any other regulated utilities in the country, and that would compensate them for the risk -- we have a hybrid situation. We have the ability to shop. We have the standard offer rate -- subject to the earnings test, and that's the appropriate balance.

When you start putting into the mix statistical tests, you run the risk of having this thing fly away from you because we showed that under the statistical test that the staff proposed in

November, that applying that to the peer group proposed by AEP, it would result in a 55 percent threshold, 55 percent after-tax threshold. That would make a hedge fund manager blush, having that type of rate of return, but that's the risk you run when you have this statistical test.

For example -- and it started with having a very risky peer group to start with. The AEP expert selected a peer group that had negative earnings of 46 percent and high earnings of 98 percent. When you have this kind of swing, the standard deviation is enormous, which triggers this very large 55 percent earnings threshold under the statistical test.

So that is very problematic. It could go the other way, too, to the utility's disadvantage. We think stable utility earnings are important. High earnings are authorized under the statute, a premium, in essence, which is the staff's original position, and that's the proper balance to compensate the utilities for the fact that customers can shop in this state as well as have the right to take standard offer service.

So that's the basic framework. We think it's workable. It is fair. It complies with the statute. It would allow the utilities to be in this jurisdiction very, very profitable. Using the specific I mentioned earlier, Columbus Southern, 21 percent after-tax return is, in our opinion, too high. That should come down under the earnings test to protect consumers as the Legislature intended.

But still even if Columbus Southern is brought down to a lower but still high level, that will be the highest profit margin, the most profitable utility in the AEP system, by far, even if you bring the earnings down significantly.

So there's no room for shedding tears. This is actually a perfect -- this is a good situation. It's a high class problem. You have a utility that is a real test. When you look at the numbers on all the other utilities, it's really Columbus Southern that's the outlier. Dayton is very high, but they have two-year pass under the statute. And you have the ability to enforce the law to protect consumers, issue refunds, pay off the deferrals, and still Columbus Southern will be the most profitable utility in the AEP system.

MR. CONWAY: It is hard to know where to start talking about this issue, responding to your question at the same time responding to Mr. Kurtz, but I would like to make a couple points.

First of all, it is his comments about what the statistical approach would provide when applied to Columbus Southern Power, he made that pitch in his initial comments in response to the staff proposal. We replied to it. It's not correct. It is absolutely not correct.

With regard to that, with regard to the 200 basis point adder he would propose tacking on as a cap, as the threshold beyond which earnings are significantly excessive, it derives from a FERC incentive mechanism for transmission facilities. It has no relationship to the significantly excessive earnings threshold in the statute. It's completely arbitrary in comparison to that threshold, and it also is based in a view of the world which is that we are now in rate base rate of return regulated environment, which we are not.

Although there has been a retrenchment from the prior regime, we are not in a cost-based regime at this point, and standards that are evoking just and reasonable returns from the rate base rate of return are simply not applicable.

I also point out that the SEET is an asymmetric test. What it does is it penalizes the utility for overearning. There is no provision in the test that on the other side protects the utilities from underearning or from significantly deficient earnings, so it has to be applied in a careful manner.

I would also just point out that the earnings for Columbus Southern Power are what they are. They will be evaluated in the upcoming SEET review process, but we already know based on discussions that we have listened to so far, there are off-system sales margins included in those earnings. There are deferrals that are reflected or supporting those earnings, and there are many other consequences from the ESP that are contained in that number.

And I'd like to turn it over to Dr. Makhija to address the question of what the appropriate method might be for establishing a significant and excessive earnings threshold.

Thank you.

DR. MAKHIJA: Thank you. The questions you have raised actually have several parts, if I may have your permission, I'd like to go through each of them by piece.

First, I think you raised the question of what does it mean to be significant, and I think everyone here is in general agreement that to understand what is significant, the starting point is what is the mean of the comparable group. But, of course, the mean is not an adequate description of the earned rates of the peer group because there is variation in rates of return among the peer group. So we must take into account the standard deviation of those rates of return.

And this is what helps us define the word "significant" because you take the mean rate of return and add to it a certain number of standard deviations and beyond which you begin to think of them as significantly excessive. And this, of course, is standard practice in economics, as you know.

For example, in the method that we proposed, we took the mean and we added about two standard deviations, and anything beyond that were deemed to be excessive. So that becomes the significant threshold point and anything beyond that would be considered excessive. This is what is referred to as a 95 percent confidence level, which is most popular or most common application of this standard.

Now, the interesting point about this threshold is that when we take that 95 percent cutoff of two standard deviations, what happens above that is either truly significantly excessive return, or it is still possible that it is part of normal variation, albeit, with some low probability.

So in this particular case when you find something beyond the two deviations, yes, it could be significantly excessive, but it could also have fallen because of nonremediation. And that's the point I think is important to take into account, because that tells us what is the extent of false positives. And you want to really avoid those false positives because you don't want to penalize when in fact it was just part of normal variation.

To underscore that point, let me give you an example of what it would be if we took a 90 percent confidence level. So this corresponds to having returns that are more than 1.28 standard deviations above the mean. So in a circumstance like this, if you were to focus on just the positive returns, which, of course, is the practical situation, what you would find is that there is a probability of one in ten of the false positives. And, of course, such a large extent of false positives constitutes a kind of regulatory risk, given that this is an asymmetrical test. So this is in part to explain the compelling argument why it is the most frequent use in economics as an application that 95 percent confidence is used. So this is one part of your question, Commissioner Schreiber, about the meaning of the word "significant."

But coming now to the issues that were just raised dealing with what the FERC adder is and what the comparable is, I think the statute, Senate Bill 221, very specifically talks about matching the comparable risk for a specific utility with the peer group. Unfortunately, this 200 basis points does not speak to any particular comparable group that we could point to because it stands in isolation without looking in any sense to what this particular utility's business could be.

I suggest to you as I look across the EDUs s in Ohio, I see a wide variety, variation in business risk. Firms differ in terms of the mix of customers, residential, commercial, industrial. They differ in terms of even their operational, do they put into under the same house just distribution or is it distribution, transmission and generation? Consequently, it is hard to argue that utilities in

Ohio, the EDUs are homogenous. And if they are not homogenous, we need uniquely different peer groups to match them. So that is the other part about the FERC.

Finally, I know some extreme numbers were just mentioned but they ought to be mentioned with a bit of caveat, because the numbers that were mentioned were without taking out the one time recurring earning items, and through this process we have all come to more agreement that what we ought to be looking at is earned returns net of these one time recurring. And if you do that correction, you get a much more reasonable distribution and, in fact the cutoff that we did propose were not close to anything like 55 percent but were more in the range of 21, 23, if my recollection is correct. So those are some of the pieces raised in that discussion that just occurred.

MR. KURTZ: Mr. Chair, if you would indulge me on just a minute on your question, I'd like to read what you have staff testified in the ESP cases. This is Mr. Caahan for staff on this very issue. It's clever and it's relevant.

The question is: "If the statistical approach is not useful, then how do you view the significantly excessive earnings issue?

"ANSWER: I see this as security a fairness issue. It is a familiar issue that the Commission has dealt with over all its history, that of balancing the interests of consumers and the utility. The word 'excessive' is the key and the word 'significant,' rather than having some esoteric am statistical meaning simply means large or important.

"QUESTION: How would you quantify the concept of significantly excessive if it is a fairness issue rather than a statistical issue?

"ANSWER: There is no way to objectively determine the meaning of significantly excessive, but as we have seen, the statistical approach is not free from subjectivity either. However, I could suggest certain considerations that might frame a zone of reasonableness. I think that the 200 basis point adder represents a reasonable lower bound. I think that 400 basis points is a reasonable upper bound."

One last little bit.

"To have a computer spit out the answer to the question of how much is too much may give the impression of objectivity, but beneath the analytical surface of spurious precision lies a large amount of subjectivity in the specification of the test, the level of proof demands, and, indeed, the unstated and underlying theoretical basis behind the use of a statistical test in the first place."

He recommended a 200 to 400 basis point premium. Based upon the Commission's informed judgment given the particular circumstances, it is a much more sound method than relying on a computer to spit out the answer.

COMMISSIONER SCHRIBER: He retired at the right time, too.

COMMISSIONER CENTOLELLA: Can I ask a few questions here? There are certain things that trouble me about this approach. First of all, I guess I'm troubled by the assertion that this is an asymmetric test. I think we have a constitutional responsibility to ensure that utility returns are not so inadequate as to constitute a taking, and, in fact there is a provision in 142 in the MRO statute which specifically requires us to look at that, and, you know, by implication, we would need to be taking that into account in determining whether an ESP was both reasonable and more favorable than the MRO.

So I guess I am troubled by the notion this is in some way an asymmetric test and that there is no sort of lower bound to which we wouldn't be obligated to make some adjustment, much as we did initially in the FirstEnergy's case when we went through the transition of the beginning last year.

So I'm wondering if you can speak as to why you think this is asymmetric and there is not some lower bound we would be obligated to recognize.

DR. MAKHIJA: I think you made a very reasonable case that this is what our mandate is, to make sure that customers don't pay in the case of excessive earnings. The difficulty I think arises in how we apply the test because the test gives rise to the possibility of false positives. So you were very much ensured, required kind of a claw-back if indeed earnings are excessive.

The difficulty lies in the confounding that occurs between a true finding of excessive earnings versus a situation where it might be actually a false positive. And it's that false positive that creates the possibility of a one-sided risk.

You see, if the false positive could have also occurred on the other side of the distribution we would not worry because we would say, okay, you run some risk of having to pay when it is excessive, but you also get help when its inadequate, and that's a correction for the very nature of trying to figure out the significance.

And that is the aspect that creates some additional risk, which, incidentally, in the end are not probably good for customers either because if they do constitute risk, and in my filed testimony, I pointed to how on the street, some of Wall Street is literally using this test to say that there are new regulatory risks, and that's the false positive component that I was referring to.

COMMISSIONER CENTOLELLA: Wouldn't we have a constitutional obligation if the utility came in and said, Look, our earnings have just gone so low that our financial integrity is jeopardized. It's a taking, wouldn't we have some obligation as a Commission to act in that instance and doesn't that add symmetry to this?

MR. CONWAY: First of all, as a technical point, there is no automatically available symmetric aspect to this test that causes or requires the Commission to bring the utility back from a significantly deficient earned return level to something higher than is deficient.

Secondly, I think the assumption in your question is that the level at which confiscation occurs is the level at which a significantly deficient earned return occurs, and I'm not sure I would agree with that. I think without having thought it through thoroughly, but I would take the position that a significantly deficient return could occur at level which is above the constitutional confiscation level. So those are two points.

And then from a process standpoint, being able to restore earnings to a level that is not confiscatory can be a long and arduous process that I personally experienced, and so I don't take a lot of warm comfort from the idea that the constitutional barrier against confiscation is an adequate substitute for something which is asymmetric in the test itself.

MR. RINEBOLT: Commissioners, I think that Mr. Conway's analysis is, quite frankly, a little too narrow. You have to look at this test in the context of the statute as a whole. If, in fact, a company is not earning an excessive amount, they won't have any money taken away from them. If, in fact, they are underearning to the point where their financial solvency is at risk, they can come to this Commission for an increase.

So what the test is, is the consumers' side of the balance. If the earnings are in excess, there is an adjustment. The utility side is essentially if the earnings are too low, they can come back to the Commission and ask for a rate increase. That's symmetrical.

COMMISSIONER SCHRIBER: That's not provided for in the law. That's not in Bill 221. It's asymmetrical in 221.

MR. RINEBOLT: There's nothing that stops them from coming in.

COMMISSIONER SCHRIBER: But that's not provided for in 221.

COMMISSIONER CENTOLELLA: I think that is provided for in 142 in the MRO, there is a symmetrical test there, and implicitly, I suppose, the utility could propose an ESP with a symmetrical adjustment component.

COMMISSIONER SCHRIBER: But that is not a SEET adjustment.

COMMISSIONER CENTOLELLA: In 142 it is a SEET adjustment. There is lower bound SEET adjustment in 142.

MS. GRADY: It's harkens back to the emergency -- it's very similar to the emergency relief statute, 4909.16 in the Revised Code. And I do agree with Commissioner Centolella that that could possibly be applied.

MR. KURTZ: I want to weigh in just very briefly. Mr. Rinebolt is right, if the utility feels that it is underearning, it can file to modify an existing ESP or wait until its next ESP. There's no requirement that the ESP be three years. It might be one year, two years or longer. It can modify an existing ESP to ask for more money or wait until its next ESP and ask for more money.

The utilities always have the right, and they're very good at it, in seeking rate increases. The test is on the other side and it protects consumers.

MR. CONWAY: Another aspect of the asymmetry, Commissioner Centolella, while the SEET when it returns earnings to consumers is returning them from the prior period, even the constitutional standard does not reach back and make up for underearnings from a prior period. It is prospective only. So I think that's an important consideration. I think it confirms that in that significant respect the asymmetry is really irretrievable in the SEET test.

MR. KORKOSZ: Commissioner Centolella, you started with the observation about the nature of the asymmetrical risk, and you went on to introduce the component of the constitutional standard of a fair -- entitled to the opportunity to earn a fair rate of return.

And this was a subject that was addressed at some length in the testimony of Dr. Vilbert in the FirstEnergy cases, and I would commend that testimony to you. But briefly a couple of points in addition to what we already heard. Another component of this asymmetric risk, if you look at typical traditional base ratemaking, the rate of return that is allowed by a regulatory commission, on average a utility may be from the investor's standpoint expected to earn that return. Sometimes it may be a little more, sometimes a little less, but on average that is the expectation of the investor. It is a prospective look based on market metrics.

The SEET is different. It is, at least insofar as it is applied under 143(F), it is a backward look at a particular year. It is also on accounting, financial reporting metrics, and those are not necessarily the same, so you don't have direct equivalences there.

But in terms of the SEET and the asymmetric nature, in the course of fixing utility rates under traditional concepts, I noted on average the investor would expect the utility to earn the allowed return.

As Dan mentioned, there's an asymmetry with SEET. There's the mechanism for a return if there were excessive earnings, significantly excessive. There's not an automatic mechanism built in or contemplated that you would supplement if they're excessively deficient.

But it is that distinction as perceived by the investor, that is, a perception of an asymmetric risk faced by the utility that necessarily increases the potential risk and hence adds to the cost of capital, per se.

As I said, these were concepts that were expanded upon in the testimony of Dr. Vilbert, which is probably a great deal more coherent than my testimony here, but nonetheless, I think those are important considerations.

COMMISSIONER SCHRIBER: Let me jump in, because I think we are kind of talking past each other. "... the commission may adjust the electric distribution utility's most recent standard service offer price by such just and reasonable amount that the commission determines necessary to address any emergency that threatens the utility's financial integrity..."

"Emergency" is the operative word here and "financial integrity." I guess you could say it is asymmetrical in the following sense. If it is five basis points above the threshold, then it is a consumers' emergency and lower rates or grant some sort of compensation back.

If it is five basis points under the threshold, it may not be a financial emergency in any sense of the word and therefore no adjustments are made. So in terms of the SEET, I do think there's some asymmetry here as far as the law is concerned. An emergency and financial integrity is considerably different from being a few basis points below the threshold, but nevertheless.

MS. GRADY: May I quickly add, and Dave did a good job of talking about the forest through the trees, what we are talking about is significantly excessively earnings on the one hand and the benefits of 221 to these EDUs. 221 a gold mine for utilities. It provides them with -- they have argued it provides them unlimited authority to make any adjustments, to get any increases, whether they are cost related or not.

And so when we talk about the SEET, the symmetry is there. The SEET is the consumer protection tool that balances out the ability of the EDUs to come in and ask for anything under the sun, unlimited or limited only by their imagination. So there is symmetry and that symmetry should be looked at as a picture, as a whole and in the context of 4928.02(A), which states one of the policies also of SB 221 is to ensure reasonably priced electric service is a available to consumers.

COMMISSIONER SCHRIBER: I think it is a gold mine for the Public Utilities Commission as well, which gives us a lot of authority, which is good, and I hope we use it prudently.

COMMISSIONER CENTOLELLA: I have a couple other basic questions about the statistical methodology here. Normally when we think about these kind of confidence levels in statistics, we are talking about what is the relationship of A to B, and can we reject a null hypothesis in terms of moving from A to B.

It seems as you though you've taken the kind of statistical approach and you've put it in a very different context where I don't ever understand what the null hypothesis is that we are rejecting. It seems like you've used the word "statistical" because statistical is in the statute and you've plugged it in here, but I'm not really sure why it is relevant here.

DR. MAKHIJA: Commissioner, I will be happy to address that. There are some moving parts here. First of all, I'm not unique in having applied it in this particular matter, but I am supportive of this approach. The null hypothesis, if I were to get technical, would have been that the mean rate of return of the peer group is indeed the rate of return that this firm could have earned. So the null hypothesis is what we saw from the firm is not statistically significantly different from the mean of the peer. So that would be the null.

And of, course, the alternative hypothesis would be that it is significantly different, which is what the SEET is asking us to check. So in that sense if you think of the distribution, you know, and you take the peer sitting in the middle of that distribution, then you have your EDU from the firm and you are asking whether it has gone beyond that threshold in that distribution.

So in that sense I think it turns out, whether it was intended or not, in effect the SEET has been a perfect fit for the normal statistical test.

COMMISSIONER CENTOLELLA: Okay. Let me raise my other concern then. This is more of a -- it's seems to me that what you're doing here is you are now comparing the return of the utility to the returns of the population as multiple returns here. Am I correct?

DR. MAKHIJA: In this particular case, of course, what we have is a sample of the peer group, yes.

COMMISSIONER CENTOLELLA: But you're comparing it to the whole population or a whole sample of returns, many returns. And I am going to take off my economist hat and put on my lawyer hat, and I get a little nervous, I guess, reading the statute where it suggests that excessive earnings are measured by whether the return on common equity is significantly in excess of the return on common equity faced by the other firms.

One might read that to say that the plain meaning of the statute, the plain words of the statute is that the comparison is to be with a single number and not a sample of numbers from different companies.

And I wonder whether or not if we adopt the statistical approach we are vulnerable to an appeal to the court that we have violated the plain meaning of the statute by comparing to a sample as opposed to comparing to a single mean or single number.

MR. CONWAY: Before you interject, because Commissioner Centolella has put on his lawyer's hat for moment, although I think you are kind of going back and forth here, I think that the interpretation of that verbiage as referring to the mean return of the comparable risk group is a reasonable interpretation and would be defensible to the Ohio Supreme Court.

COMMISSIONER CENTOLELLA: If we then say if that's the case, don't we have to say that the statute is really not referring then to the population? When you make the statistical comparison, you are really asking us to compare the single EDU to the sample of companies, and if I read the statute, the statute seems to say I have to take that sample of companies and I have to narrow that down to a number, which is the -- not the group of but "the" -- return on common equity of the comparable companies.

And you're asking me to go beyond what the statute tells me to do, and I'm wondering if this Commission gets in trouble because the consumer groups will come up and say, Well, you compared it to this whole sample and not to the mean, and that goes beyond what the statute tells you to do.

MR. KORKOSZ: Commissioner Centolella, I only have a lawyer's hat, so let me make a couple observations. Literally I'm not sure to say a return on common equity of publicly traded companies, I'm not sure that it makes sense to say that the plural, publicly traded companies, have a singular return, so I think there's some interpretive latitude granted there.

The other observation I make is we certainly have a long history in traditional ratemaking of using, in the setting of allowed fair rate of return in the ratemaking context, of looking at a peer group of companies and coming up with a proxy single representative return for them. I think there is a fair opportunity for recognition by the Legislature to recognize that this practice of taking a mean is a tool commonly used.

COMMISSIONER CENTOLELLA: I don't have a

concern about taking a mean. I have a concern of then looking at the variance in defining excess.

MR. KURTZ: All of witnesses -- and I agree with Mr. Korkosz, i don't think that's an infirmity in the statute. All the experts took the sample group and worked from that, so I think that would not be an issue.

But I would say this about the comparable earnings test that's in Senate Bill 221. It really builds upon US Supreme Court precedents, the Hope and the Bluefield cases, which really say that a utility, a regulated utility, is entitled to earn a return that is comparable, not more, but comparable to financial companies -- and we quoted this in our comments pages 5 and 6 -- that is comparable to private sector businesses that have comparable risk. That's essentially the Hope and Bluefield decision. And every rate of return witness in every utility case in the United States in the last 50 years always cite the Bluefield and Hope case as starting point.

Now what 221 did, it said not only do the Ohio utilities get a comparable rate of return, they get more. They get more than the peer group, just not significantly more. So that makes them more profitable. That's why the utilities here will be more profitable than any of the regulated utilities throughout the country, will make Columbus Southern the most profitable utility that AEP owns, but just not significantly more. And that's the balance and that's the basis of the statute.

And in Hope and Bluefield the traditional test, there is no statistical test. It is the Commission using its judgment and discretion, given the circumstances of the time, to award the rates of return, and that's what we think is the better policy, consistent law.

And certainly you were appointed by various governors to balance the interests of utilities and ratepayers, and that's what we ask you to do, not turn that over to, as Mr. Caahan said, a computer to spit out the numbers.

COMMISSIONER CENTOLELLA: If I can just follow up, can those of you -- and maybe you agree with that --

MR. CONWAY: I disagree vehemently with that, not just the conclusion but the premise. It is completely off base.

COMMISSIONER CENTOLELLA: What you would point us to in the statute to suggest that the Legislature wasn't simply attempting to define the outer bounds of what was considered to be fair value in terms of this whole line of cases, which the Legislature heard testimony about, in terms of what is fair value, and is there something specific in the statute that suggests that the Legislature wanted to depart from this whole history that they had heard presented to them, and particularly given there is some language in these statutes that is a lot like some of the language that is in the Hope case, for example?

COMMISSIONER SCHRIBER: And Hope and Bluefield is one reason I never went to law school.

MR. CONWAY: The test in the statute is not a reiteration of the comparable earnings test that is rooted in Hope and Bluefield, and the purpose of it is completely different. It's not -- we're not setting a just and reasonable rate of return on a prospective basis for a utility under a cost of service, rate-based rate of return approach.

What we are doing is trying to figure out whether the EDU is earning significantly in excess of the returns that other publicly traded companies earn that face comparable risk. It's not the standard that Mr. Kurtz has been specifying and has advanced in prior filings before the Commission, just has no relationship. The Hope and Bluefield test have no relationship to the SEET that's contained in SB 221.

COMMISSIONER CENTOLELLA: But Hope does speak to a return that compensates the utility for the risk that's assumed. There are certainly references in Hope and Bluefield to the ability to attract capital, which is very similar to the committed capital requirement piece we talked about earlier. There certainly are echos of those decisions in some of the language here. And so I guess I'm wondering why we shouldn't have those as at least some level of touchstone for what we think about this.

MR. KORKOSZ: There is a commonality to certain of the concepts, and certainly they speak in terms of kind of the financial language that is common. But let's not lose sight of what the purpose was for the Hope and Bluefield cases when they initially came into being. This was in a traditional ratemaking setting for cost-based rate of return regulation where we would be looking at a representative test year for a utility and attempting to assess its costs, which would be a representative level of costs during the course of its test year, and one of those costs would be its cost of capital or, specifically, its cost of equity.

And the difficulty or the exercise was attempting to ascertain what that cost of equity would be. It's not something you can measure directly. So we created the profession of rate of return witness and ultimately went into some landmark cases, the Hope and Bluefield cases, which use the concepts of risk, the investors' perception of risk and the like, to help establish what the cost of capital is in that ratemaking context.

And as I mentioned before, it's looking at market measures from an investor's perspective. It does not rely on book measures of the company. It's not retrospective in that sense, accounting versus market, retrospective versus prospective. Those are distinctions that I think distinguish it from the mechanics of SEET.

But more importantly, and again I commend you to Dr. Vilbert's testimony, which is vastly more coherent and articulate than what I'm telling, but the idea is that the SEET was a tool provided by the Legislature to assure that upper bounds would not be exceeded. It is not the same exercise, although you might look at certain of the same types of things, comparable groups, and assessment of risk and the like, to perform those exercises.

COMMISSIONER SCHRIBER: I think we've euthanized the source. Valerie has some questions.

COMMISSIONER LEMMIE: This is a very important issue for me and certainly my colleagues on the Commission, hence our presence here today. And I have read everything that was filed in the docket, and we, as a collective, have some questions for you. It seems like we are beginning to wind down a bit, and I would just ask if any of you have a final point or area of discussion you would like to share that might help us in sorting through the characterizations that have been made here today and understand the issues so that we can make the best decision possible.

DR. MAKHIJA: If I may just go back to the question of Commissioner Centolella, I was thinking about the heart of the question you were asking. Essentially you have a peer group, why isn't the mean enough? And it strikes me you could have two different peer groups with exactly the same mean but differing variation. Now, you would really be compelled to think whether the EDU is necessarily the same for the two groups. You have to take the variation into account, and that's precisely what the test does by laying out the limit to which the variation is acceptable before the return is significant.

COMMISSIONER SCHRIBER: Anything else?

MR. BOYLE: Going back and responding to what you were just asked about, I think in general there's a desire to try and find some simplistic way of dealing with SEET, kind of searching for that. It seems like we had the workshop and a lot of exchanges and comments, which points out how difficult it is to deal with the various issues and opinions.

All of that lends to while it is desirable to find a more straightforward way, say, to deal with deferrals or whatever the issue may be, that, in fact, at end I think we come back we need to deal with it on a case-by-case basis within SEET proceedings.

And that may not be something that is desirable because that will end up with a fair amount of debates and exchanges, almost similar to a rate case, and we don't want to go down that path entirely. But given all the nuances within each company, I don't know how we avoid needing to look at all these various issues on a case-by-case basis.

COMMISSIONER SCHRIBER: Thank you.

COMMISSIONER LEMMIE: Is there something you can give us? I am really trying to find your last word.

COMMISSIONER SCHRIBER: Paul has a word before the last word.

COMMISSIONER LEMMIE: Let me finish here. The point of my question, is there something else you feel is important for deliberations that you want to say at this point in time?

MR. KURTZ: I would like to add this. I think the Commission should view this earnings issue in the context of Senate Bill 221 as a whole, read the earnings test in the context of what the Legislature did in this fundamental piece of legislation, 221.

What was really accomplished in 221 was to give the Commission explicit authority to do what the Chairman spearheaded in the RSP cases back in the '06 to '08 time frame. That's the first thing this legislation does. It takes away -- the rates for nonshopping customers is no longer a market-based rate; it is Commission-determined rate. That's explicit authority for what the RSPs essentially did.

But what the legislation also did is it reregulated earnings. Net income is total revenue minus total expenses, and that is what the is SEET is about, it's putting context. We think that is a fundamental consumer safeguard of the legislation, and we think that our position is a fair balance between the legitimate interests of the utilities being very profitable, just not too profitable, and the consumers paying reasonable rates, which is the policy of the state.

MR. CONWAY: This is not really a wrap-up, Commissioner Lemmie, but it does touch on a question that was raised but I don't think we have spent any time answering, which is the last question, which is, can you add an efficiency mechanism to the SEET test basically?

And I think that the answer is that that EDU and the Commission can establish efficiency incentives and standards through the design of specific provisions in an ESP. For example, the FAC itself under the statute involves a prudency review periodically. That is one example.

Another example of a measure that can be incorporated into an ESP would be as part of a distribution infrastructure modernization plan possibly. And, of course, the Commission outside of the ESP does have a variety of tools in its administrative rule toolbox that it can use to oversee and promote the safe and reliable provision of service, which is an element of efficiency, I think, and I am specifically thinking about the did S rules in that regard.

And then I would also just mention to you that with regard to efficiency, the EDU shareholders do have an interest that I think aligns with the customers' interest. The management of the EDU is interested in having an efficiently run operation, just as customers are interested in that result.

Having said all that, I don't think that the SEET itself contemplates or would permit grafting an additional efficiency or inefficiency disincentive -- and efficiency incentive or inefficiency disincentive or efficiency incentive kind of mechanism into the SEET process itself.

MR. RINEBOLT: Commissioners, I would argue that consumers are actually completely ambivalent about the efficiency of the utility. Under this new regulatory paradigm, that's how they make a profit. That's one element of their profit. Unless the value of that efficiency is passed back to a customer through cost-based rates, it's irrelevant to what I pay in the bill.

So there's no alignment of customer and utility interests in those cases. What we are actually looking at here is a regulatory paradigm that has defined just and reasonable rates as rates that are not significantly excessive.

And the flip side of that is that the utilities have a variety of options through noncost-based rate increases and cost-based rate increases, both of which are features of all of the plans that the Commission has approved, to ensure that they collect adequate revenue and a decent profit. We just don't want to, nor does the Legislature, want them to collect an obscene profit.

MS. GRADY: If I can add a response to Mr. Conway's comment, on behalf of the customer parties we would emphasize we don't believe it's necessary to create regulatory incentives for efficient operation for the utilities. This would imply that the PUCO should offer these incentives when the utilities already have much and many benefits, as we referred to earlier, a gold mine of considerable benefits under SB 221; not necessary, not needed, and not statutorily addressed.

COMMISSIONER SCHRIBER: Thank you all for helping us muddle through the proceeding. That's good stuff. It is interesting stuff. I hope we will use the gold mine of tools to come to something that is just and reasonable.

So thank you all. We are off the record.

(The meeting concluded at 11:51 a.m.)

\- - -

CERTIFICATE

I do hereby certify that the foregoing is a true and correct transcript of the proceedings taken by me in this matter on Thursday, March 1, 2010, and carefully compared with my original stenographic notes.

Rosemary Foster Anderson,
Professional Reporter and
Notary Public in and for
the State of Ohio.

My Commission expires April 5, 2014.

(RFA-8420)

- - -